

The three sources of finance

Chris West & Mike Southon
May 2006

The three sources of finance

When writing a business plan to raise capital, you must consider the nature of the potential funder. Obvious, you might say, but much of the advice provided on business plans overlooks this, and goes for a generic model of ‘good’ business planning. The first lesson in any good communications course is to think of the audience – this should also be the starting point for advice on how to produce a business plan.

The three basic types of capital provider – banks, business angels and VCs – all have very different agendas.

Banks seek to make a margin on the interest they receive. Though they would love you to become the next Microsoft, their main issue is protecting their capital. As a result, their main concerns are with financials and security.

Angels and VCs are both investing for capital gain. But they have differing perspectives, too. Angels often want to be involved in the businesses they invest in, while VCs tend to regard involvement as a cost. Angels want fun as well as their money; VCs aren’t known for their wacky, fun approach to business.

Pitches to banks are often got totally wrong with entrepreneurs enthusing about products and aiming to show how committed they are, when the bank really wants to see numbers. Get a finance cornerstone as quickly as possible; make sure they play a major role in writing the plan and present it with you to the bank.

Passionate entrepreneur pitches are much more suited to angels, who are more likely to make a decision based on gut feeling. Personal chemistry plays a major role in business angel investment. Talk up the character and achievements of the entrepreneur and the key team members. If you can, personalize your business plan. What specific skills does the angel you are approaching bring to the party? Your pitch is an opportunity to be honest and say, yes, we’re weak in this area, which is why we need your skills, contacts (etc.). Financials? Get them as good as you can, of course, but angels are often sceptical about financials in business plans.

VCs will expect solid financials – companies ready for VC investment must have a finance cornerstone, and should probably have had one for a while. VCs will be looking for a well-rounded management team, rather than ‘star’ entrepreneurs. Above all, they want quick growth, and will be eagle-eyed for that potential. They want a strong market case and a clear strategy, as they will be expecting to hit a large, expanding, global market quickly.

We have recently read a fascinating paper by Strathclyde University’s Professor Colin Mason and Matthew Stark from Tenon Group. They made comments similar to the above, but also observed various capital sources being pitched to by various entrepreneurs, and noted how much time the former spent on different subjects. While their results do not ‘prove’ any of the above observations, they certainly highlight them.

The banks spent a remarkable amount of the time discussing financials: 55%. Angels and VCs spent less than half of that. On the other hand, banks weren't very interested in the entrepreneur him or her-self, spending less than 10% of their time on the topic, while angels spent nearly twice as much. Angels seemed uninterested in strategy (2% of their time), a topic dear to the heart of the VCs (11%). Banks were much less interested in the market than the angels and VCs, who both spent about a fifth of the time discussing this. Perhaps most striking of all was the lack of interest shown by any of the providers in the actual product. The bank spent less than 3% of the time discussing what the entrepreneurs actually made or did, and the angels and VCs around 6%.

The banks also showed complete uniformity in their decisions, while the angels and VCs made different decisions. The implication of this is that if one bank turns you down, don't slog round the others with the same pitch. Go away and work on it: less product, more figures. It may not be such fun but it should work a lot better.

Article courtesy of "Director" - The IOD Magazine – www.iod.com