VentureBest

February 11, 2020

Managing Financing Risk: The Big Picture

Historically the “big three” risk axis in venture investing have been Team, Market, and Technology. There’s a fourth critical risk – financing risk - that’s too often overlooked. That’s unfortunate, as with some thoughtful and recurrent planning financing risk can be managed.

Financing risk not the risk of running out of capital as such, or even the risk of having to raise capital on less than favorable terms. While running out of money is the immediate cause of death for most failed startups, in most cases it happens on account of shortcomings on one or more of the Team, Market, and Technology risk axes. In those cases, running out of money, or having to raise it on sub-optimal terms, is a symptom of other problems, not the root cause of the startup’s problem.

Financing risk manifests itself when a startup hits the cash wall because its financial planning wasn’t up to snuff. Put differently, it is when a company fails, or finds itself forced to accept a bad deal in a capital raise, not because of issues on the Team, Market, or Technology axes, but because of flawed financial planning.

Financing risk is usually rooted in sloppy/lazy thinking about a startup’s financial model. Everyone understands the critical role of the business model in startup planning. A startup with the proverbial better mousetrap won’t go very far without a solid end-to-end business model for producing its trap and connecting it with the right markets efficiently. Similarly, a startup will likely founder on the shoals of financial risk if it doesn’t have a sound financial model.

Too many entrepreneurs think about capital needs in terms of time (runway) rather than accomplishments (gaining altitude). They confuse survival-oriented financial fire drills with strategic financial planning. The strategy, in this case, being the careful construction of a financial model that supports and compliments the business model. Startups fail on the finance axis when their financial model doesn’t adequately reflect their business model.

Related Practices

Fund
Grow
Sell
Start
Venture Capital & Private Equity

© Copyright 2018 Venture Best

Aligning the business model with a complimentary financial model can be difficult; sometimes even impossible. It's a balancing act, where a business model that wants to be about opportunity maximization is set against a financial model that must reflect financial realities around access to, and required returns on, capital. So, for example, while a startup's idea may lend itself, in business model terms, to Unicorn-like business success, that possibility has to be measured against the particular startup's prospects for timely raising Unicorn-like sums of risk capital.

There is a Yin/Yang dynamic about business and financial models. It's a much more complex relationship than simply adding to one and subtracting from the other. In addition, it usually evolves over time. Changing circumstances, indigenous, and endogenous to the startup, are constantly shuffling the deck, so to speak, and entrepreneurs need to revisit the business/financial model duality regularly.

Business and financial models are optimally aligned when the buildout of the business model – in terms of risk-reduction milestones on the one hand, and opportunity-maximization milestones on the other hand – best reflects the startup's likely access to risk (and other) capital resources, in terms of both timing and magnitude. As I've talked about before, as much as investors want to maximize their returns, once in a deal they tend to think of individual investment opportunities along the way more in terms of risk reduction: I discuss this in my earlier post Opportunity and Risk Reduction: The Startup Two-Step.

Next time, a look at some of the tools for developing and refining the Yin/Yang of the business and financial models.

Related People

Paul Jones
Of Counsel
pajones@michaelbest.com
T 608.283.0125

Paul Jones
Of Counsel
pajones@michaelbest.com
T 608.283.0125

© Copyright 2018 Venture Best