

Successful Early Stage Funding
The Secret Sauce for Obtaining the Highly Sought-After, Yet Elusive,
First Institutional Investment

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The Greater DC region has many funding sources for early-stage companies – from R&D grants to institutional venture capital and everything in between. And, on the surface, the current funding market looks spectacular for in-region, early stage companies. In Q1 2006, 50% of in-region, new funding deals were first-time financings with \$91 million invested into those companies. In Q2 2006, 26% of the deals were first-time financings with \$118 million invested. Entrepreneurs see that \$200 million going into first round investments for the first half of 2006 and suddenly believe they too should get funded. The answer is: maybe – if the company can conquer the first meetings, withstand intense levels of due diligence, has a great management team, and can negotiate acceptable financial terms.

We have worked with hundreds of entrepreneurs who want to create the next new thing in technology. The vast majority are seeking their first institutional funds. They have the entrepreneurial bug, and raising millions of dollars will auto-magically make all their dreams come true.

In reality, running and growing a young company doing new and wondrous things is a hazardous exercise. Only people who bring lots of nerve, passion, leadership skills, and a love of extreme risk should really attempt it. Author John Nesheim in his seminal book, *High Tech Start-Up*, quantifies the early-stage challenge: historically, only one in ten new companies seeking capital actually gets funded, and, of those ten, only one or two will pay off handsomely for investors and employees.

The Secret Sauce of Early Stage Funding

What's the secret sauce for obtaining early stage funding? In truth, the secret sauce contains many ingredients. In somewhat prioritized order, here they are:

- **People, People, People** – Every early stage company has a great team that should include a CEO who can manage and evangelize to the market, one or more senior technologists who can build excellent products, and one or more sales executives who can successfully put products in the hands of customers that can pay for it. Deeper technical, marketing, and financial capabilities can be built post-funding, but investors love to see a core team that delivers vision, products, and sales.
- **A large overall market (with a clear initial market)** – Large markets drive investor meetings, because large markets mean rapid revenue growth, lots of analyst coverage, broad customer adoption, and successful liquidity events. A smart, early stage company knows

what market segments it wants to attack in what order and can clearly articulate this to investors.

- **Products that provide the trifecta: Create unfair advantage, serve as pain killers for customer issues, and can scale rapidly** – It's a cliché, but investors do really want the next new thing in three ways:
 1. Investors want to believe that new products that come to market will be unique for 12 to 24 months and that these products can be used as the basis for more products down the line.
 2. Investors love products that are “pain killers” – and not products that are vitamins. Pain killer products solve big problems for customers, and their effect can be measured in products. Vitamin products make companies feel good – and maybe even make them healthier – but don't produce quantifiable results.
 3. Investors love products that scale. Scaling can mean many things: The product can serve many users simultaneously at a reasonable operating cost; the product can be sold effectively by a reasonably well-trained sales force; or the product can be installed by a relatively low number of people in a reasonable time period.
- **Early customer traction** – The early stage, institutional investor of the mid- to late-1990s that invested in a team and dream no longer exists – at least in the greater DC region. Investors want to see customer validation before a \$2+ million round goes into a company. Traction doesn't necessarily have to be a signed and installed deal, but it does have to be something that commits customers to the product – a Beta test or an LOI, for example.

Lastly, investors want to put their funds into companies that feel **real** and have a **low risk profile**. **Real and low risk** mean that investors can imagine certain tangible events will occur over time:

1. Management will be able to grow and morph the company into a market leader.
2. The initial product will lead to a series of products and not be condensed into a feature set that is part of products in a related market category.
3. Revenues will become predictable, so that the company won't depend on a low number of huge sales to sustain growth.
4. Most importantly, investors can imagine making a great return on investment at the end of the day.

Remember the Nesheim rule of investment: 100 companies seek funding – 10 get funded – 1 hits a financial home run. As an entrepreneur, your first swing at the market is to convince investors that you are that 1 in 100.