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Business insights from Dave Berkus

Could you answer these tough investor questions?

Posted on December 19, 2013 by Dave Berkus

By: Arthur Lipper

In the process of raising funds to create and develop a business, entrepreneurs make many statements to those they seek to attract as investors. In my years of investing, I've developed a set of tough questions that are sure to elicit both information and a vibrant dialog – questions not on the usual checklists of angel groups or investors. So here are a number of them. Can you answer these? If not, isn't it worth the work to prepare for the time you'll be asked some or many of these? And isn't it worth the effort for your own good as you build for success?

If you are an investor in an early stage venture, wouldn't a dialog using these questions help greatly in defining and perhaps reducing your risk?

Revenue projections: What will happen to the company if the revenues and earnings projected on a worst case basis are not achieved as predicted? When will the company run out of money if the development of the enterprise is at a slower rate than expected? How much skin do you and your fellow founders have in the game? In a liquidation, would you have profited at the expense of your investors by taking high salary or draws before breakeven?

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Liquidity event: Name at least five companies that might be ready to acquire the enterprise if successful. On the flip side of success, which companies or individuals are most likely to want to buy whatever is left of the company if it is unsuccessful?

[Email readers, continue here…] *Metrics and management:* What might be the first indication the company will not be able to achieve its goals and objectives? When and under what conditions should the CEO and management of the company be changed?

Valuation and fund-raising: How did you arrive at your proposed pre-money valuation? Has this been tested with investors? Who else has been approached to provide funds? What will the proposed managers of the enterprise do if the project does not proceed?*Management experience and skin-in-the-game:* What has been the experience of the founders and managers in past ventures? Will you and your managers plan to invest cash on the same terms and conditions as you ask? Would you and your managers invest funds, if loaned to them by the investor or others, in the enterprise on the same terms and conditions as is being proposed to the investor?

Profit potential: What is the proportionate profit potential relative to cash investment between the investor(s) and the managers in the event the business is as successful as is predicted? What is the single most important event you expect to foresee for success, and what will happen if it does not occur when anticipated?

As most human endeavors fail to achieve the results originally hoped for the above questions are fair and reasonable – because your angel investor is being asked to accept your forecasts and event predictions to entice him or her to invest in your enterprise.

Arthur Lipper has been a well-respected member of the international financial community since 1954. He has served as advisor to and member of numerous financial exchanges, and was the founder and CEO of Arthur Lipper Corporation and co-founder and Chairman of New York & Foreign Securities Corporation. Today he serves as Chairman of British Far East Holdings Ltd. He has written numerous books and articles for entrepreneurs and investors, and was the publisher and editor-in-chief of Venture Magazine.

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6 Responses to *Could you answer these tough investor questions?*

Harry Keller *says:*
December 24, 2013 at 9:18 am

These are good questions. How will they change for a company that is in revenue without having any investors yet? What if the company has already gone through profit, followed by loss, and achieved even greater profit through lots of grit and determination? Is a previous offer to buy the company a good basis for valuation?

Almost always, new companies have to change strategies in response to unexpected market events. Even old companies have to do this or fail (e.g. Digital Equipment Corporation). The smaller the company, the easier to adapt.

Fortunately for me, I can readily answer the questions. Also, I'm fortunate in not needed money to survive and grow but rather to grow much, much faster. We get to pick our investing partners. If you have a new business, try to get to that position before giving away a chunk of your company.

Dan Hoefflin *says:*
December 24, 2013 at 9:37 am

What great, succinct questions! Thanks, Dave, for your continuous contributions to the entrepreneur!

Arthur Lipper *says:*
December 24, 2013 at 9:54 am

In the financing of growth royalties can be used to avoid equity dilution. Royalties can be paid on a segment of revenues such as revenue increases over an agreed level or on sales in defined geographic areas or on specific products offered by the company.

Owners should remember that royalty payments are tax deductible to the royalty issuer and are ordinary income to the recipient after recapture of investment.

Businesses are worth what buyers will pay and therefore owners should be aware of the valuations being placed by investors on comparable businesses.

Michael North *says:*

December 24, 2013 at 10:58 am

This article contains useful suggestions for the “Risk Assessment” section of a business plan — a section that is often understated, lacking force and detail compared to the upbeat narrative of the rest of the plan.

The ability to think in detail about the negative scenarios, and respond to them on his feet without resistance, is one mark of a potentially capable entrepreneur.

Arthur Lipper *says:*

December 24, 2013 at 3:44 pm

If a business owner asks “What will $5.0 million cost me over 20 years if a 5 year loan is at 12% and a 15 year royalty at 1% of revenues commences on the loan repayment?”, the answer can be found by entering the likely revenues for the 20 year period at http://www.REXdebt-shareRoyalties.com. If projecting specific revenues is difficult just put in as many years as you can project and then use the CAGR feature by entering a Compound Annual Growth Rate of revenues for the years which are past the projected years.

The debt feature should make the capital raising much easier for business owners.

Mark Weyman *says:*

January 7, 2014 at 4:06 pm

Two things I learned. First, you never make money working for someone else. Second, all “partnerships” tend to end badly.
