

The Hot Startup

or

Characteristics of Early Stage Companies that Attract Outside Investors

James L. Woodward

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Jim has been an early team member and CxO of eight successful startups, each of which returned more than a million dollars to its stakeholders. The eight startups, before and after sale, have had revenues of close to a billion dollars. His current positions include CFO of Zeetoo and Director of InBoxer.

He has been active in the MIT Enterprise Forum since 1980, holding a wide variety of positions including Chair. He writes a monthly column on startup issues for the Forum Reporter which is available at the Forum website.

He is a member of the Launchpad Angel Group, is Chair of the Audit Committee of the Episcopal Diocese of Massachusetts, and is on the Finance Committee of the Massachusetts Council of Churches. He has an MBA with Distinction from Harvard and a BA from Cornell.

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October 2, 2007

What You're up Against

One Angel Group's Annual Numbers

- 600 Plans received– 450 rejected quickly - bad geography or industry
- 150 Reviewed by Screening Committee - 22 chosen for presentation
- 22 Make presentation, twelve turned down for variety of reasons
- 10 Into Due Diligence - five fail, usually too narrow a team
- 5 Acceptable, one wants too high a value or other unacceptable terms
- 4 Funded

I Look Hard At:

- Team. Is the team consistent with its vision?
- Plan. Is the plan for the business coherent?
- Market. Is it just right – not too big and too small?
- Gross margin. Can this be a profitable company?
- Barriers to entry. Why will others fail in this market?
- But not the technology – I take it for granted.

Team

- If you're going up against Google or going to change the way everyone's medical records are kept, you'd better be Hall of Fame players.
- If you plan on owning a \$50MM market, the standard is lower, but you'd better know the market.

The CEO

- Good CEOs hire B+ subordinates; great CEOs recruit A+ colleagues. The quality of the #2 player is the best indicator of the quality of the CEO.
- Must have proven leadership skills.
- Must be in charge – no ambiguity at the top.
- Must be accomplished presenter, as he or she will be selling to investors, customers, employees, and others for the life of the company.

The Supporting Cast

- A CTO, usually not the CEO – CEO and CTO are both full time jobs – must be able to manage the tech team as the company grows.
- Marketing skills, to figure out what the world really wants.
- Someone who can sell; this might be the CEO
- A CFO if and only if financially complex.
- Manufacturing skills if it's an issue and particularly if it's going to be sourced overseas.
- A hole in the team is not a problem, if there's a plan for filling it.

Real World Experience

- Five MIT PhDs don't make a team.
- Neither do three software geeks with a Web 2.0 demo site running.
- While industry experience is not always essential, don't pitch me a health care startup unless you have serious health care experience.

The Plan

- Don't need a **Business Plan**.
- Absolutely must have a plan.
All the Founders must agree with it.
- A few selling documents are good
 - A lot of PowerPoint slides
 - A one page summary

The Numbers

- Investors want 50% per annum on their \$\$
- In five years, this is 10 times what they put in.
- Since the Founders also want a return, at exit the company must be worth +/- 20 times the total investment required.
- The total market, therefore, ought to be 50-100 times the investment.
- Dominance of a \$20MM market is great if \$500,000 will get you there.

Gross Margin

- Profits are nice, but can come later. Gross margin is essential, as without it, you can't make money.
- 50% GM is a minimum, 60% better.
- Anything over 80% has me wondering whether you understand numbers – even Microsoft makes only 86% and in many cases it has no physical deliverable.

The Rest of the Numbers

- I don't believe them and don't care much.
- Profits more than 20% make you look naive and increase my disbelief
 - Very few companies make profits over 20%
 - Even if you could, you'd spend the money on growth, not accumulating cash.
- Despite this sage and logical reasoning, more than 2/3 of the plans I see show profits above 50%.

Barriers to Entry

- Why are *YOU* going to win in this market?
- What will keep the bad guys, well established and better funded – a thousand times better funded – out?
- Patents are nice, but may be just paper.
- Patents applied for are not always convincing.

Crucial Question: Who's Buying and Who's Selling

- Richard Santos
- VP Sales and Marketing
- Iris Graphics, 1985

Suggested Reading

- *Business Plans that Win \$\$\$* -- Stan Rich
- *Crossing the Chasm and Dealing With Darwin* -- Geoffrey Moore
- *Let's Get Real or Let's Not Play* -- Mahan Khalsa
- *Entrepreneurship for the Nineties* -- Gordon B. Baty
- *Growing a Business* -- Paul Hawken
- *Everyday Negotiation* -- Deborah Kolb
- *Speak Like A CEO* -- Suzanne Bates
- *Built to Last* -- Jim Collins
- www.smallbizresource.com
- www.mitforumcambridge.org/knowledge/editorindex.html