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Opportunity and Risk Reduction: The Startup Two-Step

Most entrepreneurs really enjoy talking about the prodigious opportunity at the end of their startup's rainbow. The reward side of the high-risk/reward equation. And that's good, to a point. The point at which the prospective investor buys into the reality of the opportunity and the entrepreneur's team for capturing it. Unfortunately, it's not a point at which most prospective investors are willing to write a check.

Persuading a prospective investor of your startup's opportunity is a first step in the selling process. The next step – the closing step – is all about the far less well-appreciated risk side of the high-risk/reward equation. Too many entrepreneurs get so caught up in the excitement around the nature and extent of their opportunity that they neglect the equally – and often much more complex – risks half of the equation. More specifically, they fail to see and efficiently account for how risk reduction fits into their financial plans.

Investors, on the other hand, are by nature more sensitive to the risk part of the equation. Having bought into a startup's opportunity, they need to know as well what the risks of capturing that opportunity are. And they want to know how, when, and at what cost the entrepreneurial team plans on dealing with those risks.

Recognizing how high the risks of a particular startup is, and what those risks are, is the beginning, not the end, of understanding risk in the case of startup investment analysis. The end point is constructing an investor-satisfying risk mitigation plan that tackles the applicable risks in a stepwise fashion consistent with a compelling investment plan. Startup risk analysis, from an investment perspective, is thus about determining the most equity-efficient (least dilutive) steps for reducing risk over one or more financing rounds.

If the above is too conceptual, think of it like this. At each financing round, the key question – assuming the investor buys into the opportunity piece of the story – is how much capital and time are needed to achieve the next big risk

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reduction milestones. Very roughly speaking, the current financing need is tied to specific milestones the accomplishment of which will take the biggest bite of risk out of the equation for the least investment and thus add the most equity value with the least dilution before the next dose of risk capital is required.

Let's consider an example. John Doe (bus/marketing) and Jane Doe (programmer – no relation) met at a local entrepreneur hotspot and came up with an idea for a web app (let's call it the Widget App) to solve a problem for hair salon owners. They figure (reasonably, if almost certainly incorrectly – that is a different topic) that they will need $3 million to get from launch, to an estimated $40 million exit (also reasonable, if likely incorrect). How much should they pitch for now?

The simple answer is $3 million. Of course, nothing is simple in high-risk/reward entrepreneurship, and $3 million is also the wrong answer. That's because at this stage of the startup – the starting line – the risk is as high as it will ever be, which means the valuation is as low as it will ever be. Which means the dilution associated with taking $3 million in the first financing would be enormous – indeed, on these numbers almost certainly prohibitive (for the entrepreneurs and the investors). (For a quick and very simple refresher on startup valuation, see "Startup Valuation on the Back of an Envelope."

With the simple "all of the capital needed to exit" answer ruled out, how should Jane and John calculate how much risk capital to look for in their first round? I'll cut to the chase, and then come back with some reasoning.

Jane and John should seek a number that gives them enough capital to get them to the point where they have a solid working prototype of their Widget App that at least one target customer is willing to pay some meaningful price for. And then add say 50% to that number. (The extra is for (i) insurance (entrepreneurs usually underestimate the time and expense of hitting their milestones) and (ii) having a little cash left when the milestones are achieved will leave them in a stronger position to raise the next round. As Gene Kleiner once told me – and doubtless many others – the time to eat the appetizers is when they are being passed around.) Let's say that number, including the rainy day portion, comes to $500,000. That's their first round ask.

The rational here is that these milestones are relatively inexpensive even as they take an enormous amount of risk out of the deal. When these milestones are achieved, Jane and John will have established that they can work as a team under time and financial pressure; and that they can produce something that a real customer will pay some meaningful price for. While the remaining risk to exit is still very significant, it is probably only half of what it was before those milestones were achieved. That means that when they go out for the next round of financing – a project that will include the same risk reduction analysis – they should be able to raise that round at a valuation at least 2-3x the post-money first round valuation.

And so it goes. At each financing round, Jane and John should figure out what milestones would add the most value (by reducing the most risk) for the smallest relative amount of capital, add a rainy day cushion to it and voila, they have their ask for the round.

Now, a few caveats.

First, and as alluded to earlier, it is the very rare startup where the pre-launch planning ends up looking anything like the after-exit action report. There are just too many variables, internal, external, and mixed, for a pre-launch plan to be anything but a half-decent but almost certainly incorrect guess about the future. Still, you have to start somewhere, and the most basic analysis says that somewhere is almost always a place well-short of the estimated total risk capital need to exit.

Next, the focus on risk reduction milestones as the key metric for determining current round financing needs does not mean that investor attitudes (existing and prospective) towards the scale/nature/feasibility of the opportunity are not important. They certainly are, and they will no doubt evolve – for better or worse – over the course of the journey from launch to exit. The point is not that opportunity is fixed in the risk reduction approach to financing needs, the point is that buying into the opportunity is the pre-requisite for an investor having any possible interest in making an investment at any particular point. The tough work – figuring out the optimal risk-reduction-driven financing model from that point – comes after the investor bites on the opportunity.

Finally, while it would be nice if there was one reasonably obvious, accurate and precise answer to the risk mitigation approach to raising a round of risk capital, there almost never is. In fact, the task is as much art as science, both in terms of defining the milestones and figuring out the capital and time needed to achieve them. In my own experience, there are often multiple plausible answers, and the choice sometimes comes down to raising one flag and, if no one salutes, having another flag to try in your back pocket. And, of course, market conditions play a role: in hotter markets (markets where “too much capital is chasing too few deals”) entrepreneurs will likely be more aggressive, seeking more capital at higher prices than in softer markets.

Raising risk capital almost always starts with selling prospective investors on a startup’s opportunity, including the feasibility of the startup capturing it, as well as the scope. The hard work, though, and the work that on the one hand leads to positive investment decisions, and on the other captures the most of that opportunity for the entrepreneurial team, is about figuring out how to reduce risk stepwise in the most capital efficient chunks.

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