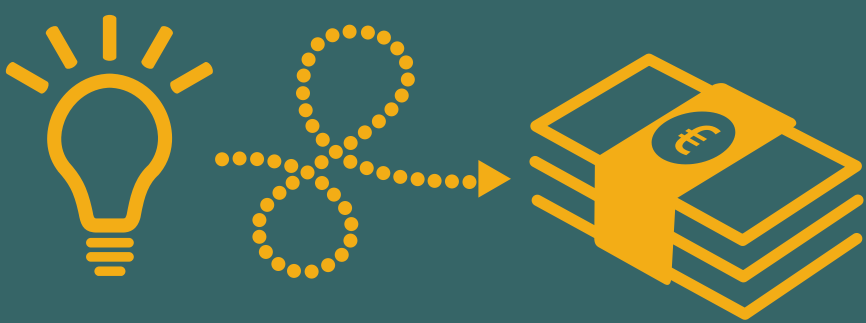
Nicolaj Højer Nielsen

# STARTUP FUNDING



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# Preface

This book is written for entrepreneurs who are wondering how they can get the necessary funding for their startup.

Maybe you're having a hard time finding investors, or you're planning to start a business but have no idea where to look for investment. I'm eager to help entrepreneurs get funding, bring their great business ideas to life, and scale them.

I know how entrepreneurs like you think. And how investors think. I've been in your entrepreneurial shoes, as I've been involved in startups for almost 20 years – both as a founder *and* as an investor, meaning I've seen it from both sides. I want to help you avoid the mistakes I made – and I've made them all. I've looked for funding in the wrong places, and counted the money before we had it. So I know how it feels to be you, as an entrepreneur with dreams and a great idea. I also know how it feels to be approached by you, as an investor, and that unless you send investors like me the right material, at the right time, with your great idea de-risked and bootstrapped, we won't fund you.

# About Nicolaj Højer Nielsen

Nicolaj Højer Nielsen is a serial entrepreneur and business angel who has been building startups since 1999. He focuses on high potential startups, and has co-founded and invested in 13 companies, primarily within IT.

He has experience of securing funding from all possible sources – friends and family, business angels, venture capital funds and public funds. His experience is based on reviewing thousands of different investment opportunities and he knows the fundraising process from both sides of the table.

His latest venture is Copenhagen United, an investment fund focusing on providing capital and mentoring for early-stage software companies.

Nicolaj dedicates a significant part of his time to help other startups. He lectures on entrepreneurship at Copenhagen Business School, and also coaches entrepreneurs. Nicolaj also holds an MBA from INSEAD.

# Introduction

There are often stories in the media about entrepreneurs and startups that went on to become very successful *after* having been turned down by banks and investors. Those stories and the stories entrepreneurs tell me about banks and investors all point to the same things: banks behave like banks and investors behave like investors. Most entrepreneurs don't realise this and seek funding in the wrong places and at the wrong time, mainly because they don't understand how investors and banks think!

Knowing who you are dealing with is key to a successful deal. This is also true when you're making a deal with a bank or an investor!

To know someone is to know how they think, and knowing how people think involves learning about what drives their decisions. Most entrepreneurs think in terms of ideas because the idea they have for a startup project drives and energises them. Their idea is the projection of their vision; it's like a pair of glasses through which they view the world.

> *"By reading this book you will learn how investors think. Thinking like an investor will make you a more successful entrepreneur!"*

The majority of investors *don't* think in terms of ideas. Actually, most investors believe that the value of a business idea is very limited – it is the actions after the initial idea is created that generate value. Investors and banks think in terms of risk and return on investment. They accept and operate with different levels of risk. To a bank or an investor, an idea is nothing but a risk, and that's exactly why many entrepreneurs can't get funding for their business idea.

An idea (no matter how good it may seem) is 100% risk. Of course, both banks and investors will say no to funding your idea. They have to.

There's a lot of talk about the funding gap facing early-stage startups, but this is mainly caused by the thought gap that exists between funders and entrepreneurs – the gap most startups fall into.

If entrepreneurs better understood how banks and investors think, they would realise the futility of pitching a project to them in its early stages. And when the time came to actually pitch, they would be better prepared and have a much better chance of securing funding.

This book is about building understanding and preparing entrepreneurs for pitching their project to investors. It's also about what entrepreneurs need to do in order to develop and de-risk their startup project enough for it to become attractive to professional investors.

Chapter 1:

# Do you really need external funding?

*The if, when, and where to look for funding is dependent on the type of startup you're creating. You will learn to identify the characteristics of each type of company and understand the implications for your funding strategy. Broadly speaking, there are three different startup scenarios.*

## Type 1: You don't need external funding!

Some companies don't need external funding. They have limited funding needs, typically because the product can be launched and generate revenue quickly. Match that with limited sales and marketing costs, and you can end up in the perfect situation of not needing external funding for your startup.

For example, if you decided to start a consulting company, your initial startup needs are limited: a computer, an office space and an internet connection and you're up and running. You hope for customers from day one, but even in the worst-case scenario, where it takes you a few months to get your first customers, your needs should be covered by your savings.

If that's you, great! You don't need to worry about how to get your company funded and can focus your energy on running and growing your business!

### Case study: Casper Blom – how to start a business at 12 years old with no funding

My granddad was visiting us one day when I was around 12 years old. He noticed I was interested in and had a flair for buying/selling cheap stuff, and asked if I could get him some cheap golf balls. I had no clue about golf balls, but said I'd give it a try!

I did some market research. Pretty fast I realised the margins on new golf balls were very bad, and I needed cash if I was going to build up a stock of imported golf balls. I had to look for another approach. I then came across the US phenomenon of *lake balls* – golf balls that have been shot into lakes by mistake and then fished up and sold as used. This sounded interesting, so I started researching the Danish market. There were a few vendors, but no large ones. All the companies were driven as part time shops, and had web pages that I thought I could do much better. I emptied my piggy bank (€40) and thought this was enough for me to get some second-hand golf balls to resell. I then called a lot of golf clubs and made a deal with one that allowed me to pick up the lake balls for free. At the same time I made an agreement with a scuba diver who would get the balls out of the lake for me for €0.15 a ball.

I then sold the golf balls to my granddad for €0.30 a ball. That gave me a nice profit of €0.15 a ball (VAT, income tax etc. wasn't included in my calculations). I then started selling the lake balls to other golf players and it started to look more and more like a real but small company.

Then in 2007, when I was 15, I decided to take my business online and bought an internet domain (www.billigegolfbolde.dk). Initially, it was just a very simple site with a contact form where you could order golf balls. Later I got external developers to make a professional web shop for me, and to this day the business is running on the same web shop. Fast forward to 2014, where the online shop is the largest vendor of golf balls in Denmark. It's expanded with other products for golfers, but its core business and revenue is still made up of used golf balls.

My advice to aspiring entrepreneurs looking at business ideas that can be realised without huge sums of funding is that they should start doing it now! Start building your business without looking for external investors and fancy business plans. Many potential entrepreneurs make starting a business overly complicated. Often you can do it relatively simply and quickly from your own funds. Later, when your business is up and running, you might want to expand and can then look for investors.

## Type 2: You need funding to get the startup off the ground

Let's say you have an idea that will take you three or four years to develop into a real product. In a perfect world, your customers would pay up front, but in this not-so-perfect world you'll need financing. In other words, without external funding you won't have a company.

This kind of company can be exemplified by a group of university students starting up in the university laboratory with an idea for a biotech company that produces a new type of medicine that can cure cancer. The lab isn't that expensive for them as they have the resources they need. At some point, however, they have to go all-in and test the drug and dedicate more resources to research and development. To put it into perspective, the total costs could easily add up to several hounded million euros before the drug is on the market.

This is the case for most research and development intensive projects. Of course, if you are a biotech company you might be able to sign a licensing agreement with a potential buyer a few years into development so you don't have to fund the hundred million euros yourself. You only have to fund a few million euros. Of course, that's still a lot to most people!

So for some companies funding is the only option. Either you get funding for your startup, or there will be no company. The question to ask is when and from which sources to secure the cash needed to build your company.

## Case study: MotilityCount – getting funding for a sperm quality home test

In 2009 two experienced researchers, Jacob Mollenbach and Steen Laursen, from the human fertility field came up with a new concept: They wanted to make a home test for sperm quality so men could get an answer about potential infertility problems in the comfort of their own home, without having to visit a fertility clinic. They did some experiments with a prototype that showed promising results, and in 2010 invited Nicolaj Højer Nielsen to join the company to strengthen the team on the commercial side. They also prepared and sent in the first patent application to protect their concept from future imitators. Nicolaj Højer Nielsen explains:

The main obstacle to proceeding was money. The estimated cost of finalising development, testing prototypes, starting production and regulatory work was around €1.5 million - much more than three struggling entrepreneurs had in their own pockets. Getting external funding was the only viable option if we were to proceed.

We quickly decided NOT to try to raise the entire amount from day one. Instead, we aimed to raise the first €500,000, which would be sufficient to finalise development and generate enough data to show our device actually worked. After months of meetings, in 2011 we convinced a public support fund and four friends to invest in the company. Then followed two years of trial and error (with over 50 different 3D-printed prototypes) until we finally had a device that was as accurate and easy to use as we wanted. In 2013 with this data, we raised the €1 million needed from local business angels, our manufacturing partner, and a public support fund to get the device manufactured and regulatory approval for sale.

Fast forward to the end of 2016. The product, under the name SwimCount, is now sold online (www.swimcount.com) and at pharmacies worldwide in collaboration with lo-


cal distributors. But this brings a new dilemma: should the company raise more money (for sales/marketing spending) to try to grow the business faster, or should it grow more slowly based on the cash flow generated by the business? As a company MotilityCount therefore went from a *Type 2: Without funding there is no company* to a *Type 3: Without funding there's no growth*.

## Type 3: Without funding there's no growth

The third subgroup of startups is, in theory, able to fund the startup themselves but might consider getting external funding to drive further growth.

One example is a startup where the upfront development cost is relatively low, for example, developing a simple, consumer-oriented smartphone app with a development cost of €25,000 or so to cover code and getting it into app stores.

The revenue model for most consumer apps is that the basic app is low priced or completely free. To succeed you need lots of downloads and a premium version for converting some of the downloads into paying users – which is also what your competitors are looking to do. As an app developer you have two choices: either you continue small scale using word of mouth, social media marketing and funding it all yourself, or you go big. Let's say you've invented a brilliant app, everything is going well and you've gained loads of local PR and users. However, before you know it the market is flooded with competing apps looking to steal your market position.

One option is to take funding to scale your business, develop a better version and storm the market. If you go it alone with no external funding and slow growth rates, your market position may be overtaken by aggressive, well-funded competitors.

For this type of startup, the question is not therefore whether you can manage the startup without funding, but if you can get necessary customer growth without such funding. And if you don't accept funding, will you be able to survive in the long term?

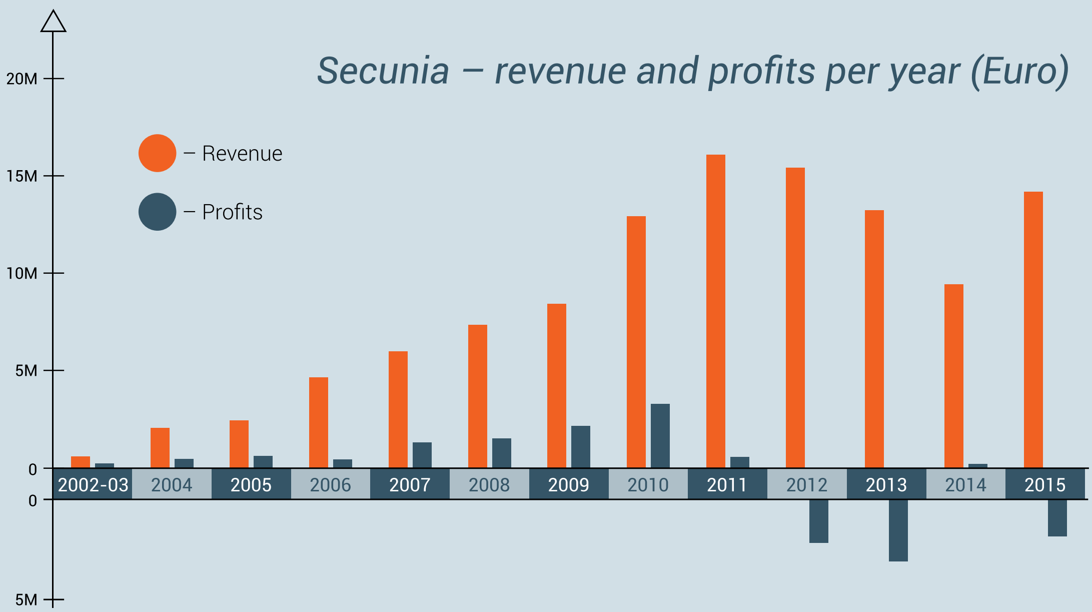
 

## Case study: Secunia – decided not to take growth capital

Deciding whether to take in capital to further grow your business is not an easy choice as explained in the case of Secunia below:

In 2002, serial entrepreneur Niels Henrik Rasmussen decided to create an IT-security company with four business partners. They wanted to develop a product that could help companies prevent exploitation of software vulnerabilities. Niels Henrik Rasmussen explains:

From our inception in 2002 we were focused on building a great business despite all odds, being bootstrapped and having competitors that had raised over US $10 million. We started off with just $26,000 and a salary pay slip of zero for the first 18 months. Back then IT-security business valuations were low after the IT bubble burst. So we wanted to build a better business case through a strong and healthy business discipline, and we focused on agile development of our services and gaining market traction. We cultivated this over the years, having strong growth year after year in our revenues and earnings.



In 2004, and again in 2005, we discussed bringing in external investors to provide growth capital in the €2-3 million range, but decided to pursue the upcoming challenges on our own terms and grow organically with our own funds. Again, over the following years we were approached and offered growth capital. Same answer – we believed we could go further and faster on our own. Over the years our organisation grew to more than 140 employees of 21 different nationalities at our peak. As we progressed towards 2010, several exit opportunities presented to us. However, we didn't want to pursue them as our business was doing great and we were having fun developing the organisation. Instead of selling our company completely, we decided to accept an offer from a capital fund where we initially sold 30% of the shares in 2010 and later sold our remaining shares in 2013.

Should we have taken investors in early instead of growing the company organically? This is a hard question. At that time we didn't want to, not only due to dilution (less ownership), but also because we would then have lost control of the business.

## Take-away points

Do you really need funding to get the business off the ground? Many companies actually don't, and if you're in that lucky situation, you should focus on building your business and not pitching to investors!

Some startups do need funding since their upfront costs are so high it may be unrealistic to finance it with your own money. Others need funding to grow the company.

In the following chapters we look at the different types of investors, which startups they might be interested in, at which stages they invest, and how to convince them to fund your company. But first let's look at how investors evaluate startups in terms of risk and reward.

Chapter 2:

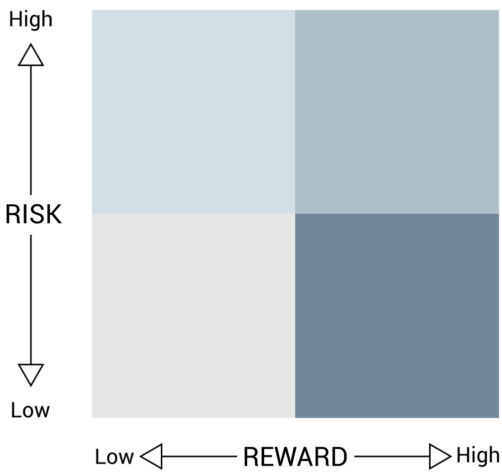
# Your startup's risk/reward profile

*To maximise the chances of your fundraising process being successful, you need to understand how investors and other funding sources like banks think, and thereby avoid the understanding gap that too many startups fall into when searching for funding. This includes learning how they think in terms of the risk/reward profile of the investment opportunity you present to them.*

# The investor matrix

Startups can have very different risk profiles and also different levels of potential reward if they're successful. From a potential investment case perspective, and in investors' eyes, this makes them very different from each other.

The risk/reward profile of your startup is best illustrated using the investor matrix model; a simple 2x2 diagram as shown below. Risk is on one axis and reward on the other. Any company can be placed on the matrix, showing high or low return and high or low risk. It's a simple tool investors indirectly use when evaluating investment opportunities.




Let's look at two cases which illustrate this difference – one with low risk/low reward and another with high risk/high reward:

**Low risk/low reward:** Local e-commerce website. An entrepreneur with a simple e-commerce website would be perceived as low risk/low reward. Why? Because it's really hard to convince anyone you will be the next Amazon. Consumers will compare prices across different online retailers, and this normally results in relatively low margins, a limited market size for simple e-commerce sites, and low rewards for the investor. The risk is relatively low because you aren't inventing a new product or putting a million euros into research and development. You're just distributing a product from another manufacturer which carries relatively little risk.

Another example is Casper Blom's used golf balls website mentioned earlier. It's hardly the next billion euro company, but since he's already proved there's a market for his product and he can sell it at a profit, the perceived risk is also low.

**High risk/high reward:** Biotech company. At the opposite end of the continuum we find the biotech archetype startup. Perhaps this is two researchers coming out of university with initial research for the cure for malaria. If they succeed in developing a vaccine, they will have a drug that sells for billions of euros and a company worth a multiplier of those billions of euros. A high reward product. But the risk? The chance that anything invented in a lab will become a marketable drug is very small. Typically, the chance of commercial success is less than one per cent. Investors know this and know that it will cost millions of euros in development. It's a classic high risk/high reward product.

Your risk/reward profile determines what type of investor will invest and when. Some investors are looking for the next Google/Facebook with an enormous financial return (which most often also comes with a high risk), while others aren't willing to take the same amount of risk but are OK with a lower financial upside. Many founders make the serious mistake of thinking that all investors are looking for high return/high risk startups. But there are just as many financing options available for low risk/low reward startups.

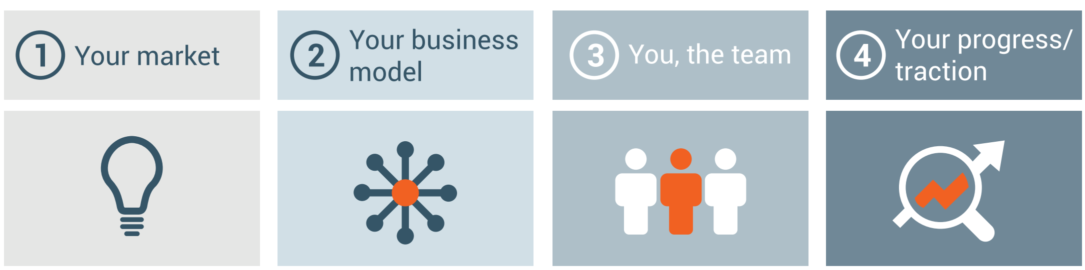
**Key note: Which risk/reward are you offering?**

A low financial opportunity doesn't mean you won't find any investors – but the type of investor interested in your startup is most likely very different from an investor looking to invest in the next Facebook. Your first job is to understand which case you have on your hands and which type of investor you need to approach and when.

Next we will investigate further what determines the risk/reward profile of your startup so you will have a better understanding of how an investor will evaluate it.

## The factors that determine your risk/reward profile

The risk/reward profile of your startup is determined by four key factors:



## 1. Your market

The industry you're in and the product you will make are key to determining your project's risk/reward profile. Some industries have a higher risk of failure than others, but hopefully also a higher financial outcome if you succeed. Different industries therefore attract different types of investors!

### *Examples of markets perceived high risk versus low risk by most investors:*

| LOW RISK | HIGH RISK |
|---|---|
| Import/export business | Pharmaceuticals/biotech |
| E-commerce websites | Consumer apps/software |
| Consulting/professional services | Consumer electronics/hardware |
| Physical retail shops | Most technology-based university inventions |

A misunderstanding among many founders is that the risk/reward profile is ONLY impacted by the industry you're competing in and the product you offer. This isn't the case. Your business model, who you are, and the progress/traction your startup has achieved impact the perceived risk/reward from the investor's point of view.

## 2. Your business model

You can develop different business models that significantly affect the risk/reward levels to better suit your own appetite for risk versus reward, as well as use different business models to attract different types of investors.

**Example 1: Software startup**

| MARKET | LOW RISK/LOW REWARD | HIGH RISK/HIGH REWARD |
|---|---|---|
| SOFTWARE | Consulting (selling hours) | Product (making/selling software) |
| BIOTECH | Consulting, joint venture, early-stage licensing | Developing own intellectual property/ patents, developing pharmaceuticals, doing clinical trials |

Imagine a group of software engineers working at a big consulting company. One day they might think: *Hey, why are we only getting a low salary compared to the high prices our employer is charging for our services to corporate clients? We can do this ourselves! We have contact with companies wanting to buy our services! Let's start our own small consulting company!*

This is a classic low reward/low risk business model. Most likely the engineers will actually make a higher salary at their new company with limited risk. The biggest risk is that they don't get the expected number of clients (especially at the beginning), but after they've built their network and reputation there will be limited risk. The business model doesn't involve putting money in any physical stock or any upfront development work. The customers will pay by the hour or per project, and this of course involves some risk of customers not paying their bills. But compared with most other business models the risk is limited – and so is the financial, long-term reward. The company's income is directly linked to the number of hours it invoices (no passive income), and in most cases the selling price for such companies (unless they become very big) is also relatively low. So investors will perceive such companies as low risk/low reward and they will therefore appeal to a specific type of investor. The funding need of such a company is also limited, so there's a good chance they don't need external investors.

But imagine the same group of software engineers starting a very different type of business in the same industry: *Why don't we start a company that builds a piece of standard software for industry X, which we will sell at a monthly subscription per customer instead of us having to build customised software solutions for each customer? We can sell the software to many customers, which means much less work involved since we are selling the same piece of plug-n-play software to each customer*. This is a very different company. Most likely they will have to put in months or years of development work before they get their first customer. And it's likely they will need more funding before they have enough customers to pay their bills. In other words – high risk. But it also gives the company a higher potential reward because, if it's successful, the company owning the rights to this popular piece of software could be worth much more than the same group of engineers selling their services on a per-hour basis.

### Example 2: Biotech startup

A biotech startup is by definition very high risk and high reward. If you follow the traditional business model of raising venture capital to develop and test your own pharmaceutical compounds (because the chance of ending up with an approved and commercially successful drug is less than one per cent), the cost of up to one billion euros for doing so must be offset by an opportunity for creating a company worth billions of euros.

This is a high risk/high reward opportunity, but there are other opportunities. You can use alternative business models that will both change the risk/reward profile of your startup and the amount of funding needed to realise your startup project.

Such an alternative business model could be where researchers team up with existing pharma/biotech companies instead of building a new company from scratch. This model could take many forms – from selling patents to the other company, to selling hours/consulting, to joint ventures. This will most likely result in the opportunity (reward) getting smaller (you no longer have the opportunity to create a billion euro company), and it will also significantly reduce the risk both for you as entrepreneur and for potential investors. Therefore, these alternative business models not only impact the risk/reward profile and the amount of funding needed but also determine who would be the most appropriate investor.

**Key note: Which business model is best for you – the high or low risk model?**

The key factor in determining this is YOU. And when you have decided which kind of company (and business model) you dream of making, you will also know the perceived risk/reward profile of the business, and therefore which fundraising sources are most relevant to you.

## 3. You and your team

Who you are has a huge impact not only on the perceived risk but also the perceived upside (reward) in the mind of the investor.

Let's take one example. Assume that you pitch your mobile game project to an investor. Most likely the investor will think 'ultra-high risk' since statistics show that only a very small fraction of mobile games launched in app stores ever become profitable.

But then imagine your first slide in the pitch deck is about your team where you have people, on both the commercial and technical side, who have successfully launched mobile games before. This totally changes the perceived risk and reward!

### Case study: Mofibo – why the CEO was the only reason the venture capital (VC) fund invested

In 2010 the entrepreneur Morten Strunge was on the lookout for venture funding for his next project. He had previously started and exited a very successful mobile telecom company but now wanted to enter the e-book market with his new company, Mofibo. He ended up in talks with the Danish, early-stage, venture capital fund SEED Capital, where Jakob Ekkelund was working as investment manager.

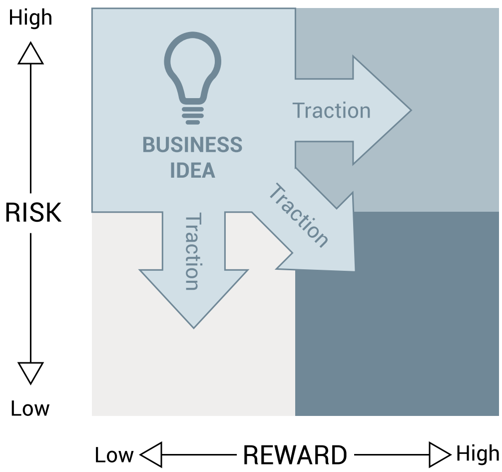
Jakob Ekkelund explains why he decided to invest in Mofibo:

When we decided to invest in Mofibo it was actually despite a lot of things: I didn't really like the business model, the product wasn't launched and there was no validation of customer interest other than gut feeling. On top of this, there were several potential issues with the cost side of the business since there were very high variable costs related to purchase of the books from publishers. So why did we end up investing in Mofibo? The answer is very simple – the founder and CEO of the company was the well-known local entrepreneur Morten Strunge. I had followed Morten and was very impressed by the way he had run (and exited) his previous company, a mobile phone company. I guessed that Morten, with his experience in building great teams and adjusting his business model according to market response, could do it again – despite all the questions related to the business. Without Morten as CEO I would one hundred percent never have invested in Mofibo.

*I totally understand, but knowing that investors prefer to work together with experienced entrepreneurs doesn't suddenly make me a successful serial entrepreneur.* Of course not, but even first-time entrepreneurs have to realise that absolutely the most important element in the investor's analysis of your business proposal is the quality of your team. So BEFORE approaching investors you have to gather as strong a team as possible because this has a huge impact on your ability to get funding.

## 4. Your progress/traction

The final element that determines the perceived risk/reward of your project is how far along you are in the process. The same project (market + business model + team) will change significantly as you go along!




Most projects are low reward/high risk when you're at the ideas stage! Statistics show that only a few startups make it all the way from an idea to a successful business.

Many things can go wrong in the process. Maybe you don't manage to get a great team. Maybe you aren't able to build a great product. And at that idea stage (with no customers), it's hard to argue that you will attract a lot of customers.

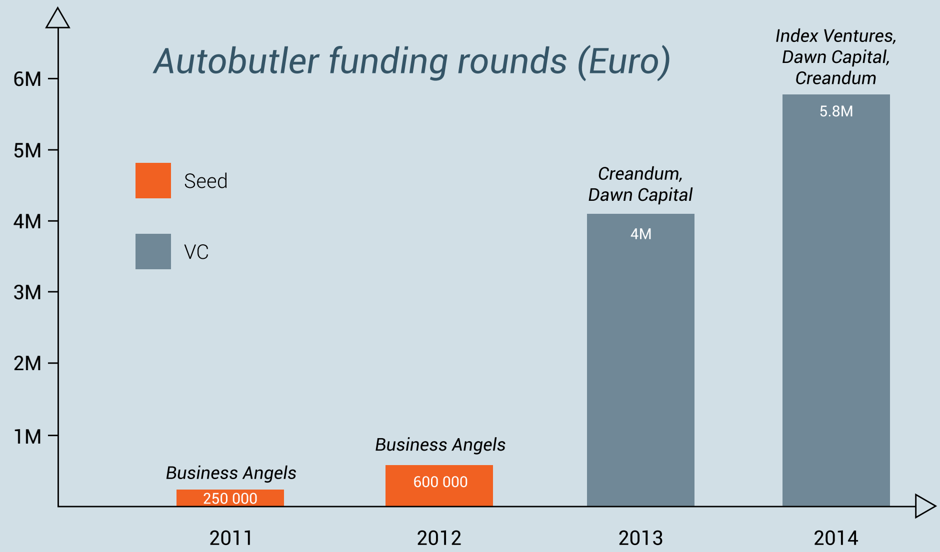
But progress (or 'traction' in popular startup jargon) changes all this! Imagine the above idea for a mobile app game. Maybe they didn't get investors at the ideas stage because the investors didn't believe they were able to pull it off. But maybe they were able to develop and launch the game anyway. If done successfully, this progress/traction changes everything. Results from real products/users beats every type of forecast!

## Case study: Autobutler – the law of attraction for startup funding

Founded in Denmark in 2010, Autobutler is one of Europe's leading online marketplaces for auto repairs, offering car owners an easy way to get quotes from garages. It currently has a network of garages and customers in Denmark, Sweden, UK and Germany. Peter Michael Oxholm Zigler, co-founder of Autobutler, explains:

In the initial phases of Autobutler's entrepreneurial journey, we had a really hard time raising money. That said we weren't really trying to raise funds for the first six months. We did meet up with a few angels, angel networks and seed investment funds, but it turned out to be a waste of time. And they all turned us down. Why? Because we were inexperienced at building businesses and raising money and had nothing but an unproven idea. We basically had no product, no money, and no process to get there, so the risk was too high.

After some serious focus on building a simple product, we had some initial traction with a beta launch of our product in Denmark, and very solid media coverage through our own PR efforts. We were suddenly in a better position to talk to angels. A few angels started to show interest and we pursued them all. Some lost interest, but we managed to keep three interested and played them against each other. In other words, we slowly began to understand how to play the fundraising game.




It's the law of attraction. Once you become interesting, everybody wants to dance. On that note, we closed our first angel raise after approximately 16 months – and raised €235,000 in that round.

The traction in the market (growing number of users) we were able to create from our first angel investment suddenly made us more interesting to VCs, who started to open their doors. However, they were still a bit reluctant since we hadn't yet proved the (international) scalability. Again, we had to refocus on building the business so we opened up in the Swedish market and showed immediate traction and performance that was two or three times better than the Danish case.

This early adoption to the Swedish market completely turned the tables. All of a sudden we were perceived as a digital player, operating in a huge potential market space that had shown proof of concept and scalability. We were literally hunted down by national and international professional investors—the law of attraction again. We had the upper hand and could play hard to get – ultimately defining our own value to a certain extent.

That resulted in a Series A round with Creandum (VC fund) opening up the German market, followed by a Series B round with Index Ventures (another VC fund) scaling into the UK market. We were on a roll.

Eventually, PSA (the company that owns Peugeot and Citroën) saw the potential and the strategic fit with their corporate strategy, resulting in them acquiring the majority of the company in August 2016.

**Key note: You contact investors too early**

The main reason entrepreneurs are not able to attract investors is NOT because of ‘bad’ ideas but because they contact investors too early in the project when the perceived risk is much higher than the perceived reward.

## Take-away points

Investors evaluate startups according to perceived risk (high/low) and perceived reward (high/low), and they are diverse in what they're looking for. Not all are searching for the next Facebook (which almost always comes with high risk), and many are OK with a much lower potential upside if you can argue that the risk is also lower. Your startup's risk/reward level is not only related to the industry you're in but also your chosen business model and team, and the perceived risk/reward profile changes greatly as you progress with the project.

The main reason many entrepreneurs fail to raise funding is not due to ‘bad ideas’ but because they approach the wrong type of investors at the wrong point in time, before they achieved any ‘traction’ to show to the investors. Traction beats everything!

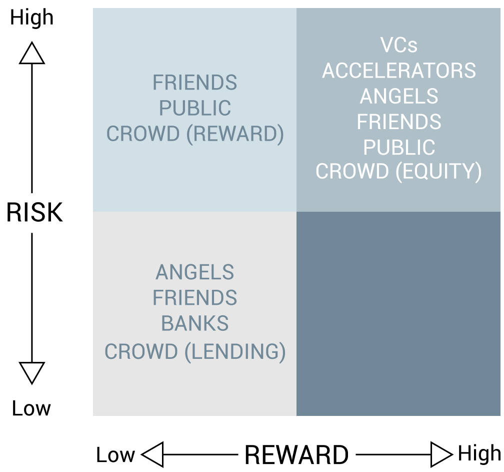
Chapter 3:

# Who invests in what and when

*Let's now go into more detail and analyse which type of investors are interested in different types of projects and at which phase they might be interested in your project.*

## What do investors look for?

In the investor matrix below, the different types of investors have been placed according to the risk/reward projects they are normally interested in. This is a simplification since each group of investors consists of many individuals, but it gives a good indication of their preferences.




**Venture capital.** Venture capital funds are looking to invest in companies that can be resold for hundreds of millions of euros within a few years. They are looking for extremely high rewards but are also willing to take high risks. Only a very small fraction of startups qualify for this kind of reward, and one of the biggest mistakes in the funding process for startups is to spend your time chasing venture capital funds when you clearly don't have an interesting proposal for them.

**Startup accelerators.** Startup accelerators are looking for startups that can become very big, and are essentially looking for the same types of deals as venture capital funds.

**Business angels.** Most business angels are also looking for something that can become 'big', but they're not as extreme as venture capitalist funds in their requirements for return, so you don't have to approach them with something that could be worth hundreds of millions. Even if your startup isn't the next big thing, business angels might be interested anyway. One of the biggest mistakes founders make when approaching business angels is to believe business angels are only driven by financial return. Money is only one reason why business angels invest in startups.

**Banks.** Unlike other funding sources, banks don't provide equity but instead they lend money to companies in return for interest. They don't therefore gain anything amazing if your company suddenly becomes massively successful. With only a very low reward potential (interest rate), they are only willing to take very low risks. Many startups make the mistake of chasing bank loans when their startup clearly has way too much risk to be interesting to banks.

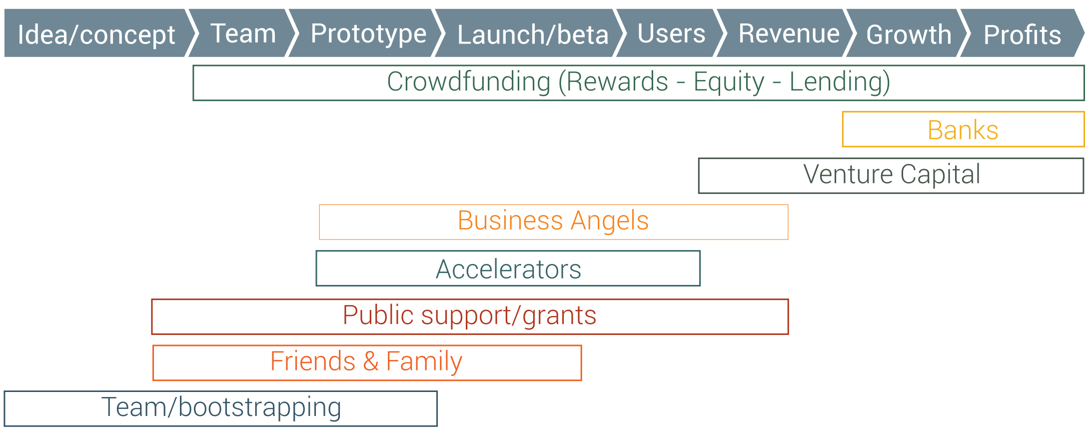
**Crowdfunding.** Crowdfunding attracts different investors depending on the crowdfunding model. With reward-based crowdfunding, individuals take a risk on unproven products because they feel some kind of affinity with the company; in exchange, they receive a discount or another non-financial reward. Equity crowdfunding attracts slightly higher investments in exchange for equity, with the risk of failure offset by potentially having shares in 'next big thing'. Crowdlending is a safer investment, where investors receive interest but play no part in the upside when a startup succeeds.

**Friends/family.** Friends and family don't really invest in your business – they invest in you. This also means they invest all over the place – even in projects that don't make sense from a financial point of view.

**Public support.** Many startup projects generate value for society, and governments all over the world want to provide financial support to startups in their various forms. A common mistake made by startups is to overlook this very important source of funding.

## When do investors invest?

The funding sources are not only different in regards to WHAT they invest in, but also WHEN they want to provide funding for your company.




**Crowdfunding.** Reward crowdfunders normally invest quickly and for personal reasons, which means they'll invest earlier than most professional investors. But they need something to get excited about, so at least a semi-functional prototype is usually required. Equity crowdfunding normally attracts higher investments in the hope of a large financial reward, so success is more likely after the first professional funding rounds, while crowdlending is later again. Crowdlending platforms normally won't even accept a campaign unless the company has a stable cashflow.

**Banks.** Startup founders should forget about banks in the initial phases. The risk is simply too high for banks to be interested until the company is early-stage positive. But some public support programmes exist that can de-risk the projects in a bank's mindset and thereby make a bank loan more accessible earlier in the process.

**Venture capital.** Venture capital funds are willing to take very high risks in their pursuit of very high financial rewards. Many startup founders believe that a willingness to take risks means venture capital funds invest mainly when the startup is at the idea stage. Nothing could be further from the truth. A venture capital fund normally invests when there are signs of commercial traction, meaning the company has launched its first product and generates a lot of users and/or revenue.

**Business angels.** Business angels invest earlier than venture capital funds. But even business angels ideally want some traction before they invest. This doesn't need to be real revenue, but ideally means the company has already gathered a talented team which has built the first beta product.

**Startup accelerators.** These are willing to go in early because they see their role as accelerating startups to a point where they can get further financing – typically from business angels or venture capital funds. But even accelerators want more than a business idea. As a minimum they want to invest in a talented team which already has built a prototype of the intended product.

**Public support programmes.** There are public support programmes even from the very early phases, but the majority of those work only on a co-financing basis. This means that the government only pays part of the costs and the startup needs to find supplementary funding from other sources.

**Friends and family.** All professional investors want some traction before they'll be interested in investing. So which initial investors will provide you with money before the professionals step in? In many cases, your friends and family!

**Key note: You don't need to raise all your money now!**

A common mistake among entrepreneurs is trying to raising ALL the money they need for their company – from the idea stage to the point where the company is profitable – on day one. This is almost always impossible since many investors, especially those with deeper pockets than you and your friends/family, won't invest until you've got more traction. So focus on raising enough for the next milestone which will attract different investors!

## Case study: Funding for The CloakRoom – different investors for different stages

The CloakRoom case illustrates that different types of investors are attracted to different development stages. The CloakRoom is a personal (online) shopping service that makes it easier for men to dress well

Co-founder Kasper Brandi Pedersen explains:

We initially got €20,000 from friends and then we started contacting business angels. The introductions we got through our network were to traditional tech investors, but they didn't like our labour-intensive and inventory-heavy concept, and therefore decided not to invest. The angel we eventually found, via LinkedIn, was a former entrepreneur from South Africa who had recently moved to Amsterdam.

He loved brainstorming with two hungry entrepreneurs. We asked him for advice several times, and at some point he proposed putting in €10,000.

When we were later about to accept a seed investment from a crappy fund, he thought it was a stupid move and decided to up his offer to €150,000. He turned out to be the greatest guy ever, extremely talented and helpful, always available, and always cutting through the bullshit. We learnt a lot from him and still do. Even though we are 250 people now, we still regularly ask for his advice.

| INVESTMENT TYPE | FRIENDS & FAMILY | BUSINESS ANGEL | VENTURE CAPITAL (seed round) | EXISTING INVESTORS (bridge round) | ACQUIRED BY COMPETITOR |
|---|---|---|---|---|---|
| INVESTMENT SIZE | €20k | €150k | €1.2m | €1.5m | Equity deal |
| COMPANY AGE | 0 years | 0.5 years | 1 year | 2 years | 2.5 years |

We only started seed fundraising when the traction was very clear. The business case was easy to understand; we had huge customer demand and were struggling to ship enough boxes from our little showroom. We needed €1m to scale the operations and that's what we raised. It was a clear investment case and the fundraising went pretty smoothly. We actually accepted the first term sheet we received from Connect Ventures who turned out to be a great partner.

After the seed round we got almost unlimited scalability because we partnered with an external warehouse and made deals with 50 brands. Our growth was explosive and we had a lot of interest from VCs across Europe, from which we hoped to raise the first real VC round (Series A). We must have met with 15 VCs in London alone, but in the end we didn't manage to close a deal.

The lack of a deal was caused by a sudden slowdown in growth. Our growth had doubled every quarter, and our marketing team made some very nice projections for how many customers they could get via Facebook for an acceptable customer acquisition cost (CAC). But suddenly the pool of leads dried up – we had simply reached everyone we could reach on Facebook too many times so that the number of new customers quickly went down.

When you're on a roll as an entrepreneur you tend to think that growth will continue forever as long as you keep pushing and hacking, but there's always a wall. However, investors aren't excited about startups that have had little or no growth for three months, no matter how rapid the past growth was. It's just too risky and there are plenty of startups with consecutive growth to choose from.

We had to make a choice between slowing down growth and trimming the organisation, or accepting a bridge round from existing investors at a lower valuation. Since my co-founder and I still had a combined equity stake of 70 per cent, we chose existing investors for the down round (a down round is startup jargon for a financing round where the share price is now lower than the previous investment round).

The bridge round gave us enough financial wiggle space to stabilise growth and improve unit economics, however that is not a sexy mission for aggressive young entrepreneurs. We had no ambition to be a local champion. We wanted to keep growing, which required substantial investments in inventory and supply chain optimisation. Therefore, we started talking to a range of old-school retailers and e-commerce competitors.

The best offer came from a German competitor, Modomoto, who had built their own fulfilment centre from scratch instead of outsourcing. No one else in our niche had done that. Combined with their superior tech stack, this made their unit economics the best in the business. To make it even better, they were only active in German speaking countries, whereas we were the market leader in Denmark, Sweden, the Netherlands and Belgium. The business case was clear: by combining the operational efficiency and profitability of Modomoto with the customer satisfaction and high order value of The Cloakroom, we would be positioned for market leadership in all our seven markets.

One month after we signed the papers I was living in Berlin working for the merged company. We integrated the two organisations on a technical level first, which turned out to be less painful than the cultural integration between the two offices. In January 2017, 12 months after the acquisition, we were able to run all functions from Berlin and it was time to close the Dutch office down. It was a beneficial financial decision, but a painful process. My co-founder and I decided to leave our positions and we now are financially safe because we hold equity in a big German company run by smart people, while we are free to build new startups. However it was hard to say goodbye to the greatest rollercoaster ride of our lives.

## Do you really want their money? Now?

By now you know what kind of companies different types of investors are looking for and when in the process they are interested in investing. Knowing that will greatly increase your chances of conducting a successful fundraising campaign by approaching the right investors at the right time!

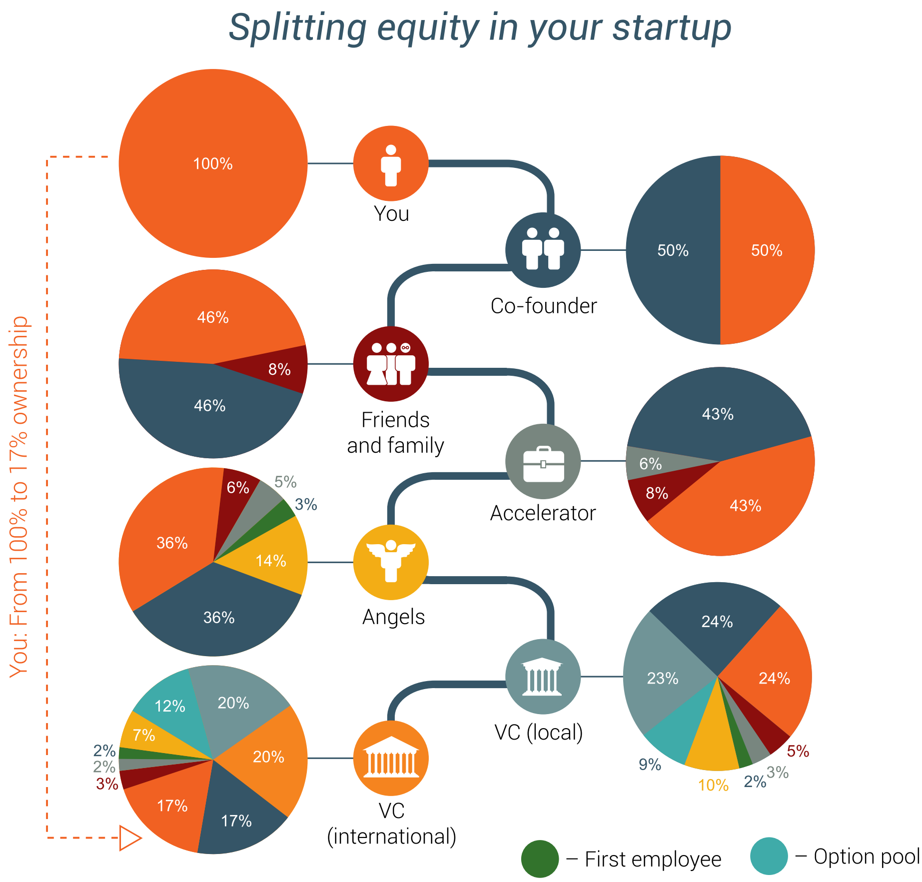
The question is, do you really want the investors' money?

Why shouldn't you? Well, first of all because no investor will be giving you the money for the sake of your blue eyes – except your mum and uncle, of course. The rest want something in return – a share of the company. In startup jargon this is called 'dilution', when your share of the company is diluted by investors.

The example below illustrates a typical dilution for a company that receives funding from the usual suspects at the different stages of the company. It starts with you getting a co-founder, and having friends, angels and accelerators invest in the company. Next you give shares to the first employee and later employees in the form of an option pool, and then you receive huge investment from a local venture capital fund and later an international venture capital fund.

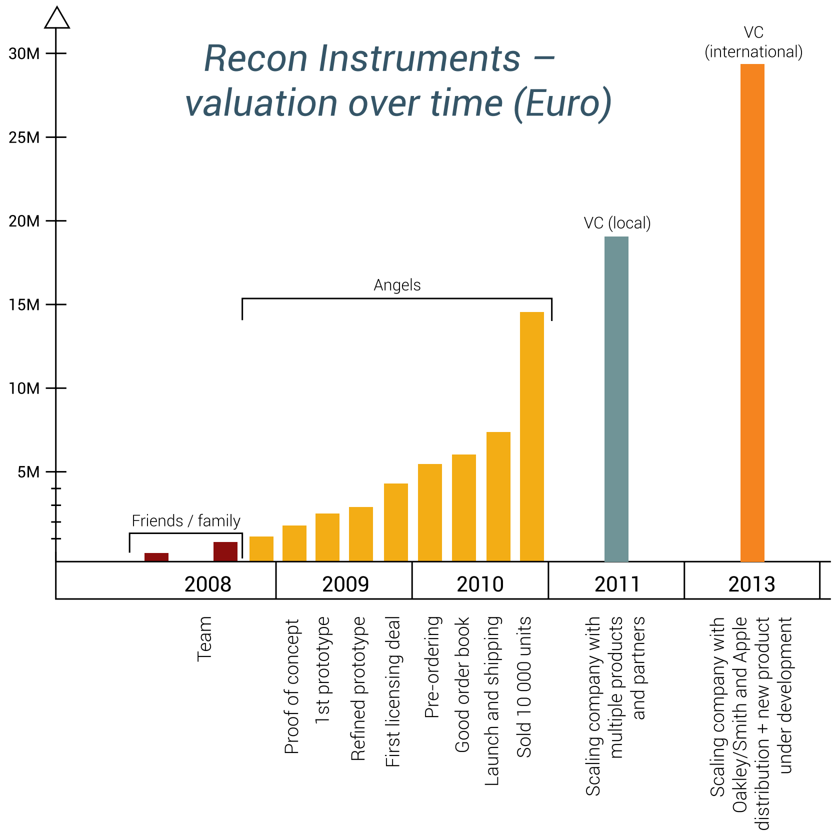
So is going from 100% of a very small cake to 17% of (hopefully) a large cake worth it? This depends on your specific situation and what you really want to do with your startup. Is it more important for you to be in control of your company, even if it's a small one, than to grow it into a world-leading company? Then you certainly shouldn't go this route! But if you have a startup where you need funding to grow, or grow fast enough, VC and other types of investors might be exactly what you need!

You should ask yourself: *Do we really need the money? Will the money really make a tremendous difference for our company – or could we achieve what we want without it? And if we need money, do we need it now or could it wait till later?*




It's hard to find entrepreneurs who regret they didn't take in external investors earlier in the journey, while it's easy to find entrepreneurs who regret taking in investors too early when (they know with hindsight) they would have been able to bootstrap longer.

Why do they regret it? In many cases because they now know the huge value jumps a startup takes when reaching new milestones. Whereas the value of an idea is close to zero, the value skyrockets as the startup builds a team and prototype, launches a product, gets revenue and starts to grow rapidly. The value is exemplified below with the pre-money valuation of Recon Instruments during different stages.




Recon Instruments was a Vancouver-based startup, founded in 2007 and sold to Intel in 2015. The idea was to combine electronics with sports equipment in the form of swim goggles, snow goggles and sun glasses, with built-in head-up display (HUD).

The first investments you take in are very expensive since the value of your company is low. So you will have to give up a lot of your company to the investor for a relatively small amount of money if you take investors in early on. And if you end up taking too much money too early, you might end up owning only a small fraction of your company at exit. This not only impacts your financial upside but also your ability to be in control of your company.

## Take-away points

Different types of investors have very different appetites for risk. What's attractive for one type of investor can be much less attractive to another simply because they invest in a different corner of the investor matrix. Those looking for high risk/high reward cases include venture capital funding, startup accelerators and business angels, while banks are looking for something completely different.

The risk/reward of an individual startup changes as it goes through the different phases. Typically, the first to invest in a startup are your friends and family because they invest in you and not your business. Most professional investors want to see more progress before they invest.

Even if you come to a point where you can get external funding, you should think twice before accepting the investment since it will involve you owning a smaller share of the company and also result in potentially loss of control of your company.

Chapter 4:

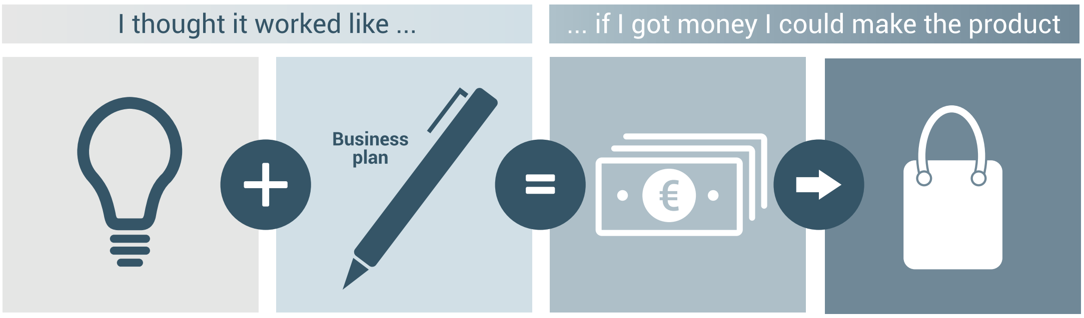
# Why can't you find an investor?

*As a first-time entrepreneur, you probably think your idea is cool, has huge value and investors will trip over themselves to give you their money. They won't. Your great idea is probably not great – and even if it is great, it's almost certainly not original.*

## Investors don't invest in ideas

Every first-time entrepreneur, including myself when I founded my first company, thinks coming up with the idea is the hardest part of the startup, and the part where the idea is put into practice is the easy part. Nothing could be further from the truth and that's the primary reason why your idea alone will not find funding.

When I was a graduate student at Copenhagen Business School, I had an idea for a business, an online magazine. This was 1999, so it was quite new at that time. My idea was for a magazine by amateurs that published their articles about cars, girls and gadgets; an online version of the magazines GQ and FHM.




I thought it worked like this: I'd make a business plan and send it to investors. The investors would then also think it was a great idea and they would give me the money I needed. With that money I could create my website, get customers, build a company and conquer the world. That is how I thought it would work. Really.

It didn't. I spent weeks writing a business plan and sent it to a lot of potential investors (venture capital funds) with no results. No one was interested in investing in my idea! Why?

**Because no one invests in a business idea alone.**

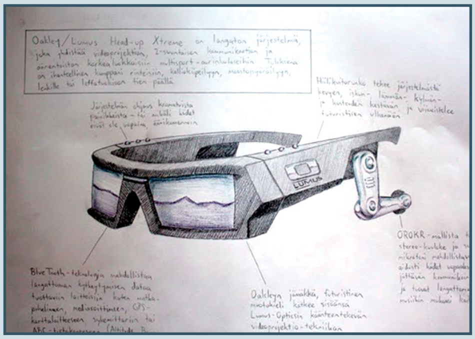
Today, 15 years later, I meet plenty of students and entrepreneurs who think just like I did then. What they think is a *brilliant* business idea is most likely not a brilliant business idea. And what they think is *just* implementation is not just implementation. An investor will start the discussions by reminding you that your idea is nothing. What happens afterwards is what creates value. A bad idea with brilliant execution is better than a brilliant idea with bad execution.

## Case study: Recon Instruments – an idea that wasn't unique


My friend Dan Eisenhardt co-founded the previously mentioned startup Recon Instruments in 2007. As a former competitive swimmer, he wanted information about how he was performing delivered to him in real time, in the form of goggles and glasses with built-in head-up display (HUD).

Was it a unique idea? Not really – even though I initially thought so.

I was one of the first investors. I helped Dan and his co-founders secure further funding and reached out to my network to look for potential investors. One of my former classmates, Rudi Airisto, responded and said he wanted to invest in the company. But the really interesting thing was the files Rudi attached to his email containing drawings of a product idea that was very close to the vision behind Recon Instruments.



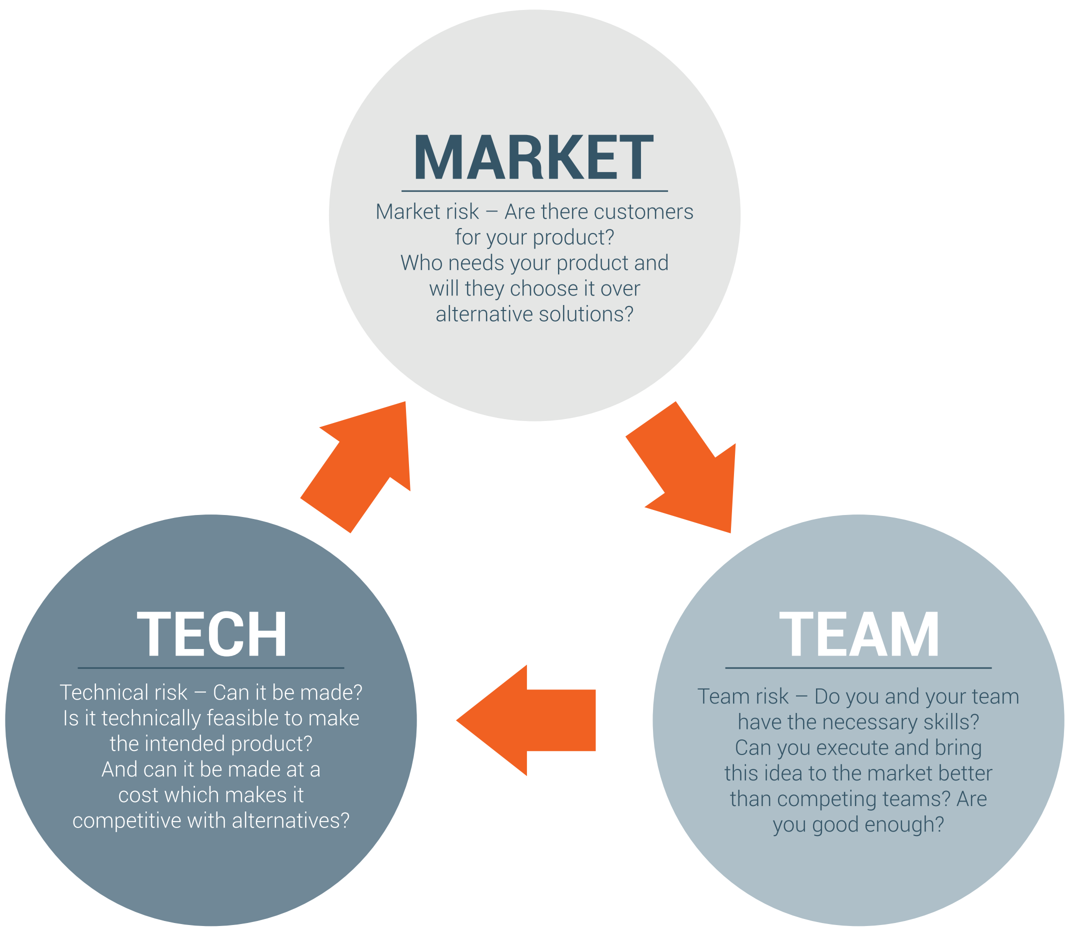
What Dan and the rest of us thought might be a unique idea, wasn't. In my network alone, there was at least one person who had the same idea, and that meant it was likely that hundreds of people across the globe had thought of the exact same idea as Dan. Fast forward eight years; the company became a success and was sold to Intel in 2015. The success of Recon Instruments wasn't due to the founders having a great idea at the right point in time. It was a success because the people *wanted* to do it, and they did the hard work necessary for the next eight years. They created a success not based on the idea but based on the execution with numerous small, smart decisions over a number of years.

### Key note: Ideas are not worth much

Investors know that what separates a successful startup from a failure is not the unique idea but the hard work done by the team in the many years following the initial idea. And that's exactly why most investors don't invest in ideas.

## What are investors looking for?

So if your idea isn't enough, what more are investors looking for? What kind of progress/ traction do they want? Of course, all investors are different but their analysis can be summed up in the following three areas on which they evaluate the risk/reward profile of your startup:



## Market risk

Many startups go under because there isn't a real demand for their products. Even if you, as founder, believe the product will solve a 'big problem' for many people, this may not apply to the real world. So the initial analysis by investors is often centred around the following questions: *Is there a real demand for the intended product, will enough people buy this product* and *how much will they be willing to pay for it?*

Examples of products where investors evaluate early-stage startups with low versus high risk:

| LOW PERCEIVED MARKET RISK | HIGH PERCEIVED MARKET RISK |
|---|---|
| Pharmaceuticals | Diagnostics |
| E-commerce | Consumer apps/games |
| Consulting/professional services | B2B software |

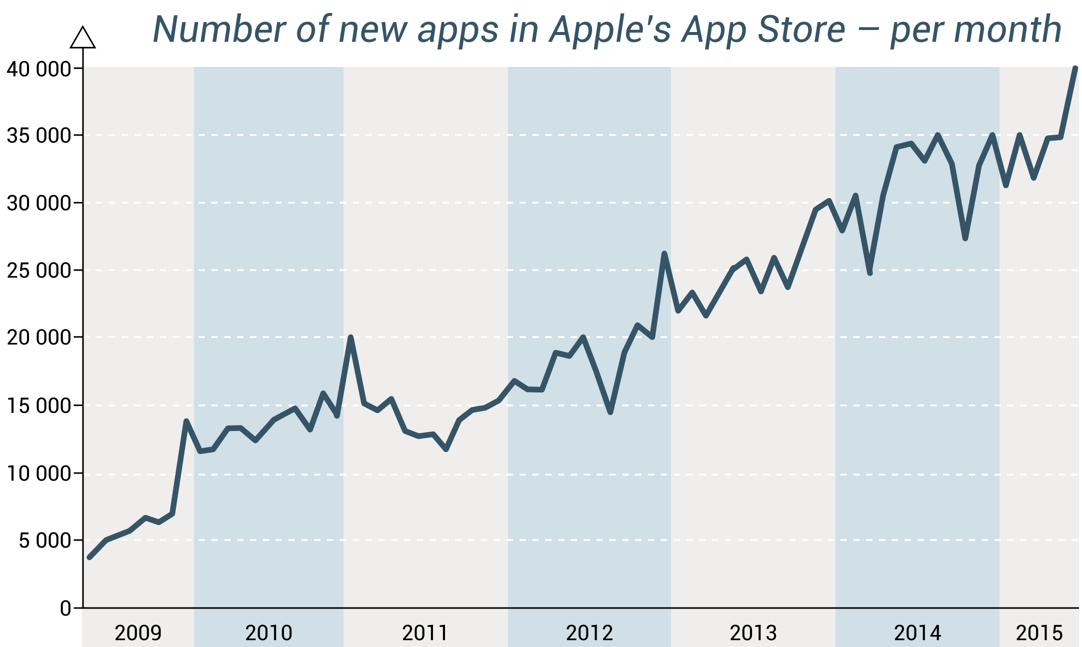
**Key note: Investors focus a lot on market risk!**

Most startups believe the technical risk of making the product is the biggest problem, when what often kills startups is not a lack of a good product, but a lack of customers. For many innovators, the market risk is even higher than the product risk. You have invented a cool product but will people buy it? In your dialogue with investors you will have to focus on convincing them (ideally with real data) that there is an actual need for your product!

Of course, the level of market risk varies a lot from startup to startup. Some early-stage startups have a very high degree of market risk while others don't.

The archetype for a startup with high market risk could be a company that wants to develop applications (apps) for consumers. Yes, we have all heard about the success of Angry Birds – the mobile game which earns the company Rovio hundreds of millions of euros in revenue per year. But did you know that Rovio produced 51 unsuccessful mobile games before hitting the jackpot with Angry Birds? And Rovio isn't special in that sense. It is very hard to predict pre-launch if a mobile app will be successful or not, and therefore many of the world's most prestigious and successful game developers have statistics similar to Rovio's.

The same high market risk goes for most types of consumer software and apps. We have all heard about the handful of very successful apps most of us use such as Facebook, Instagram or Dropbox. But every day there are more than a thousand new apps launched. Every single day! How many become huge or successful enough to support a small company? Not many! So when entrepreneurs pitch 'I have this great idea for a new app', most investors are cynical and want to see real customer data before they'll be convinced this could really be the next big thing. Coming up with an idea for an app is rarely enough, but the good part is that you can usually develop a beta-version (a minimum viable product), on a limited budget (financed by yourself or by friends and family), and use this to show there's demand for your product. If you can do this, investors will stand in line to invest!




Source: https://www.statista.com/chart/3530/app-store-growth/

## Technical risk

While there might be a market opportunity (demand for your intended product), technical challenges could prevent you from taking advantage of that opportunity. For example, there might be a demand for selling trips to the moon for €10,000 per person, but can it be done? Is the technology available to take people there and bring them back safely for a cost you can make money from?

| LOW PERCEIVED TECHNICAL RISK | HIGH PERCEIVED TECHNICAL RISK |
| --- | --- |
| Consumer apps/games | Pharmaceuticals |
| E-commerce | Cleantech |
| Most IT startups | University spinouts in general |

Some startups have huge technical risks while others have low risks and this impacts how potential investors perceive the opportunity. Let's illustrate this with a startup that has a high degree of technical risk:

**Researchers who want to make more efficient batteries**

One very interesting research area with huge commercial potential is the improvement of current energy storage technologies (batteries). For years consumers have found it a major pain to have to recharge their mobile phones daily, but now this pain has spread into many other industries (car/home batteries, storage of electricity generated by wind turbines etc.). In all these industries there is a need for more efficient batteries as the world tries to move away from fossil fuels. Entrepreneurs and investors have of course spotted this 'billion-dollar' opportunity and are pouring money into tons of startups that are trying to make better forms of energy storage. But these startups also carry huge technical risks! It's a long and very bumpy road from showing potential in the laboratory to actually making it commercially available to consumers and businesses worldwide. Are you able to replicate the positive results? Are you able to produce it on a huge scale? Will the technology be stable and safe enough to implement outside the lab in houses/factories? Are you able to produce the batteries at a cost so low that it will be commercially attractive? There's a huge technical risk but the business opportunity is so enormous that investors are willing to take that risk.

Other startups have much lower risk of failing due to technical issues. A good example of startups could be within e-commerce. Most likely you are using existing software for your online shop that you have purchased from third parties and adjust to your needs (design, integration with other IT systems). It will cost you money and time to implement, but there is very little risk that it can't be done. In this case investors aren't concerned about technical risks.

Whether or not you suffer from market or technical risk, most investors realise you suffer from at least one risk – the risk of your team not executing the plan.

## Team risk

This is the risk that is you; the risk of you and your team not having the skills or experience required to take full advantage of a given market opportunity.

Even with startups that have high market risk and/or high technology risk, the team risk is seen by many investors as the biggest risk factor associated with startups. It doesn't matter if the market opportunity is huge and the technology is available for making the product. If you and your team don't have the required skills to execute it successfully, you will fail in the development or sales phase, or be beaten by the competition who will take advantage of the market opportunity better and faster than you.

### Key note: Can YOU really do it?

Many startups fail to raise money from investors, not because they can't communicate the huge business opportunity, but because they fail to convince the investors that *they* – the team – can take full commercial advantage of it.

The contrary is also possible. I know of investors who have funded a startup *without* being convinced about the market opportunity and knowing there is high technical risk. Why? Because they saw a strong team with the stamina and drive needed to face and overcome the market and technical challenges they will meet.

A good example of how a great team can impress investors is Airbnb. Paul Graham from Y Combinator didn't really believe in the Airbnb business model, but he saw a great team that had managed to survive a year without investor funding by selling cereals. He believed if they could sell cereals they could sell anything and they could make Airbnb a success.

Why are investors so focused on a strong team and less on your business idea? Because your idea is really only an untested hypothesis about the world. You have defined a problem that some people or companies have, and you have come up with a solution to that problem. But is that actually true?

One of the most interesting studies on what makes startups succeed or fail, is the Startup Genome project. Based on data from 3,200 technology startups, the team of researchers from Startup Genome investigated whether sticking to the startup's initial business idea or changing strategy along the way impacted the chance of success.

**Startup Genome concluded that startups that change a major part of their business once or twice are more successful than startups that change strategy more than twice or not at all.**

In other words, your initial assumptions are most likely wrong and you will have to adapt as you learn more about your customers and their demands. The chances that your original idea is polished enough to create a successful company is very slim.

All investors know that, and that is why they won't be impressed by your 'great' idea alone.

They want a team that is so strong they will convert the 'bad' Plan A, to a successful Plan B or C.

## Case study: Bootstrapping at AirHelp

Background: AirHelp is a startup that helps travellers get compensation when flights are delayed, cancelled or overbooked. AirHelp does the paperwork, follow-up and legal action, in return for 25% of the compensation amount awarded from successful claims.

Henrik Zillmer, CEO and founder of AirHelp, gives his view on funding:

Don't start with fundraising!

This is the biggest mistake you can make as an entrepreneur. Unless you've started a lot of companies in the past with a couple of successful exits, you're not able to raise capital without showing traction first.

During the first year of a startup, you need to spend all your time validating your business model and getting traction. When you have a beautiful hockey stick curve to show, you're ready to fundraise. Any time sooner and you'll end up wasting your time and, more seriously, spend less time on actually building your company.

Imagine being the investor. Ask yourself: Would you invest in a startup with an idea, but no traction, or would you invest in one that shows an increasing customer base, retention and revenue?

"But I can't afford a year without salary," you say.

Of course you can! Ask your bank or your friends for a loan. If you're not willing to make sacrifices, entrepreneurship isn't for you. Reducing your standard of living for a time is only the beginning.

That's how we started in AirHelp. We bootstrapped for 12 months, living from savings and credit card debt and then, only after we reached a steady flow of new customers, did we move into fundraising mode.

# Take-away points

Entrepreneurs must start to think like investors if they are to be successful in securing funding for their startup project. This means thinking and working in terms of *technical risk*, *market risk* and *team risk*.

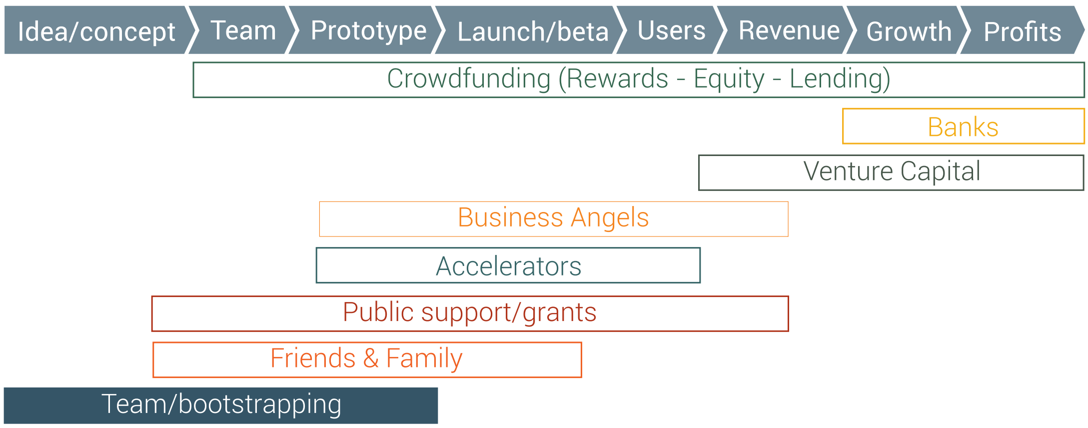
When you start up your project, all three types of risk are high since you haven't proved anything yet. The chances of getting an investor to invest when you are at the idea stage is therefore very low! The more an entrepreneur can reduce these three risks, the more attractive the project becomes to investors in general and less equity needs to be 'paid' for the investment.

The first step in reducing the risk - and improving the perceived reward – of your startup is to gather a strong team around you. Investors know it's the team, and their skills and hard work over several years that make a startup successful, not the initial idea. Your team and your co-founders are therefore your first investors, and they are the topic of the next chapter.

Chapter 5:

# Co-founders are your first investors

*You de-risk your business idea by working on the project via your own funds – bootstrapping – until it reaches a point where its risk/reward is attractive to investors. The first and most important bootstrapping step is getting co-founders on board and getting the right team in place. You will most likely not be able to pay co-founders properly and they are therefore your first investors. They invest their time but not money and are crucial for attracting investors later.*




# Why have co-founders?

Do I really need co-founders this early on? The answer is 'yes' and here is why:

## 1. Co-founders add competencies

If you're good at building a product, chances are you're not the world's greatest salesperson – and vice versa. Your startup project needs both, and if there's only you then you are going to fail. You are working to prove that your business is viable and that investors should therefore invest. In most cases this work involves both building the first version/prototype of your product (to reduce technical risk) and getting the first users/customers/partners on board (to reduce market risk). You need co-founders who complement your core competencies to achieve initial traction.

## 2. Co-founders add credibility

Even if you're the type of person who can cover all the bases yourself, it won't do you much good in relation to investors. Investors believe and invest in the team. Remember, you don't build the team simply to secure funding but also to build the longer-term business. If it is only you, chances are investors will say 'no'.

It is very unlikely that all the distinct skills needed to drive forward a startup are within the same person. Even if I meet one person I believe has all these skills (and I haven't yet), I will wonder what will happen if they're run over by a car tomorrow. I will also be concerned this is a one-man band because they've been unable to convince anyone else to join their company. Is something wrong? Don't they want anyone else in or does no one want to join because of them? Either way, it's a red flag in the eyes of most professional investors.

## Advice from an investor: Never invest in one-person startups!

Lars Buch was in charge of Startupbootcamp in Copenhagen for three years before turning to a corporate venture at Leo Innovation Lab. Here Lars explains his view on founding teams:

Normally I wouldn't invest in a single founder (or in a team where one person owns the shares and the team have no ownership), because being a single founder normally means one of three things: it's too early to invest, the founder underestimates what's needed to build something sustainable, or the founder is simply an asshole.

I'm OK starting a dialogue with a very strong, single founder, but then the very first (only) topic will be about what critical resources are needed to build this company, and there will be no actual transfer of money before those resources are in place.

## Which co-founders do you need?

One of the most extensive studies into what makes startups successful was done by the researchers at Startup Genome. Data from thousands of (mainly IT) startups was processed in order to determine the common factors that successful startups share. One of the most important findings was that startups which have a balanced team of both a technical founder and a business founder are far more successful in the long term, compared with startups that have either a technical or a business founder.

Balanced founder teams raised on average 30% more money, grew the customer base by 290% more, and were less likely to fail when compared with non-balanced teams.

These findings match the experiences of most investors with regards to the set of core team competencies they need to see – product development and sales.

## Product development

You need someone who can develop the product. The type and kind of developer you need obviously depends on the specifics of your project. Without such a co-founder (if you don't have the technical skills yourself), it will be hard both to bootstrap the startup and to convince investors to come in.

A typical example is that of a business-oriented entrepreneur who has an idea for an app but doesn't have someone with the technical skills needed on board. The entrepreneur is essentially in the process of building a software company without a software developer on the team. Investors will take one look at this and turn away.

> *"If you're starting a restaurant and you can't cook, you need to team up with a chef."*

### Key note: Help! I can't find a technical co-founder

Finding the right person to fill the position of technical co-founder can be difficult. I often come across startups looking for a developer who wants to become a co-founder but can't convince anyone to join. There are several reasons for this: good developers are in short supply, and many of those who could consider joining have worked with people who have promised them a lot but delivered very little. A third reason is that developers tend to not be risk takers. Many of them aren't entrepreneur material.

For these three reasons you have a lot of business people chasing a few potential technical co-founders and promising them riches. After they have been promised this one or two times they become immune to offers.

If you're struggling to find a technical co-founder, you should consider outsourcing to show that you, as a business person, are committed to the business and attempting to get some traction. Get an agency to develop the first version of the app, even if the result is much simpler than your grand vision. Do a beta launch and hopefully you will have positive feedback from the first users. Now you have something to show and this will make it easier to convince a technical co-founder (and later investors) to join.

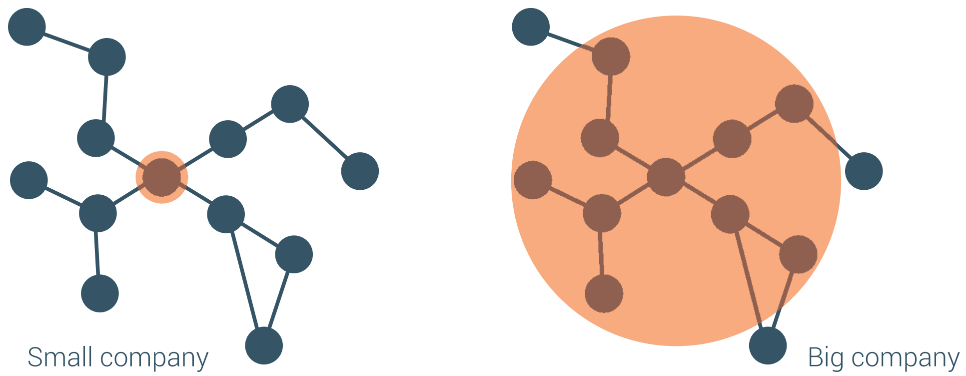
## Sales

You also need a dedicated salesperson to join your founding team – an extrovert who likes to communicate with the outside world, with customers, partners, vendors and investors. Someone who is good at selling the project and the vision. In startup jargon, they're sometimes called a 'product visionary'.

These sales are not only to customers but to all key stakeholders, and that's why it's a full-time job, even if your company's product has not yet been fully developed.

Think about the differences in competencies needed in small versus large organisations. If you're working in a big company, all your competencies are there in the organisation and the majority of your stakeholders are internal. If you need a product manager, legal advice or a marketing graphic drawn, all the competencies are found inside the organisation. You still need to convince the other employees to help you realise your goal, but you're all in the same boat and that tends to make things easier.

*Working in small vs. large companies*




In a small startup the internal bubble is much smaller: you and your co-founder(s). When you need funding you need external investors; when you need marketing you need to collaborate with an external marketing company. Every time you need something extra you need to look outside the organisation. Basically, all the important resources are controlled by external stakeholders and you can't call your boss to have them do as you like. You need to convince them, and in many cases you need to convince them in other ways than paying them huge bucks now (since you're bootstrapped, your finances are most likely limited). You need to sell your project and vision to them and make them want to work with you rather than taking a better-paid position elsewhere. This 'sales job' quickly turns into a more than full-time dedicated position.

**Key note: You need the salesperson now**

You need the sales guy from day one to build all the external relationships – you can't wait until your product is developed and needs to be launched. That's too late! Investors know that, and generally prefer teams with technical and sales resources present when they invest.

## Could you use outsourcing or regular employees instead?

The purpose of bootstrapping is to bring the company sufficiently forward to make it fundable in the eyes of investors. But you could argue that getting a co-founder on board is just one means of bringing the company forward, so let's discuss two obvious alternatives to getting a co-founder:

1. Outsourcing, where you pay an external company by the hour or per project
2. A formal employee on a long-term contract

### Using outsourcing

I sometimes hear from business entrepreneurs who say, 'Well I can sell, I can do marketing, I can do PR but I can't code, so I found this software development company who can develop the app for me'. And I hear technical developers say, 'We are the software guys, we invented this software. We can't sell, but we have found a sales/marketing agency that will do the selling for us'.

Both are typical examples of outsourcing where you try to outsource either the development or the commercialising to external parties. In theory this sounds good: you stick to what you're good at, keep a hundred per cent of the equity of the company, and hire external companies to do the rest. In practice it hardly ever works like this.

The first obvious problem is whether you can afford to pay the outsourcing company for their assistance. They bill you like any other client and that can quickly become very expensive. Startup projects tend to take much longer to be successful due to longer development times and because getting the first customers on board takes time.

The other reason why early-stage outsourcing rarely works is that the task is still in progress. You might have decided that your app should feature functions a, b, c, d and e, but shortly after the first customers have tried the app, you realise you need functions f, g and h. A lot of startup work is based on assumptions and with every step forward you learn some of your assumptions are wrong. This is how it goes for most app-based startups. In fact, this is the nature of starting up. Mistakes need to be made to arrive at the final successful product.

**Key note: Outsourcing scares away investors!**

It is very hard to get outsourced core competencies to work in the early days of your company, and even if you believe you can, it often scares away potential investors because they themselves have had a bad experience with it.

You need both business and technical people who are in from the outset and committed to going the full distance. And that is the problem with outsourcing: the people you outsource to aren't committed to your project in the same way as you. Say, for example, you get the first version of the app back from them and you quickly realise changes need to be made. You will have to pay them each time because they are not invested in the project the way you are and don't work for free. They bill you by the hour or job. Co-founders don't think like that. They think long-term and in terms of building a successful company. That is what investors want to see, and why they will say 'no' to startups where either sales or research and development (R&D) has been outsourced.

## What a VC looks for in a startup team

Ulla Brockenhuus-Schack, General Partner at SEED Capital, explains:

It's extremely demanding to build a company and only the strongest and most dynamic teams survive. It is therefore crucial your team has diverse competences. That means you have a product visionary: someone with industry expertise, capable of building relationships and selling your vision to clients and investors; and you have a tech rock star: a product developer who can implement that vision and attract further tech talent. These are core institutional skills, which need to be deeply embedded in the company, and not something you buy.

Outsourcing key functions doesn't work as startups depend on being agile. Also, making up for the skills your team doesn't have by outsourcing important tasks is expensive, and will give you less time to prove your worth before you run out of money.

**Exceptions to the rule – use outsourcing as a short-term solution.**

Outsourcing some key skills can work in the initial phases of the startup because creating a team is sometimes a catch-22; you are trying to convince team members to join this fantastic new company but you don't have any track history. So you could get a prototype made by an external outsourcing agency to test the market assumptions and use it to attract the potential developer who will become the co-founder. Or you outsource the sales side and hire a part-time business developer to test market assumptions and get some letters of intent or generate interest, then you can use this success to get the co-founder salesperson involved. So, long-term outsourcing doesn't work but you can use outsourcing in the short-term to get started on testing your assumptions and to attract the talented co-founders you really want.

## The contrarian view: I don't need a software developer in the founding team!

For 99 per cent of professional investors, having no developer is a deal breaker when looking at a software startup to invest. But there are some for whom this is not the case, in most cases because they themselves have succeeded using outsourcing in the initial stage of the development phases.

Thor Angelo has successfully used IT outsourcing for several startups he has started or invested in. He explains his thoughts on what it takes:

Not having a software developer on my team is not a deal breaker. Of course having one will not hurt, but I know you can get it to work without one. For me it's more important to have the product visionary on the core team where the initial software development can be outsourced.

That's why in all the projects where I'm founder or investor, I have the initial development tasks outsourced to the Ukraine. I've found a good outsourcing company there which I use to get the 'minimum viable product' developed. Later in the process we can move the development closer to the rest of the team by building up an internal development team.

I believe that one of the 'secrets' in making such outsourcing work is a short cultural distance. For European startups that will mean using teams in Eastern Europe (Lithuania, Ukraine, Poland etc.) and not further away such as China and India. A too-large cultural distance makes collaboration way too hard!

Another common mistake made by startups when outsourcing is not having properly specified the development tasks up front. This involves producing very detailed feature lists and mock-ups and agreeing a fixed price for such development. This is of course easier said than done since it requires you – the startup – to think and to test the detailed functionality of the mock-up with potential users before development starts. Many skip this point, which leads to a variety of problems when the development process starts and it turns out that the detailed functionality hasn't been agreed upon.

It definitely helps in the process if you have some technical understanding. This makes it much easier for you to specify the intended functionality in detail and also to discuss issues with the outsourcing company along the way. So if you lack technical understanding, team up with someone from your network to help you do the specifications and ask the development teams any technical questions.

Or to sum up: having no technical co-founder shouldn't be an excuse for you not to start your startup. You can certainly start by using an outsourcing company!

## Employees not co-founders?

Outsourcing development or sales is a bad idea because the nature of the transaction is such that the resources focus on short-term gains and not the longer-term company vision. Could you hire people on regular contracts instead of making them co-founders of the company?

To clarify, a 'co-founder' is a person who has a significant equity stake in the company which they get in return for no, or a very low, initial salary. In contract terms, an 'employee' is a resource where the main motivation comes from the monthly salary and not from the long-term equity upside.

The first question is whether you can afford to hire an employee on a regular contract. Let's assume you want to start a software company and need a seasoned software developer to lead the product's development. The going rate for a skilled software developer in Western Europe can easily be €75,000 a year. And if they're just an employee and not co-founder, why should they work for you in a high-risk, early-stage startup instead of a secure, well-paid job in a big organisation or in another startup where they can become co-founder?

Even if you can afford to hire someone, you need to think twice. The benefit of hiring talent is that you don't have to give them a share of the company, but if they're thinking like a regular employee, they'll be unlikely to go the extra mile or stay with the company when things get tough. And things will get tough. Let's assume that your startup follows the path of most startups, where the first product doesn't sell very well. The salesperson you hired won't get a commission and will probably start looking for another company where they can earn that commission.

Again, co-founders don't think like that and that's why investors will tell you that's what you need – both on the sales and the technical side of the business. A co-founder will increase your chances of funding and long-term success.

**Key note: The beer test**

How do I pick the right co-founder? Apart from their formal qualifications, ask yourself if you could drink a beer with that person. You are starting on a five or 10-year journey and you will spend more time with them than your wife or husband, so you need to find someone with the same vision for the future.

A lot of it is down to gut feeling. Do you want to drink beer with them? Do you want to be in the same room as them for the next five to 10 years, for more than 10 hours a day? If you aren't certain about having a beer with them, don't pick them. It's better to compromise a bit on formal qualifications and find someone you can work with. They can always improve their qualifications and skills, but if you can't get on with them, that's much more difficult to change.

## Incentivising co-founders and early employees

You need co-founders who are driven by the long-term vision they're building. To ensure their loyalty, you need to provide them with equity.

But how much do you give away and to what types of team members? Below is an overview of the major differences between co-founders and early employees:

| | CO-FOUNDERS | EARLY EMPLOYEES |
|---|---|---|
| Joining the company when? | In the earliest days of the company – typically before launch and before external funding. | Typically joins company after the company has received funding and/or launched product |
| Company size | 2 to approximately 4-5 | 4 upwards |
| Salary? | Initially often no salary, since company is bootstrapped. Later salary, but significantly below market rate. | Yes, but below market rate |
| Primary motivation for joining | Vision and equity stake | Mixed – both salary but also vision/equity |
| Typical equity stake | Initial equity to be shared either evenly among co-founders (typically 25-50%) or if main co-founder, the other minimum 10% equity. | Depends on both seniority and how early they get in. Very rarely more than 5% (and then only for exceptional hires or an experienced CEO) – typically much less. |

## How much equity should you give your co-founder?

Co-founders come in when there's no funding, no revenue, and therefore no money for a salary. But how much equity should they get in return for working for free and taking that risk?

Let's say you've spent time and money working on an idea. Six months later you bring in a co-founder – that could be a sales/marketing guy if you have the product development competencies. That person is willing to work for zero pay, and you both believe that realistically you are 12 months away from being able to pay yourselves a salary. The question is *how big a part of the pie should that co-founder get?*


My personal view: You have run 100 metres out of a marathon

One valid point of view is that you are the 'real' founder – you have come up with the idea, and have already spent a considerable amount of time and money developing it. So you should have much more equity than your co-founder who joins now. You might give that person an offer of 20 per cent of the equity and keep 80 per cent for yourself.

The other perspective is very different. Even though you've spent six months on the idea, it will most likely be 10 years before you have built a successful company. The steps you have taken so far are few compared to the steps you will take together for the next nine years. Ninety-five per cent of the work is still ahead of you. In this scenario, you would offer your co-founder a 50/50 deal because the real work is just getting started.

My personal view is more in line with the second perspective. You have just started on a long journey, you will be in the same boat together for many years, and you will need to make sure they are in it for the long run. I believe this is in your own interests, even though it will leave you with a smaller part of the cake – but now there's a much bigger chance the cake will be larger in the future!

An alternative scenario is a negotiation with the co-founder resulting in a quarter of your equity. Perhaps this satisfies the person for now, but what about in three or four years' time, after their share has been diluted by investors and stock options to employees?

**Key note: Too little equity for co-founders can disturb future investors**

The uneven split among co-founders can also be a deal-breaker when negotiating with future investors. If a key person (as your co-founder by definition is) doesn't have a fair share of the equity, this will be perceived as a problem. They know that this might demotivate them later when they suddenly only have (say) five percent of the equity due to dilution.

The right number of co-founders is typically two to four. Or as the famous quote from Jeff Bezos, founder of Amazon, goes: *If you can't feed a team with two pizzas, it's too large.*

## Advice from an entrepreneur: Three co-founders is the magic number


Amir Schlachet is the co-founder and CEO of Global-e, a startup that provides online retailers in Europe and the US with a cost-effective and risk-free service that handles the complexities of their cross-border sales.

Here Schlachet shares his view on the optimal number of co-founders for a startup:

I believe a team of three equal-stake co-founders is the optimal structure for a startup founding team.

I have no idea how single founders can ever achieve anything without being supermen and/or having truckloads of luck. In today's highly complicated and fast-changing world, it's super-important to have multiple view points from people who are equally committed to the business, especially when important strategic decisions are made (and in a startup almost every decision can potentially be strategic for the business).

Two co-founders are better, but assuming they will have different viewpoints (which they should) on many topics, making decisions will not be easy, and may lead to unnecessary compromises or one side feeling like he's constantly overruled.

Four co-founders is a "crowd", leading to problems ranging from decision making (see the above rationale for two co-founders, only doubled), through to the founding team splitting into two "parties" of two co-founders each, holding opposing views. I actually know such a case, where the main VC investor told them only one couple could stay and the other one must be bought out. On top of that, each of the four co-founders has only a 25% stake in the company, which is quickly eroded in the first couple of rounds, potentially to the level where the stake of each co-founder is no longer meaningful enough for him/her to invest the time, money and effort necessary for the endeavour to succeed.

Taking the above into account, I believe a team of three is the magic number for a founding team. It provides the necessary level of viewpoint diversity, while making majority-vote decision making very easy, and allowing each founder to retain a sufficiently high stake in the company

## Case study: Building a great team with no money

Instead of having your network as financial investors, you can have them invest time/work in return for equity in your company; as Peecho did.

Peecho is a Dutch online print-on-demand service that was started in 2009 by two ex-employees of Albumprinter, Martjin Groot and Sander Nagtegaal. Peecho is a platform that connects websites to print facilities all over the world and offers a way for owners of digital content [websites] to monetise their content or audience because they can sell their digital content items in print to their visitors.

Initially, like most small startups, Peecho had trouble making ends meet and was searching for a way to get the company up and running despite a lack of capital. Founder Sander Nagtegaal explains how they did it by creating a community:

Obviously we didn't have any money – and I mean nothing; just enough to start the company, basically. First we needed a team, and we needed a good team because if you want to build a serious platform, you'll need awesome programmers. But such a team usually requires money so we planned on making a community that would work a fixed eight hours per week. This community as a whole would be entitled to a certain amount of stock [in the company], however, the community itself would decide how big the community was going to be, which was the catch. So we asked the best programmer we knew, 'Do you want to join? You are going to be the first member of the community and for now – you are the community. So if you want to add more people to the community, you're welcome, but then you'll have to share your equity.'

We gave him a chunk of the company and within four weeks we had four new programmers in the community working on it because the amount of work was simply too much for one person.

By creating a community and letting the lead programmer find and decide whom he wanted to work with, Peecho circumvented the trouble of finding and convincing skilled programmers to join, since the lead programmer only picked the best people he knew because he had to share his pull of shares. This approach enabled Peecho to find the right programmers to build a technical team and the initial four programmers are still working for the company today.

# What if...

Value is created *not* by the initial idea you (and perhaps your co-founders) had, but by the work done in the decade after. And because you often initially can't pay a decent salary to your early employees, you will have to give them shares in the company instead.

**Key note: Get the paperwork in place – including shareholders' agreements**

Entrepreneurs want to save money (which is great) and hate bureaucracy (which is also great). This often leads to a big problem: you don't get your paperwork in place with your co-founders! This creates problems in the future if/when a co-founder needs to leave the company (either in a good way or is forced out). Then you really miss the shareholders' agreement that regulates what happens in such a situation. Therefore, before you get funding – before your company is worth anything – you and your co-founders need to sit down with an experienced lawyer and get the paperwork for your startup in place. You will regret it many times over if you don't do this, and it *can't* wait until 'later'.

But what if co-founders or early employees leave the company? Statistically, some will – for several reasons. Maybe they don't believe in the company's vision any more, or maybe a co-founder or early employee isn't performing and you want them to leave. A common mistake is to not include a take-back clause in the initial equity agreement that covers the event that a co-founder or early employee leaves the company.

So-called 'dead equity' shares in your company that are owned by persons not active in it can become a burden. They tend to demotivate active employees/co-founders: *Why should I work full-time for below market rate, and create value for the co-founders doing nothing just sitting outside the company with a lot of equity?* Investors know that and too much dead equity can become a deal breaker when you're looking for external funding.

This can be avoided by creating:

1. Rights to buy back the shares if the person leaves. This is typically used in cases where the co-founders have already divided up equity in the company among themselves. If the person isn't active anymore, the remaining parties will have the right to buy back the stock at a share price set way below market rate to make it unattractive to leave the company. You normally make a time period for the clauses, so after the co-founder has 'earned' their shares, the buyback right kicks in. This period is typically three or four years.

2. Stock options where promised equity is earned over time. An option is the right to buy shares at a given time in the future at a predetermined price (typically very low). This instrument is typically used when hiring early employees to whom you want to give equity. Instead of getting equity up front, they earn it over time. And such a stock option program lasts typically three or four years in which a proportion of the shares are earned on a monthly basis. If the employee leaves after (say) six months, the company has only a very small equity at stake. Depending on the legal regulations (which differ from country to country), the company might even implement rights to buy back shares from the employees, even if these have already been vested and bought.

By doing the above, you can minimise the risk of having too much dead equity in your company!

## Advice from a former VC: Avoid dead equity

Christian Thaler-Wolski is a former venture capitalist who now acts as mentor and advisor for startups. He strongly warns founders against dead equity:

By dead equity I mean shares in your startup that are not owned by persons actively contributing to the company. Dead equity is a big issue. In short, any shareholder in an early-stage startup that has neither invested real money, nor contributes actively, can be considered dead equity. We are not talking about one or two per cent for an advisor; we are talking 10, 20 or 30 per cent for a co-founder who has left, an angel who didn't invest real money, or a parent company that has equity simply because once upon a time it felt entitled.

Equity is the most expensive form of capital. There is NOTHING more valuable, because it's equity that's needed to ensure the long-term motivation of founders, key employees, board members and advisors in the many years it will take before the company becomes successful. Problems are easily created if the equity is spread too thinly because significant shares in the company are held by people who provide no value to the company. Therefore it is of the utmost importance that when founders start they have an agreement that stipulates vesting of shares and outlines what happens when one of them leaves prematurely.

**Key note: Use a good lawyer!**

Never give equity to co-founders or early employees without having vesting or buy-back rights in place. Since the legal framework is relatively complex, and different from country to country, you need to get advice from a lawyer experienced in dealing with startup equity in your jurisdiction.

## Take-away points

A strong team not only helps you build a great startup, it also helps attract outside funding in the future. Find a strong, complementary group of co-founders and early employees, and bootstrap your business to reduce the risk for investors. A good team requires (at the minimum) the core competencies of product development and sales.

These core competences shouldn't be outsourced. If you need to develop a product quickly, you can outsource some development work, but only for prototyping – this is the exception to the no outsourcing rule. Your core team should never be outsourced.

Typical mistakes when bootstrapping include not giving equity to your early employees, giving equity but no rights to take back that equity, and not getting good, local, country-specific legal advice.

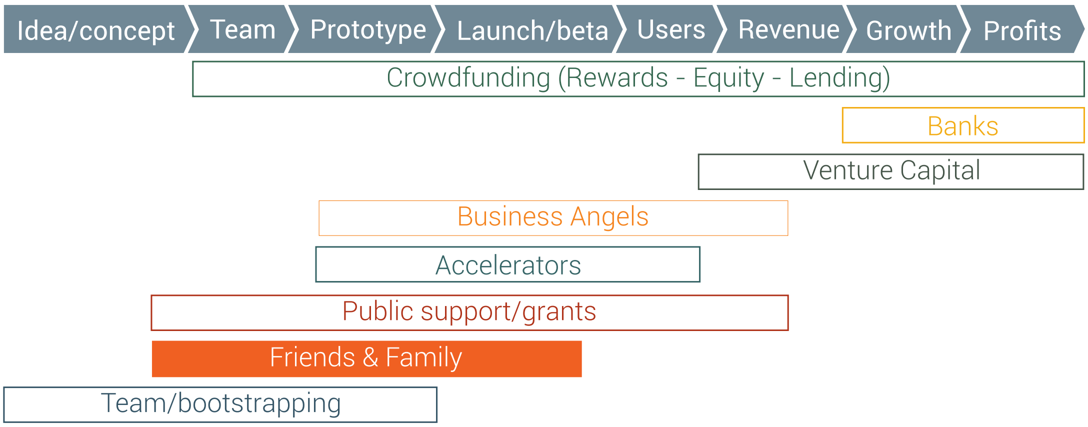
Chapter 6:

# Friends and family financing

*What can you do when you realise that even with a great team on board, none of the professional investors think your project is interesting or mature enough, and you're running out of cash so bootstrapping isn't an option anymore? My bet is that you'll do what most other entrepreneurs do in that situation: turn to your friends and family for financing.*

*When friends and family invest in startups it is sometimes referred to as the "three Fs investing": friends, family and fools. Friends and family are often the first investors in a startup, and they are usually the least qualified to make decisions on the inherent risk and reward. They are the first of all non-professional investors and they make their investing decision because they know you and trust you – not because of your business idea or acumen.*

*To avoid becoming the fool, or risk taking advantage of friends and family and ruining relationships forever, read this chapter carefully.*




## Case: Funding from friends and family – the Peecho story

Peecho is the previously mentioned print-on-demand platform for magazines and books.

The company got its initial traction via bootstrapping, but eventually needed additional funding. After failing to raise venture capital funding, Peecho decided talking to venture firms wasn't leading anywhere. They decided to try a completely different approach: raising the money from their friends and networks.

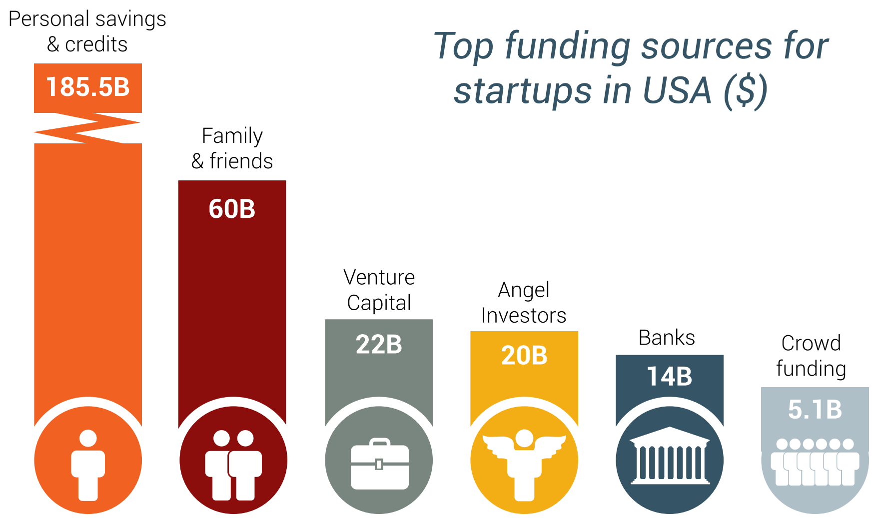
Sander Nagtegaal from Peecho explains: We made a list of people we knew; old bosses, people who were well known in the startup scene, successful entrepreneurs we knew etc. We made the list and said: 'Are they useful, can they spend some money and do we like them?' Then we filtered them, mainly on the 'do-we-like-them' question, and started calling them from the top. We said: 'We only have a product – we have no customers, no revenue. We are going to sell part of our shares right now and we have chosen you as one of the selected few. You can now buy one per cent of the company for €10,000. It's your call, no questions asked – take it or leave it!'

Within 20 minutes, Peecho had sold 10% of the company (€100.000) and had successfully got their first funding round. As Sander explains:

We should have done that two months before. Actually, I will never talk to VCs again at that stage of the company for money. I will talk to them for advice and customers. What they do is to talk to every company around, so they know everybody and can connect you to potential customers (B2B) – and usually they want to do that, especially if it's a portfolio company (of the VC) because then they can keep an eye on you. So if you are really successful with the customers of their portfolio companies they might move in because they have access to actual figures and data which is interesting to them.

## Where do most startups get funding?

Despite what most entrepreneurs believe, investment from family and friends is one of the largest sources of capital for startups. Take a look at the image below. It shows where the money for funding startups actually comes from.




Source: https://www.fundable.com/learn/resources/guides/startup-guide/funding-your-startup

According to data compiled by Fundable, approximately 1% of startups are funded by angel investors and a tiny 0.05% is funded by VCs. Most startups (57%) are funded by personal savings and credit. The second largest source of funding (38%) is friends and family.

That's $60 billion that friends and family invest in startups in the US per year, more than the combined investments by VCs, business angels and banks. In other words, apart from your personal savings, friends and family are the biggest sources of capital for startups!

That fact is interesting because it is obscured by all the attention VCs and business angels get. You can't open a book or a newspaper without reading about a VC-funded startup, new angel investors or a crowdfunding success story. But behind all those headlines hides the fact that, after your own money, friends and family are the biggest sources of capital.

## Case: LanguageWire – how a family member provided 'smart money'

LanguageWire was founded in 2000 and is now one of the top translation companies worldwide, with offices across Europe, €20 million in revenue and a hundred employees.

Co-founder of LanguageWire, Thor Anglo, explains how the founders got their first investor:

We had no clue about how and where to get funding for our startup when we started LanguageWire, so we wasted a lot of time contacting and meeting venture capital funds. These meetings gave us absolutely nothing and were very disappointing. The local VC funds were themselves very young and inexperienced at that time, and they didn't even seem to know we didn't have a case relevant to them.

We also went into dialogue with a public fund which actually offered us a rather bad deal which at the last minute we decided not to sign after advice from another entrepreneur. But there were not that many other potential investors – at least no one we knew of. How to get funding for a startup was like a black-box to us.

We ended up having a family member invest in our company and act as our 'business angel'. His initial investment was €150,000, followed by a further €150,000 if we reached some agreed milestones. In return he received 25 per cent of the shares in the company.

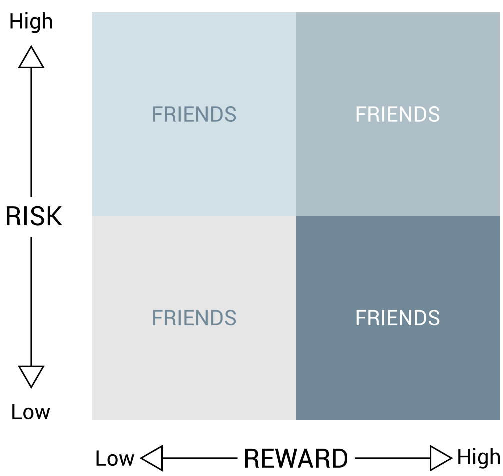
He wasn't an experienced business angel, but he was a very experienced entrepreneur. He was an enormous help to us (especially in the first three or four years), providing us with a lot of practical advice on how to run a business. So for us this was for sure 'smart money' despite the fact he wasn't a formal business angel but a family member.

## When do friends and family invest?

Friends and family invest right from the idea stage and continue investing almost up to the growth stage of a startup; they don't continue investing all the way to the end of the timeline when the amounts have become very big. That €10,000 from your uncle makes a hell of a difference when you're starting your business, but when you're growing your business from 10 employees and want to expand all over Europe you need €5 million. And most importantly – you are now in position to go to professional investors with much deeper pockets who are in the business of taking risks.

## Why do friends and family invest?

Friends and family are non-professional investors because they invest in you, not your startup business venture. They invest because they like you, they trust you, and they know you. Of course, your friends and family will try to understand the business idea and they won't just write a blank cheque, but the overriding reason they invest is because of you – which is why they're willing to invest early. It's not because you've come up with a fantastic new concept; it's because they know you and want to support you even though what you're doing doesn't make that much sense to them.




Because it's all about you and their relationship with you, friends and family invest in everything. This is unlike other types of investors or funding sources who have a clear position: the

VC who wants high risk/high reward or a bank that doesn't take risks. Friends and family are typically not risk averse – and they're not especially interested in or focused on any particular industry or technology.

Their desire to invest is dependent on your relationship with them, and they therefore invest in all quadrants of the risk/reward matrix, even in cases that, from a strict financial point of view, might not make sense.

## Case study: Bidstack – 'anti-selling' to friends and family


James Draper is the founder and CEO of Bidstack, an online marketplace that enables anyone to bid on unsold, last-minute, digital billboard space to promote their message for minutes or hours. He explains his experience of raising money from friends and his personal network:

I had basically nothing but an idea – no name, contracts/contacts etc. – but I needed some money to start realising the grand vision of the company. I therefore started to reach out to my extended network for some initial funding.

When raising money in the extended friends and family round, we were careful to take money from people who could afford to lose it. Many got over-excited by the Bidstack concept, but were going to overstretch themselves financially.

I spent just as much time anti-pitching the concept to them as trying to sell the vision I had for the company. The beauty is, just like with clients, they start pitching your business back to you. In the end I took in £40k – at a £350k valuation – from four different private investors within my extended network.

### Key note: Saying no is hard

It can be relatively easy for you to get funding from friends and family. The hard part is ensuring the investment won't result in a broken relationship. Therefore, if you think the investment has the potential to destroy your relationship, don't accept money from them! This is the hard part – saying 'no' to people who want to invest because you understand that they don't know what they're doing, or you don't think they can afford to lose the money they want to invest.

## The main mistakes when taking money from friends and family

Whilst an investment from friends and family is an attractive source of capital, there are some major mistakes that need to be avoided to reduce the risk of destroying families and friendships.

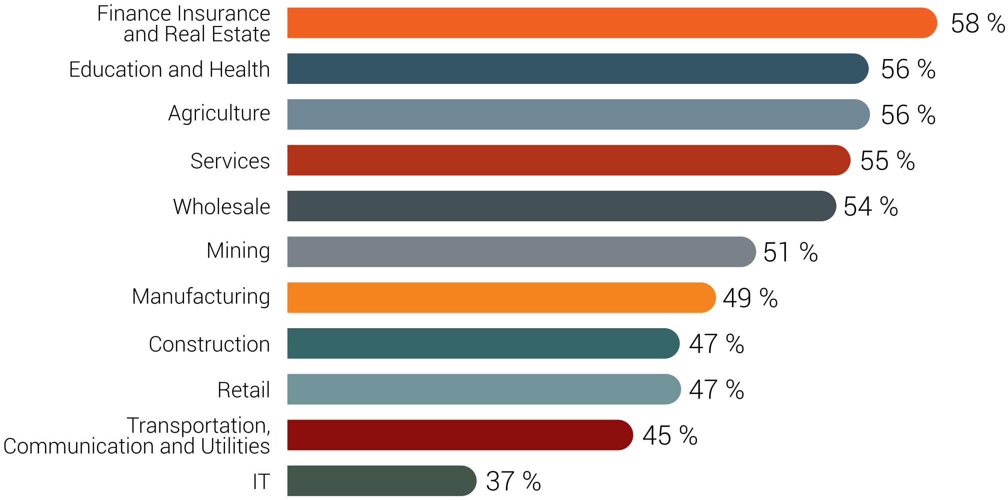
*Top 5 mistakes when taking money from Friends & Family*


### Mistake 1: Taking money from someone who doesn't understand how risky startups are

The number one mistake, which founders keep making, is taking money from someone who doesn't understand the high level of risk associated with startups. Even when they realise that entrepreneurship is risky, they may believe that because you're their wonderful child or grandchild, you'll be able to beat the odds and become a great success.

Friends and family need to know the reality that most startups fail, and failing means bankruptcy and that not a single euro will make its way back to any of the investors. You have to explain again and again that whilst your business might get big, there is more than a 50 per cent chance the company will go bankrupt, and if it does they won't see a single cent.

*Survival rates for startups after 4 years – per industry*




Source: http://www.statisticbrain.com/startup-failure-by-industry/

If you doubt whether your friends and family really understand the risk, don't take their money. For two reasons:

1. **Ethical** – it's not OK to take money from people who don't really understand the risks
2. **Selfish** – due to broken relationships, your actions will haunt you if/when your startup fails.

## Mistake 2: Taking money and not explaining the problem of illiquidity

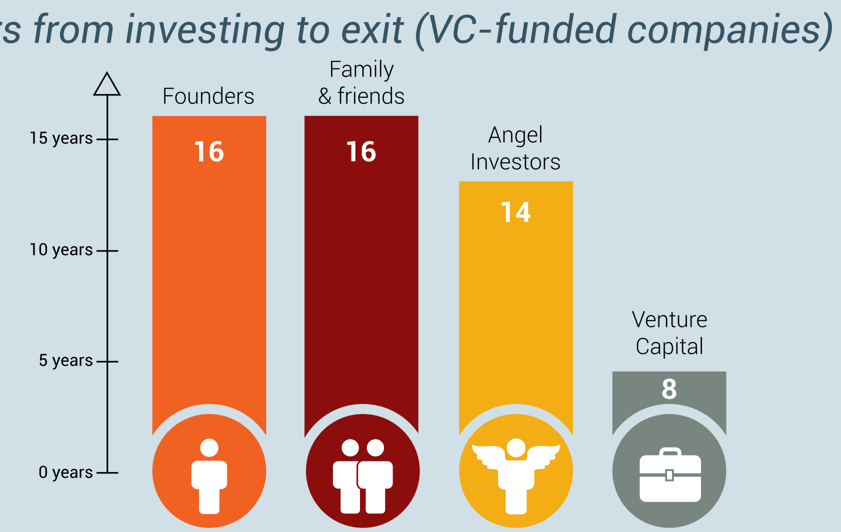
Even if you have a successful startup, your investors can't get their money out. This often comes as a surprise to friends and family investors who assume you will be an overnight success and will sell the company for €100 million a year down the line. Even if you are successful, that will take five to 10 years. But even in the unlikely event that you build a company worth a hundred million euro, and your investor has three per cent equity and therefore on paper are worth €3 million, it's actually very difficult for them to get that money out. There are two reasons for this:

1. Typically, you sign a shareholder's agreement making it very hard for investors to sell shares because the intention is you invest together and you go out together. So, the investors are in general only allowed to sell shares when all shareholders exit (during a trade-sale or IPO).
2. Even if there is permission to sell to outsiders it will be difficult to find outsiders who want to buy, because the market for unlisted shares is very limited. Your startup may

still be burning a lot of cash. Yes on paper it may be worth €100 million, but the only people actually willing to take that kind of risk are the VCs who are already investing. Your friends and family investors can't expect to easily find another friend or family investor who will pay €3 million to buy out their shares.

## VC-backed companies: how many years from when you invest until you exit?




Source: Basil Peters (www.basilpeters.com), based upon data from Jeffries Broadview, Dow Jones Venturesource

If you invest in a company that reaches for the skies and eventually secures venture capital funding, you might be lucky to get a really big exit, but you will also have to be invested in illiquid shares for many years!

The graph below shows an example where a company pursues several rounds of VC financing and the average time it take for founders and early-stage investors from creating or investing in the company until the VC-backed company eventually exits.

Of course it's just an example – your exit could come much faster even if you take VC money – but make sure your investors know what could happen.

Maybe they had a spare €200,000 they wanted to invest in you but they were planning to buy a house with some of that money five years from now. They won't be able to because even if you are successful, the chances of them getting the money out is very low. You will have to explain to them that the money they invest in you will very likely be lost. Alternatively, they won't see any return on their investment for at least 10 years.

### Key note: Startup shares are illiquid assets

Make sure your investors are fully aware that the shares in a startup are illiquid. The reality is that when you invest in a startup and it is successful, you need to wait for some kind of exit scenario, an IPO for example, before you can get your money out. Make your investors fully aware of that, and the potential problems this can create for them if they want to take their money out of the investment prematurely.

## Mistake 3: Taking money from people who can't afford to lose it

The third mistake founders make is to take money from people who really can't afford to lose it. They may have the money available and they could invest it in you, but if they do and they lose it, will they be able to lead the same lifestyle now and in the future? If they planned on using the money for their retirement fund and they can't travel as much as they'd like if they lose it, then they can't afford it.

My rule of thumb is to only take five per cent net of the investor's equity: if you have a potential investor who is worth a million euros, losing €50,000 is OK because they can continue their lifestyle even if they lose that money. And it's likely there won't be an impact on your friendship.

## Mistake 4: You take the money as a loan

The fourth mistake is when the founder accepts funding from friends or family in the form of a loan – say a standard loan with 10 per cent interest. Most private investors who have never operated with startups before think 10 per cent is high interest. Actually, considering the risk in a startup, it's way too low. For most early-stage startups a fair, risk-adjusted interest rate should be more than 50 per cent!

If you don't know if the interest rate you have set is fair, low or high, a quick test is to see if you could borrow the money from the bank at the same rate. If not, then you know you have set the interest rate too low. Of course, a low interest rate is OK if both parties know that, and that the low interest rate reflects that the loan should be seen more as a gift than a loan on commercial terms. The problem arises if they don't know that this is a low interest rate because you aren't giving them an upside.

Let's say your startup becomes the next Google, and the reason you become so successful is that your friend or family member lent you €100,000 that you repaid with interest and said thank you. When they see all the other investors who invested with equity become multi-millionaires and they only get their €100,000 back with interest they might be a little angry.

## Mistake 5: Too high valuation when taking equity

The final mistake founders make when raising money from their friends and family is getting too high a valuation. You might be surprised to hear you can get a too-high valuation, but the problem is your friends and family have never done this before. They don't know what is a fair valuation for your type of startup. They don't really understand the risk. So when you go to them with an offer of one per cent of your company for €200,000, they might think that's fine. Which is OK until the next funding round two years later, when the share price has fallen by 50 per cent even if you're very successful. Your friends and family investors might think you've cheated them. You can try to fix that by giving them more shares, but you still have the problem that they think they didn't get a fair valuation.

This is fine if they know it might happen, if they're looking to help you and accept that the money they provide is more of a gift than an investment. If not, you should try to overcome the problem with a convertible loan; a popular solution in the US but less so in Europe.

**Convertible loans.** A convertible loan is essentially a normal loan from a lender to your company, with typical interest of five to 10 per cent, but it also comes with an upside to the lender who can convert the loan into equity later on.

Convertible loans provide friends and family investors the right to convert the loan to equity at a discount compared to the share price set in later rounds.

Most often the two parties are too closely related to be able to actually negotiate terms (it's really hard to negotiate with one of your best friends). What you can do is agree that it's a loan and if the startup needs more funding, the lender will get a discount compared to later investors.

That way you may start by accepting a normal loan for €100,000. Later on, when a VC fund wants to invest €2 million at a per share of €100, that gives the lender the right to convert the loan into shares with a discount compared to the new funding round. That way you will avoid the problems associated with two amateurs negotiating a price for the shares based on not enough experience and too little information. The discount will typically end up in the 15 to 25 per cent range compared to the share price the new investor pays.

# Take-away points

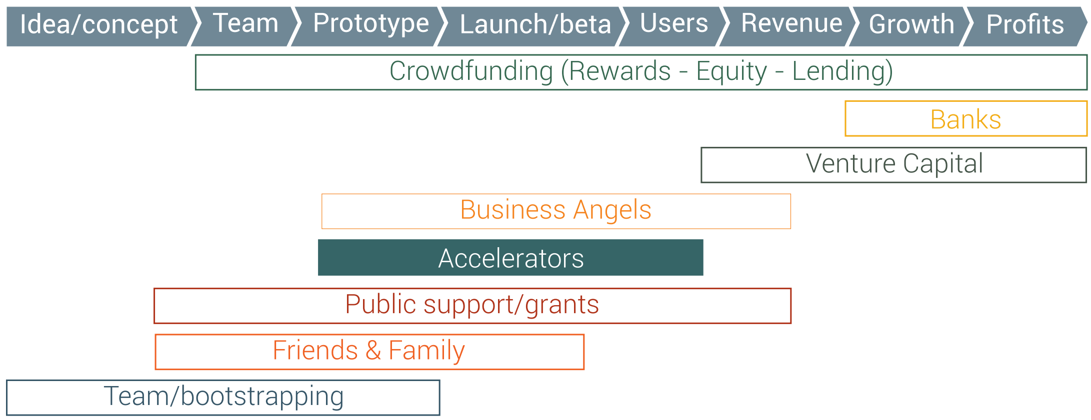
For most startups, friends and family are an important source of funding. If they trust you they are most willing to invest in you very early on. But there are many pitfalls and if not enough attention was paid to potential problems, broken relationships are the result.

Most non-professional investors don't really know if your business has a good chance of success or not, and they are blinded by your personal relationship. Think really hard before accepting funding from friends and family. Make sure they know the high risk and that they will have to wait 10 years or so for any return on their investment to be paid out.

Chapter 7:

# Startup Accelerators

*A startup accelerator might be the tool you need to advance your startup to the point you're able to attract other kinds of funding. In this chapter you will learn about the benefits and downsides of being accepted into an accelerator programme and what you should be aware of before applying.*




## What is a startup accelerator?

Accelerator programmes are essentially *startup factories*. They speed up the process of creating successful startups.

An accelerator is typically a three- to six-month programme involving intensive, on-site training and mentoring of the startups. As a startup, you are accepted into a cohort – much like being accepted into a business school – where you work with all the other startups that have been accepted, attend workshops on how to build your business, and receive mentoring from experienced entrepreneurs. You are working towards what is often called a *demo day* when a lot of influential people, VCs, investors and business angels will be present and each startup will showcase their project and how far along they are in the process.

## Accelerators vs. incubators

You may wonder what the difference is between an accelerator and incubator and for good reason because the differences aren't clear cut. Whilst accelerators are relatively new, incubators have been around for a while. Normally, you don't go to an incubator for just three to six months – it's essentially your workplace. Incubators build services on top of their office spaces to add value for the startups, which can include mentoring and workshops. But an incubator is typically less intensive, longer term and more focused on creating a good office environment than an accelerator. It helps you connect with other startups, but is still just an office with added benefits.

| | INCUBATOR | ACCELERATOR |
|---|---|---|
| Offering | Office space and shared admin. Mentoring in varying degrees | Teaching, networking, mentoring, help getting investors |
| Commitment from startups to join | Normally no specific requirements regarding work load | Most accelerators only accept startups where founders work full-time |
| Co-working space included | Yes | Yes |
| Term | No fixed term. Rent space often for a longer period of time | Startups accepted in 1-2 cohorts per year. Programme typically runs for 3-6 months |
| Payment | No equity. Rent office-space (sometimes offered for free) | Equity (3-8%), getting €10,000-50,000 in return |

Startup accelerators are a relatively new type of company (pioneered by Y Combinator in 2005 and TechStars in 2006) from the US. They have now spread all over the world and thousands of different startup accelerators are accepting startups in their cohorts.

The table below contains a selection of the most renowned accelerator programmes with active programmes in the EU. Many more accelerators are being created each month, and many of the famous US accelerators might have created EU programmes by the time you read this!

| NAME | WEBSITE |
|---|---|
| Tech Stars | http://www.techstars.com/ |
| Startupbootcamp | https://www.startupbootcamp.org/ |
| Seed Camp | http://seedcamp.com/ |
| 500 Startups | http://500.co/ |
| Mass Challenge | http://masschallenge.org/ |
| Accelerace | https://www.accelerace.dk/ |

## What's the business model of an accelerator?

How do accelerators make money? Some are financed partly or fully by public money, but the majority are private organisations. Privately-run accelerators provide you with a bit of cash – typically between €10,000 to €25,000 – mentoring and training, workshops and a small office.

And for that you pay three to eight per cent of your equity.

This is the real reason accelerators exist. Unlike some incubators, they don't want to make money on training or office space. They hope that among their students are the next DropBox or Airbnb, two of the most famous examples of companies that have participated in accelerator programmes and become big. The accelerators bank on owning five per cent of the next Dropbox.

**Key note: Accelerators behaving like small VCs**

The basic model of accelerators emerged because they thought they could make money by having five per cent of a hundred startups if a few became very successful. What the accelerators realised – like many business angels have – is that they also need their own funds, otherwise they quickly get diluted in the success stories. For example, they might have five per cent of the next Dropbox, but then along comes a big VC, and because the accelerator doesn't have money to invest, they suddenly find themselves owning one and not five per cent. Many accelerators are building up more funds so they can co-invest with VCs that come in later. Because of this, the distinction between accelerators and VC funds is becoming blurred.

## Why include accelerators in a book about funding?

You might wonder why we're discussing accelerators when the funding provided by them is so small. Such small amounts can often be raised from friends and family or business angels, and in most cases the cost will be less than what accelerators demand.

But the real value that accelerators can bring is not the initial funding they provide, but that the accelerators are the gateway to further financing after demo day.

Take as an example the statistics below from Startupbootcamp, one of the leading EU-based startup accelerators. Of the 345 companies that have participated in their accelerator programmes across the EU, 229 (73%) raised follow-on funding. The average funding raised per startup was €734,000.

Are these statistics biased in the sense the best accelerators can pick and choose among multiple startups so they therefore get the best ones – those that would have raised capital even if they didn't participate in the programme? Yes, most likely, but despite this bias there's the feeling that participating in accelerator programmes can have a large, positive impact on the startup's ability to raise follow-on funding.

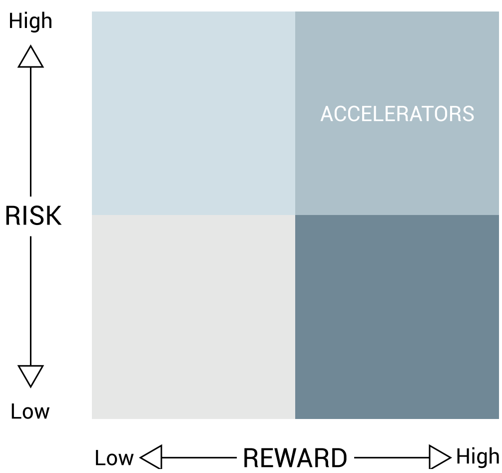
*Statistics from Startupbootcamp*

| | NUMBER | PERCENTAGE |
|---|---|---|
| Total Startups | 345 | |
| In Program | 32 | 9% |
| Graduated: | 313 | |
| – Active | 247 | 79% |
| – Acquired | 10 | 3% |
| – Folded | 56 | 18% |
| Graduated Funded | 229 | 73% |
| Avg. Raised per Startup | €734K | |

Source: https://www.startupbootcamp.org/

## When and what do accelerators invest in?

Typically, accelerators are interested in early-stage startups, roughly at the same stage as an early-stage business angel would invest. Since accelerators only give startups a small amount of money, they know they can't target startups that already are far into their development because they will never give five per cent of their company in return for €20,000.

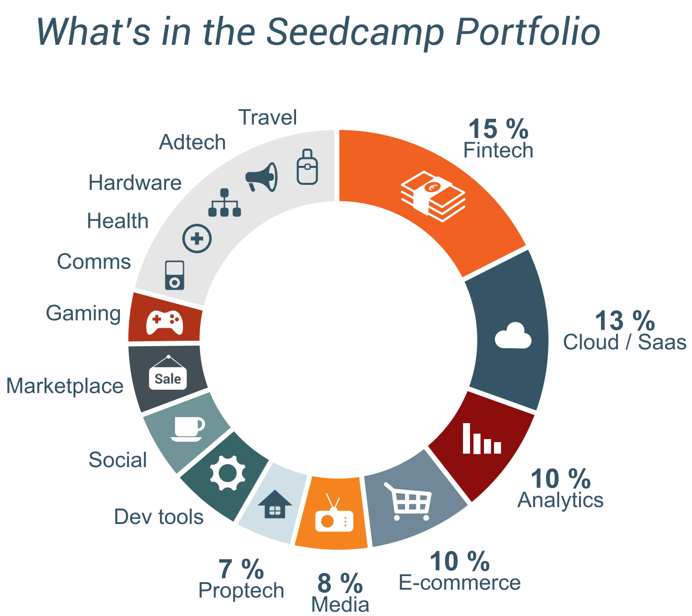


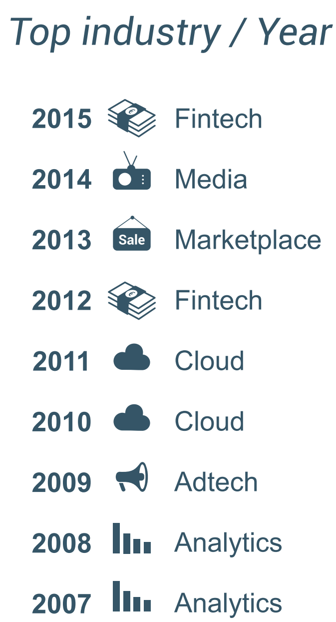
At the same time, accelerators aren't interested in just one person with an idea. As with early-stage business angels, to get accepted into an accelerator programme you need to have assembled a great team, have a good understanding of the market, have a problem to be solved (which you can show you know how to solve), and be able to provide evidence of the market. If you have a few users or customers already, that's a big plus.

Accelerators go for high risk/high reward startups. They are willing to take the same high risks as a VC fund, but unlike VCs – who are looking for a more mature company with a proven business model – accelerators go in much earlier because of the small-scale investment required.

They are on the lookout for candidates that can become big, very fast, because they own only about five per cent of that company. That's why most accelerators are looking for technology-based startups, especially within software, and to a lesser extent also hardware and health.

The graph below illustrates the portfolio of Seedcamp in terms of its different industry sectors, and also how the top industry sector has changed over time.




Source: Seedcamp

**Key note: Don't join an accelerator to get the money**

You should not consider joining an accelerator just to get your hands on €20,000. This money is basically provided to ensure you and your team have enough to survive on for the length of the programme. And the money will burn very fast because the accelerators expect you to relocate the team to the place where the programme takes place.

## What's the value to the startup?

Here are the three reasons you should consider an accelerator programme:

*Benefits of startup accelerators*


### 1. Learn the trade

One of the key benefits of being part of an accelerator programme is the opportunity to learn hands-on entrepreneurship from experienced mentors and peers. The value proposition of the accelerator is that whilst they maybe only have three or four full-time people employed, they have 50-plus senior mentors, some of whom are investors or serial entrepreneurs. These mentors host workshops and give free advice on how to build your company.

You can see the accelerator programme as an intensive training camp where you are doing the equivalent of a hands-on MBA in entrepreneurship with like-minded people. This is very valuable to first-time entrepreneurs but if you have already run four startups, you need to ask yourself if participating in an accelerator programme is worth it. Most likely it won't be. You have probably made all the mistakes necessary to have already learned what the mentors will teach you.

## 2. Access

If you're a first-time entrepreneur, you probably don't have access to 50 serial entrepreneurs or VCs you can talk to whenever you want. Connecting with successful entrepreneurs and VCs is one of the key benefits of an accelerator programme.

You become part of a community during the programme which provides the kind and level of access that would be difficult to achieve anywhere else. That's not to say you couldn't achieve this on your own, but we all know how busy investors and experienced entrepreneurs are. It's a lot easier when the accelerator has already invited them to spend an evening with you.

One of the key events during the accelerator programme is the 'investor night', where the accelerator makes sure hundreds of business angels and venture capital partners attend your presentation. Such attention is almost impossible to get for the average first-time entrepreneur, and is a major reason behind the very positive data on investments in companies that have participated in accelerator programmes.

## 3. The halo effect

The third value is in the kudos your startup might get by being part of an accelerator. This is only valid for the top accelerators worldwide and it's like a self-fulfilling prophecy. If you've been accepted into a great accelerator, you must be good so VCs and business angels will want to talk to you and give you their money.

You can see this 'brand' you get from the top accelerators as the startup version of getting an MBA from a top-tier business school like INSEAD. Do you become smarter/better through the teaching they provide? Most likely. But even if you don't, people will probably think you're smarter since you were accepted into INSEAD and therefore you have a higher chance of success.

There is little doubt that if you are a first-time entrepreneur and get accepted into one of the top accelerators, it will create value for you. Not only in terms of know-how or access, but the brand value alone of having graduated from Tech Stars or Y Combinator (for example) makes up for your time and the equity!

### Case study: Why 3DHubs joined an accelerator

3D HUBS

The 3DHubs platform connects people who want to make 3D prints with local 3D printer owners. Since its launch, 3DHubs has experienced a huge growth in users and connected print hubs (over ten thousand production locations in more than 140 countries), making them the world's largest network of 3D printers.

The initial idea for 3DHubs came to life in a conversation between two co-workers then working at 3D Systems; Bram de Zwart and Brain Garret. They realised there was an absence of infrastructure supporting the future promise of 3D printing. Bram and Brian quit their jobs early in 2013 and launched 3DHubs in the Netherlands and Belgium a few months later.

When 3DHubs launched, users joined the platform within the first week. Only a few months later it had grown to become the largest 3D printing platform in Europe. By this time, the startup had joined the Rockstart Accelerator and the huge traction quickly got the attention of investors who were connected to the accelerator programme.

Bram de Zwart explains: We got in touch with a lot of investors at the Rockstart Accelerator. The accelerator gets 400 applications and only admits 10 startups into the programme. This attracts a lot of investors since they save a lot of time and don't have to filter out the not so ambitious or untalented people.

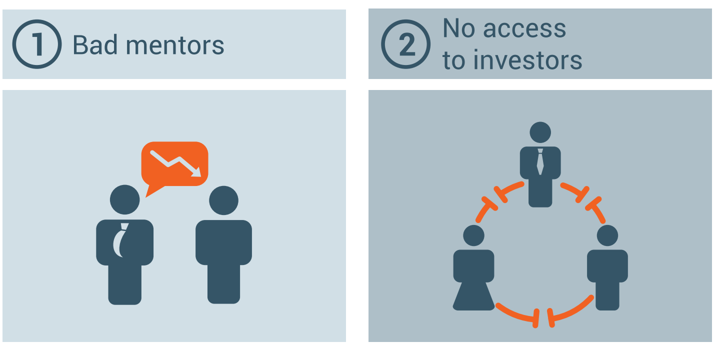
The huge investor interest soon turned into an initial seed round and was backed by two Dutch business angels and two micro VC funds. What happened was that we had already agreed on an investment with the Dutch investors when Balderton [VC] contacted us at the last moment and said they wanted to participate. Actually, it was so last minute I had to ask the Dutch investors if they were willing to decrease their size of investment so we could make some space for Balderton.

I think one of the best decisions we made was to apply for Rockstart Accelerator. Joining an accelerator can not only help to propel the development of your startup but also give you valuable access and exposure to potential investors.

## Downsides of being in an accelerator programme

Now that we've looked at what an accelerator programme can bring you, who they're looking for, and when they invest, let's look at the possible downsides.

*Downsides of startup accelerators*



### 1. Bad mentors

The first problem with an accelerator programme is bad mentors. Mentorship is the cornerstone of basically all accelerator programmes. The reason why only a handful of full-time accelerator employees can handle 10 to 15 startups per semester is down to the mentors associated with the accelerator.

## Advice from a former partner at an accelerator: Do your due diligence!

Lars Buch, former head of Startupbootcamp Mobile accelerator, explains:

One of the biggest mistakes startups make when applying to startup accelerators is not doing their own due diligence on the accelerator! The startups should validate the performance of the specific accelerator before spending time applying to it. The best accelerators openly share their performance data – survival rates of startups, how much investment the startups attract, employee growth rates, etc.

If the accelerator doesn't share this data the startup should think twice. If they're still interested, they should confront the accelerator and ask for the information directly. There are 2000 accelerators out there, and many don't provide the value startups hope for. By performing due diligence, startups can minimise the risk of wasting time, money and equity on an accelerator that doesn't work!

The problem is all accelerators basically chase the same small pool of mentors (ideally serial entrepreneurs and investors) with the right experience, track record and credibility for providing mentorship. But these people are often very busy and reluctant to spend their evenings with you since they have a huge deal flow already.

This point leads to another downside, which is the risk that the mentorship you will get from the average accelerator (not the top tier accelerators) is mainly from corporate people or advisors (consultants or accountants, for example) who see this as a way to get into the startup community and maybe invest time/money in a startup. They could well be honest people with good motives, but they could also be people who are bored at work or consultants who want to create a new deal flow, with little experience to share.

### Key note: Check out their mentors!

Check out the mentors of the accelerator you are considering applying to. Who are they? Have they created startups themselves? If possible, talk to startups that have already participated in the specific accelerator – what kind of mentorship did they receive? This isn't necessary if you're accepted into one of the top-tier accelerators where the mentors are very experienced. But it's essential if you're considering joining one of the hundreds of other accelerators out there.

## 2. No access to investors

The second potential downside is that you don't get access to the investors you were promised. With the exponential increase in the number of accelerator programmes, many don't have that access because the same 20 VCs or the same hundred business angels simply don't have time to connect and engage with each one.

If you participate in an accelerator programme that isn't top tier, you may not get access to the investors you hoped for because business angels and venture capitalists won't prioritise their participation in that particular accelerator's investor night. The fact you graduated from an average accelerator won't help you much either when you try to book meetings with investors. They simply won't believe your startup is any more interesting than the average one.

### Key note: Do they provide access to investors?

Check out the specific accelerator's ability to connect startups with investors. Ask for the investor statistics from past batches – how many of the startups raised follow-on funding? From whom did they raise it and how much? If the accelerator says they don't have the data or aren't willing to share it, this is a warning sign, perhaps even a red flag. A key part of the accelerator's value proposition is the ability to help startups attract follow-on funding!

# How do you get on an accelerator programme?

If you've decided that an accelerator programme is the right move for your startup, then how do you get accepted into an accelerator programme and which programme should you apply to?

## 1. What's right for you

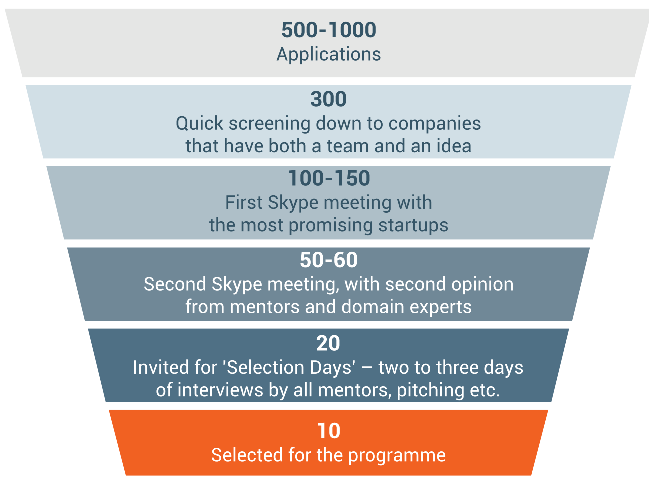
**Location –** The network and access you'll get will depend on your specific location. If you apply to an accelerator in Amsterdam, for example, there's a big chance the majority of the network and mentoring will be in the Netherlands, although there will also be people flying in from Western Europe.

You also need to think long-term. Why build a network in a city which you plan to move from afterwards? If you want to build your company in London it might not make sense to be in an Amsterdam-based accelerator because then you have to convince investors (who may be from Amsterdam) to invest in a London-based startup. It might be better to apply to accelerators where you will most likely build your startup afterwards.

**Broad versus specialised accelerators –** Is there a cluster for your industry that makes sense for you? Part of the trend with accelerators has been to become more specialised by providing accelerator programmes within specific niche industries. There could be accelerators for finance and technology companies, for medical companies, or for hardware companies. You should consider if it makes sense for you to apply to one of those because there is then a greater chance you will receive specialised advice you can use. If you're working with financial technology, it might make sense for you to place yourself in London, home to one of the biggest financial clusters in the world.

## 2. Application process

*Typical application process for startup accelerator*



All accelerators follow a formal application process where you fill in an online form with your details including your education and information about your team. Accelerators might ask for extra information (perhaps a video application), but the process is similar for most of them.

Of course, they can't meet and greet all 500 initial applicants. They want to quickly get from 500 to 100 candidates without interviewing them, and this is what the written application is for. Competition for places is fierce and you need to be prepared to allocate time and effort into making your application excellent. In my experience, accelerators only spend minutes per application deciding if it will be a 'yes' or 'no'.

The remaining hundred or so candidates will be subject to a more in-depth screening – perhaps a Skype interview to get a better sense of the people behind the startup. After that the field of candidates might have been reduced to 20 or 30. These will be invited to an in-person interview or to selection camps where the evaluators will spend a few hours or even a day with each team. Based on the results of the camp, the accelerator will choose the 10 or so candidates who will be invited into the programme.

## 3. How to come through the pre-screening process

I have interviewed a lot of the decision makers on these accelerator programmes and asked them what common mistakes they see startups make during the selection process. Here is what I learnt:

**1. Maturity.** The startup isn't mature enough. Because so many startups apply, those with only an idea to present will be discarded. Accelerators want to see projects and teams that can show evidence of what they can do and that they can do it. One person and an idea isn't enough; you'll get rejected right away. The simple fact you are one person gives a clear negative signal there must be something wrong; you are too early for the accelerator programme because you haven't got a team together, or something is wrong with your idea because nobody wants to join your team.

The accelerators (especially the top ones) can afford to be very picky and will want to see some validation of the maturity of the project, either on the market or the team side. On the market side, you might have a prototype or some users, on the team side you might have three or four cool people who have left great jobs to join you. Lesson here is: if you're too early or don't have a team, don't apply.

**2. No pain.** The accelerators feel you have an invented problem. There is no pain for the customers, so the problem you believe a lot of customers are having doesn't exist. When I asked accelerators how they decided whether they believed the problem existed, they frequently said it was both a gut feeling and also what they had seen in the past. Many of them are experienced and have already seen other applicants who've tried to solve a similar problem, and they've seen that the problem wasn't big enough.

It could also be that the niche is simply too small. Remember, they're looking for something that can attract VC funding and it has to be something they believe can be big one year from now.

**3. Lack of market understanding.** Accelerators receive and read hundreds of applications. If they have been operating for more than just a few years they might have seen many thousand startups applying to their programme. They know what's going on in the market; they know many of the startups in the US and Europe. They may hear a startup claim they're the first in the world to do something, but have seen three other startups already doing it. When startups claim something like this, it shows accelerators the people behind the startup have not done their homework. It's OK that there are other startups trying to solve the same problem, as long as you show how you're different.

**4. Way too far.** Some of the startups that apply are too far down the road to be of interest for an accelerator programme. If you've already taken part in an accelerator programme, or have already raised €500,000, you shouldn't be willing to give up eight per cent of your equity for €20,000. If you are, either there is something wrong and you know it, or there's something wrong and you don't yet know it. Either way it's a problem and you won't be selected.

**5. You're not serious.** This is about the sum of many small signs. If you're asked to make a video in the application process about your team and product and you don't make it, or no one in your team is working full-time at your startup, these are small signs that make the accelerator worried you are not serious. They want you to jump in now and show you're working day and night on your startup. Of course, you might need to have a part-time job as a bartender to pay the bills, but you need to show you really want this. If you don't put in the time necessary for making a killer application and a professional looking video to go with it, why should the accelerator believe you have what it takes to build a successful business?

**6. The financial part.** What accelerators are really afraid of is that you will run out of money halfway through the process. They know they are only providing you with €20,000 and so they need to see you have a run rate that is long enough. Accelerators know you won't be able to secure follow-on funding the day after the end-of-programme. They need to know you have enough money to last until an investor comes in, and they know this is not possible if your team is too big and/or has a too-high monthly burn rate.

## Advice from an accelerator: Be committed!

Cristobal Alonso is CEO of the startup accelerator Startup Wise Guys and has shared here what he believes is the biggest mistake startups make when applying to accelerators:

You shouldn't waste your time applying to a startup accelerator if you are not committed!

Many founders are applying to accelerators just to try their luck and are not fully committed to their startup. Some might have a good idea and background, but they're not ready to quit their day job and fully commit to their startup.

The whole idea with a startup accelerator is that you are fully dedicated to the startup and work full-time in the months where you are accepted into the accelerator. So don't waste your own time – and the time of the accelerators reviewing your application – if you don't really want to do it full-time! We *will* find out during the selection process!

### 4. How to get to the final 10

Startups that pass with flying colours on each of the above six points will be well on their way to become one of the hundred or so candidates who get through to the next round – and who may eventually become one of the selected 10 candidates.

Two factors stand out when it comes to making it all the way.

**The team.** Accelerators know it's all about the people and will ask themselves if your team has what it takes to be successful. They will use a mixture of tests and interviews to evaluate your team's skills and aptitudes. Do you have the formal skills? Do they trust you have what it takes? Do you indicate you can actively work together as a team? Are you willing to think long term on building agreements so you can kick out founders who don't perform? Are you fun to work with? You might be cool, you might have a great product, but if you appear difficult to get along with and collaborate with, you won't get through. The accelerator will also become your shareholder and knows if your personality is against you, it will be hard for you to get follow-on funding because it's all about people.

**The unfair advantage.** The second thing accelerators are looking for is what VCs call the 'unfair advantage', a unique feature of your business that isn't easily duplicated. There might be a customer problem that you're able to solve, but do you really have what it takes to resolve it? Are there clear indications that your approach, technology or software constitute a unique solution? Do potential investors really trust you have what it takes to be a global winner?

## Take-away points

Don't go to an accelerator for the small amounts of money they are investing themselves. The main role of accelerators, in a funding perspective, it to be a stepping-stone towards further financing from business angels and VCs.

Accelerators are looking for much the same in startups as VCs, but accelerators go in much earlier. However, don't make the common mistake of applying to an accelerator when you only have an idea. Go when you have a team and some kind of indication you have a solution for the customer problem you've identified.

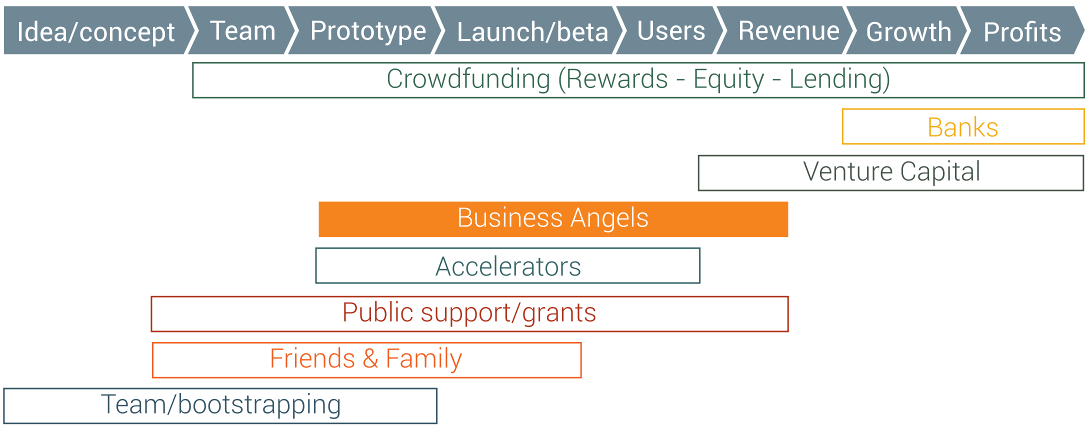
But before you do, evaluate the pros and cons – is the level of mentoring, training and access to investors enough value for you to give away your time and equity to an accelerator?

If it's of value to you, only apply to an accelerator programme if you have the time and interest to do it properly. Otherwise, you will only be accepted into third tier accelerators who might not be able to create the value you're looking for.

Chapter 8:

# Business Angels

*Who will invest in your company after you've bootstrapped? Many founders conclude that business angels (private investors who invest their own money in startups) are next. This is how business angels differ from VC funds that manage and invest other people's money. In this chapter we will investigate the best ways to catch a business angel and how to avoid the most common mistakes entrepreneurs make when looking for business angel investments in their company.*




## When do business angels invest?

Business angels are typically the first investors in startups and invest much earlier than venture capitalists. Unlike with venture capitalists, you don't need massive existing revenue or millions of users for getting a business angel interested in your company. However, most business angels don't invest when you only have a business idea in your head or down on paper in a business plan. They want you to have taken the first steps.

This is especially true for projects with a high degree of technology risk and still in the research and development phase. In many cases, the business angel doesn't have expert knowledge about your technology and will have a hard time evaluating risks. Therefore, many angels prefer not to invest when you are too far away from the market (typically more than a few months before launch) and haven't demonstrated your technology actually works.

### Case study: Franco Gianera - entrepreneur turned business angel

amazonbuyvip

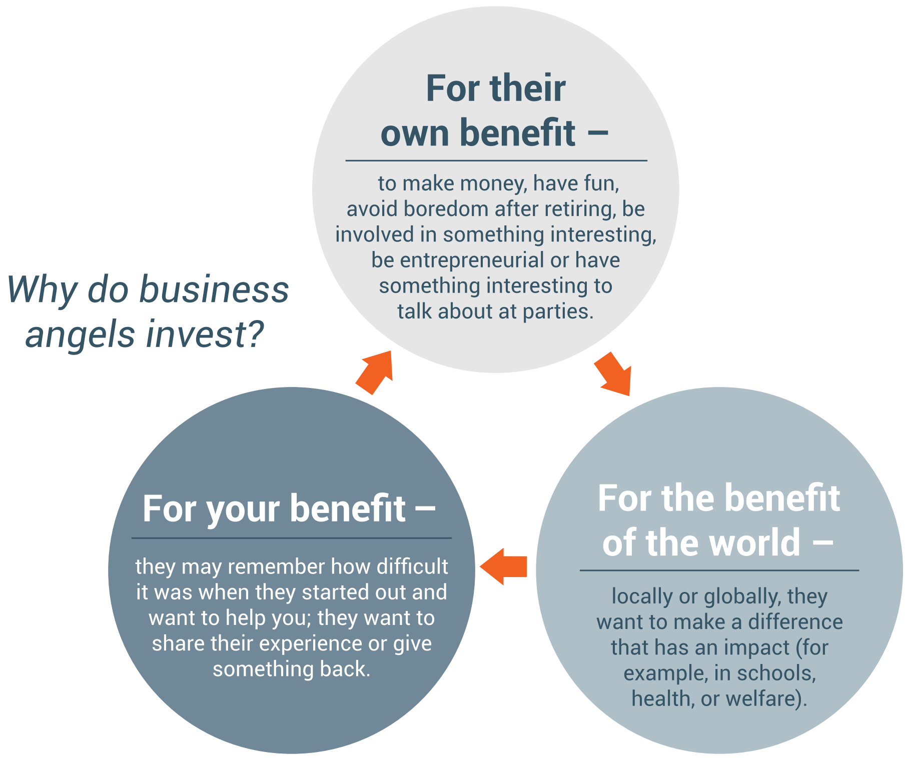
A former business consultant for Andersen, Franco Gianera left a CIO position at Adecco to follow his entrepreneurial dreams by co-founding Buy Vip (the Spanish premium clothing retailer bought by Amazon for €70 million in 2010). Today Franco works as an angel investor with investment into a variety of startups (for example, Smarto, Spotlime and Marchetti Atelier). He explains:

Throughout the course of my career, I have acquired a quite varied mix of competencies. Business consulting strengthened my managerial skills and while with Adecco I gained an international perspective and network. I now want to make the most of this wealth of experience, participating in the lives of tech startups that operate in sectors I know.

At this moment, I'm investing on a 'spot' basis: I select companies I like, with teams I like, operating in industries where I have some expertise. I also provide mentoring and advice. In the future my goal is to invest in a more structured way, but for now I invest on an ad-hoc basis when I meet interesting startups.

## Why do business angels invest?

The reason business angels are willing to take higher risks than other types of investors by investing earlier in the process can be explained by looking into the reasons they get involved in startups. This understanding will help you pitch your business proposal in the right way.



Here's an example. In one company I invested in, one of the business angels is worth €200 million. Why would a business person with a net worth of €200 million invest in a startup which only has the potential to earn them an additional €5 or €10 million? For most people (myself included) a €5 – 10 million profit would be a great reason to invest. But if you're already worth €200 million, you would easily make €10 million per year if you invest your equity passively in the stock market or other asset classes. So why invest in risky startups? Because the financial gains are not the real motivation for his investments in startups.

There are three main reasons for business angels to invest in startups and getting rich is rarely the main motivation.

## Business angel: Why do I invest in startups?

Tommy Andersen is a tech entrepreneur and business angel who has invested in early-stage startups within multiple industries. He explains:

So why do I invest in startups as a business angel? Well, primarily because I want to give back to the startup community and pay it forward. Of course, I also want to make a good deal and hope the company I invest in will become immensely successful and provide a solid return on my investment, but I know of the risk of investing in early-stage companies, and that I would most likely get a better return on investment if I invested in other assets. Angel-investing isn't for the faint of heart and I recognise that.

**Finding business angels for Recon Instruments**

When I helped Recon Instruments secure seed funding, I reached out to several potential business angels in my network. During that process, I targeted angels who had previously invested in tech startups and thus knew the risk of investing in an early-stage technology company like Recon Instruments.

This way, I could focus on those who were most willing to take risks, and not waste my time on angels who either don't invest in technology companies or only invest later when the company has a less risky profile. I also tried to target angels who had a personal interest in skiing. I assumed they would easily grasp the value proposition of Recon Instruments (ski-goggles with built-in heads-up display).

**Til:** 'Nicolaj Højer Nielsen'
**Emne:** RE: INSEAD - Recon Instruments (skiing + angel investment)

Dear Nicolaj

Looks fun and I hope potentially profitable. Please send me the exec summary.

Regards
Michael

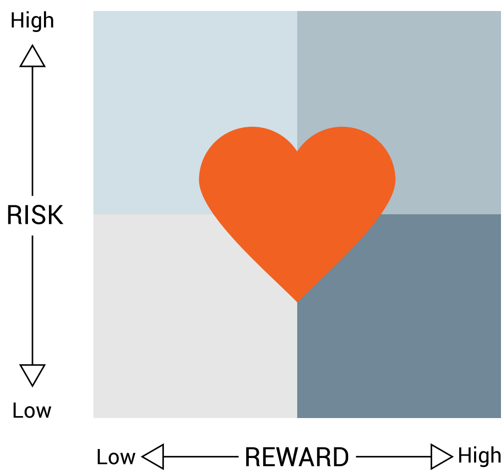
The response above from one such business angel sums up the thinking of many business angels when they evaluate investment opportunities: it has to be fun – and 'potentially profitable'. The message is this: you rarely convince a business angel to invest if you're only offering profit to them.

**Key note: Business angels don't only care about money!**

You need to understand why angels invest before you can get them to invest in you.

Most entrepreneurs, when seeking funding, make the mistake of thinking that business angels invest mainly to make money. Of course, that's one of their reasons but many business angels are rich already or know they could increase their wealth by investing on the stock market or in other asset classes (for example, land or property). You will increase your chance of a successful pitch to business angels if you understand why they're interested in startups – and it's rarely only for financial gain!

## What do business angels invest in?




So which type of investment cases are business angels looking for? Are they looking for the very high risk and high reward cases that can bring in hundreds of millions of euros just like VC funds?

No. Business angels invest all over the place, both in 'the next Google' and also in businesses perceived to be low risk/low reward. Some business angels even invest in cases where they believe the actual risk is far higher than the potential reward justifies (high risk/low reward), but they still want to invest for other reasons than the financial outcome.

# Different types of business angels

One reason why business angels invest so differently is that they are not a homogenous group but a very diverse mix of people with only their interest in investing in startups in common. Business angels are not just serial-entrepreneurs who have become multi-millionaires!

It's important for entrepreneurs looking for financing to understand the differences between the different groups of business angels, which is the reason they make investment decisions so differently from each other.

In simple terms, there are three types of business angels:

| | NEW ANGELS | BA NETWORKS | SUPER ANGELS |
|---|---|---|---|
| Role | Typically passive but often wants to be involved on an ad-hoc basis; you have the chance to get valuable know-how | Varies but one angel often acts as lead and is typically very active while other investors are more passive | Typically actively uses their own network and personal brand to help make the startup a success |
| Alone or in consortia | Usually invests alone but you can pool them together to reach your funding goal, e.g. use 3-5 different investors | Most prefer to make consortia with other angels from same network: spread risk, more power | Invest alone or with other investors they trust (both private and institutional investors) |
| Investment size | Typically, less than €50,000 per person per round | Varies, but a typical investment round comprises of €100,000-500,000 invested by 2-5 angels together | Varies, up to €1 million per company, but more often €100,000-250,000 per investment round |
| Industry focus | None, but much harder to convince investors if the technology is so specialised they don't understand the problem or solution | Varies, but normally at least one person in the consortia has the industry know-how necessary to convince them | Experienced entrepreneurs who typically invest in the same industries as those in which they made their own money |
| How to find them | Your extended network, i.e. friends of friends; typically don't consider themselves business angels but have equity from successful corporate careers or startups | BA network web pages; you can upload a deck and ask to pitch in front of the angels; better chance of success if you are introduced to one of the angels beforehand | Articles and public information on people who have built successful companies, and invested in startups; better to be introduced via mutual contacts |

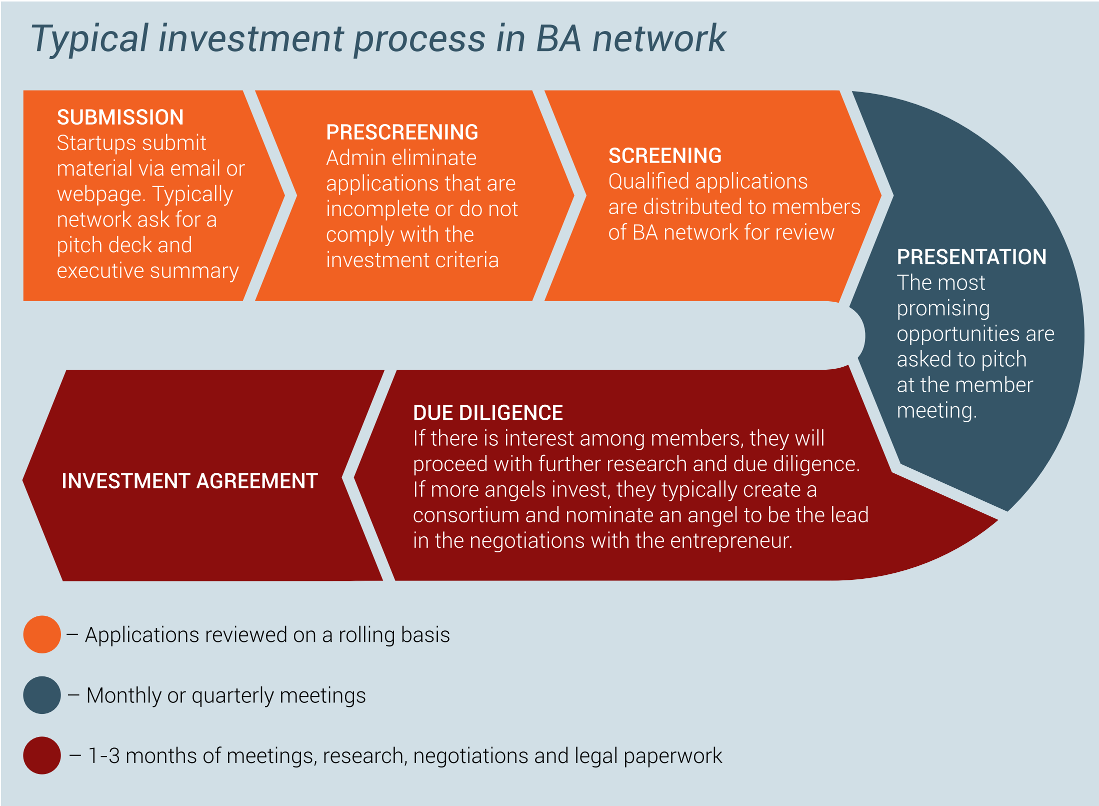
## Business angel networks

Some business angels prefer to invest in collaboration with other angels. This is called 'syndication' and is often done via business angel networks all over the world, where a group of angels meets informally on a regular basis to discuss potential investment opportunities.

So why do business angels prefer to invest together instead of alone?

*Why do business angels prefer to invest together?*


1. **It works as a deal aggregator.** By being part of a network the angel gets access to startups seeking capital outside their personal network and gets a number of investment opportunities with limited effort.
2. **The angel has limited funds.** One of the key differences between business angels and other types of investors is that the amount of money most angels have to invest is limited. Being part of a business angel network (and investing with other members) enables the angel to spread their investments over several different startups and mitigate some of the risks.
3. **More eyes on the same deal.** Angels (unlike venture capitalist funds) don't have a large team of people to help analyse the deal; they are most often alone. But by engaging in the business angel network they can discuss the potential deal with other members and co-invest with them, thereby limiting the perceived risk of investing in the company.




Business angel networks are made up of a broad range of people including senior executives, lawyers, accountants, bankers, entrepreneurs, and people with 'old money'. What they have in common is entrepreneurship and desire to invest some of their equity into startups.

They're likely to be looking for a good financial return of typically at least three to five times the money they invested if they're looking at an early-stage company. However for the majority of members they are honestly interested in s and the financial return is only a minor part of the reason they invest and are members.

Most of them are also experienced in business angel investments. They have done several deals (alone or in a network) and even if they haven't, they quickly learn the dos and don'ts from other network members. That's why entrepreneurs approaching members of these networks will quickly realise that negotiations with regards to investment terms and valuation can be relatively tough. These business angels bring a lot of experience to the table and know from other deals what a 'fair price' is.

To locate your local business angel network simply do a Google search in your local language for something like 'business angel network' AND the name of your country or city (if you live in a larger city). Alternatively, go to the website of the European Business Angel Association (www.eban.org) and search for members in your home country.

## Case study: How Spotlime got funded via an Italian business angel network

Francesco Rieppi explains how he used funding from a BA network to grow Spotlime, a mobile ticketing app for last-minute events in Milan, Italy:

In 2013 I worked in Berlin and I used to go back to Milan only once or twice a month. Having worked in Berlin on the case of an e-ticketing platform, I saw a huge, untapped potential in the Italian events sector due to its high unsold shares. After building a minimum viable product that scored a good conversion rate, I quit my job and flew back to Milan where I started to contact clubs and events managers and signed the first deals. In early 2014 the beta version of Spotlime was published on the app stores with a daily selection of the coolest events in Milan.

In 2014 we won a competition and joined the Mind The Bridge Startup School in San Francisco for three weeks. We never joined an accelerator programme in Italy and we didn't really need it. We were four co-founders with diverse backgrounds and complementary skills, ranging from marketing to design and computer engineering, so we covered all the skills needed to build and manage the platform.

Instead, we got a seed investment of €200.000 from IBAN (an association of Italian business angels) and one of the co-founders of Fastweb. At Spotlime we had cross-boundary skills and lots of experience in the ticketing business, which was crucial in getting funded by the angel investors. I think a good pitch matters more than any business plan at this early stage. You have to transmit your vision very clearly and 'sell' it to the investor, showing traction and the strength of the team.

### Super angels

Not all angels prefer to invest via formal business angel networks. This is especially true for the so-called 'super angels'. These are high net worth individuals who have typically earned their money via their own ventures (exits) and decided to invest a significant portion of their proceeds in new startups.

Some have investment as their main job (operating like a micro-VC fund), while others maintain jobs (often as CEOs of new startups) while operating as business angels on the side.

Super angels are different from typical angel network members in that:

1. They believe (often rightfully so) they have a huge deal flow directly via their own network so they have no need to source deals via business angel networks.
2. They often have relatively high net worth and are willing to fund the entire investment round themselves in early-stage startups. They don't see a need to syndicate via networks (if they want to syndicate, they often have huge professional networks they can co-invest with).
3. They often invest in the same industries in which they have made their own money. They know who to call to check the validity of a business idea or team. Many feel they don't need to get more eyes on the deal from the members of a business angel network. They are confident investors and can do the deals themselves.

## Case study: SimpleSite got a €2 million investment from a super angel

Business angel investments are often viewed as small and used to start the business almost from scratch. But you can also find business angels with much deeper pockets who invest later in the process. SimpleSite bootstrapped at first, and then after proving their business model, got a huge investment from a local super angel.

Morten Elk started SimpleSite in 2003 with the goal of offering easy web-building tools for micro-businesses. Its business model is the software as a service (SaaS) model, in which they advertise online and get clicks from interested users. Some of these create a free website and some eventually become paying subscribers. SimpleSite grew organically until 2012 when it had annual revenue of €4.5 million, 29 employees and a net early-stage of approximately zero (it invested all potential profits into future growth via online marketing).

Morten Elk explains their rationale for taking in a business angel as investor:

The key thing to understand about our business model is that we effectively 'buy' customers with a given lifetime value through marketing. To have profitable growth, we must, on average, pay less for the customers than the lifetime revenue they give us (minus variable costs, naturally). In 2012, it was clear we knew a few things very well:

1. We knew how to calculate the lifetime value (LTV) and acquisition costs per customer (CAC).

2. We were making very good business in a few markets and we had proved that by translating to more languages we could address more markets with exactly the same 'money machine'. So that was a tremendous growth opportunity.

3. We knew that to fully exploit that opportunity, we would need extra short-term funding to translate to more languages (a fixed investment) and start marketing in those markets.

We got in touch with a local investor, Kaare Danielsen, founder of Jobindex – the job advertising platform Kaare built from scratch that got listed on the Copenhagen Stock Exchange. I lived in the same student hall as Kaare when I was studying, but we'd never been closer than that. But we knew each other because we were both entrepreneurs living in Copenhagen and sometimes attended the same events. I was therefore comfortable reaching out to Kaare and started by pitching to him via email.

Kaare invested €2 million in SimpleSite; money that enabled us to get off the ground with international scaling much faster than if it had been self-funded, and enabled us to grow the business from €4.5 million in revenue in 2012 to close to €10 million in 2016.

I believe Kaare only dared to invest such a large amount because we knew our business model and metrics extremely well, and the funding was clearly to be used for a non-speculative scaling of a model with known metrics, performance and profitability.

From the investor point of view, that obviously lowers risk and makes it easier for the startup to close funding on comfortable terms. So although not all funding-seeking businesses can obtain the kind of clarity about metrics and business model we had, it really helps if you can.

## New Angels

One of the biggest mistakes founders make when looking for business angel financing is to only focus their attention on angels who invest via business angel networks, and the super angels they know from the media (and TV shows like *Dragon's Den*). What they miss is an important group of business angels – the group I call 'new angels'.

New angels are people who don't perceive themselves as business angels and are therefore not members of business angel networks or other trade associations. Most of them don't advertise themselves as 'investors' but are interested in entrepreneurship and make early-stage investments just like other business angels.