Raising Capital to Fund a New Idea

Mark Working

Professional sport is the pinnacle of athleticism, and the NFL quarterback is the central focus of the sport of football. No one gets to that position without being uniquely gifted, but there is still a dispersion of success among those who athletically make the grade. The ultimate source of success has and will continue to be debated.

Physical talents like speed and elusiveness (e.g., Michael Vick, Fran Tarkenton, Roger Staubach, Steve Young, Russell Wilson), and arm strength (e.g., Dan Marino, Brett Favre, and John Elway) certainly help, but arguably the most successful quarterback of all time, Tom Brady, falls short on physical attributes compared to others.

> "It would be impossible for the human brain to assess the chaos of the football field in real-time, so the ability to quickly recognize patterns "compresses" the mental load and allows good decisions to be made faster."

But the game's most decorated quarterback has an edge on a different kind of attribute: making good decisions, quickly. Taking three or five steps backward from the snap, assessing the field, and delivering a completed pass downfield all happen within a few seconds, in which the other twenty-one players on the field are moving at breathtaking speed; and arm strength ceases to be a useful attribute if the ball is delivered straight into the arms of a player on the wrong team.

It would be impossible for the human brain to assess the chaos of the football field in real-time, so the ability to quickly recognize patterns "compresses" the mental load and allows good decisions to be made faster. Tom Brady, seventh on the depth chart at the University of Michigan and an unheralded sixth-round selection in the NFL draft, has leveraged his ability to quickly recognize patterns into an all-time career NFL leader in passing yards, touchdowns, and Super Bowl wins.

Pattern Recognition

There is a point to this. Pattern recognition is critical to good, timely decision making, not just in sports. Investors, especially successful ones, practice the same by defining the attributes they look for when seeking new opportunities. When a business opportunity fits into a "box" defined by specific criteria, investors have greater confidence in predicting an outcome and will be more aggressive about pursuing the opportunity—or when the potential investment doesn't fit the "box," the investor can avoid the opportunity cost of pursuing a situation with a low probability of a completed investment, pass on the deal, and quickly turn to the next one.

The criteria could be size, industry, or management composition, but ultimately it comes down to proven (which means repeated) financial attributes. The more history there is to show a pattern and a link between the presence of certain attributes (customers, suppliers, margins, managers, asset composition) and a positive outcome for an investor, the more easily the pattern is recognized and its use as a filtering mechanism entrenched.

> "Discipline pays off over time, with resources spent on the situations that fit the investor's box yielding the most successes."

Back to Tom Brady for a moment. It is somewhat ironic that a quarterback who has used his pattern-recognizing skills to such effect on three decades' worth of defenses was almost completely overlooked—because of the scouts' own pattern recognition. The accepted predictors for success as quarterback in the NFL have not changed: teams believe that tall, strong, fast men with cannons for arms and a history of winning at the high school and collegiate level will dominate at the next level. Those who don't fit that archetype – the scouts' "box" – get passed over.

> "When a business opportunity fits into a "box" defined by a specific criteria, investors have greater confidence in predicting an outcome and will be more aggressive about pursuing the opportunity."

A new mousetrap, new business model, new channel of distribution, or new materials composition can each change relationships among suppliers, company, and customers, thereby establishing a new set of circumstances that might not fit into a previously recognizable pattern (either good or bad). Capital raising in situations where the pattern is not quickly recognized or where the investor has not been trained on that pattern becomes much more difficult. Smart defensive coordinators have had success when they confuse or somehow overturn the pattern library in Brady's brain. But while a quarterback like Brady has no choice but to play the game and assess the chaos in real time, in the investment world, an unrecognizable pattern can be dealt with by rejecting the opportunity and moving on. The uncomfortable investor opts not to play.

Pattern recognition is institutionalized at investment firms. Initial screening is often conducted by junior or business development staff, the ones with the least experience to allow them to see around corners. It is understandable that investors are trying to limit resources spent on opportunities that are a low probability of success. Discipline pays off over time, with resources spent on the situations that fit the investor's box yielding the most successes.

Tall Walls to Climb

The capital seeker has three walls to climb if the opportunity at hand is not a perfect match for a well-trodden pattern: getting past the gatekeeper, gaining a sponsor within the firm, and providing a due diligence path. We offer a few thoughts on each stage.

Getting past the gatekeeper. The best way is to start communications with a decision maker, usually a partner who makes investment decisions. Past experiences with a firm or an individual on previous opportunities usually gets past the gatekeepers. If not, it is important to tie the current opportunity to the firm's past experiences and/or stated parameters in some manner so that there is some overlap with the characteristics the firm seeks.

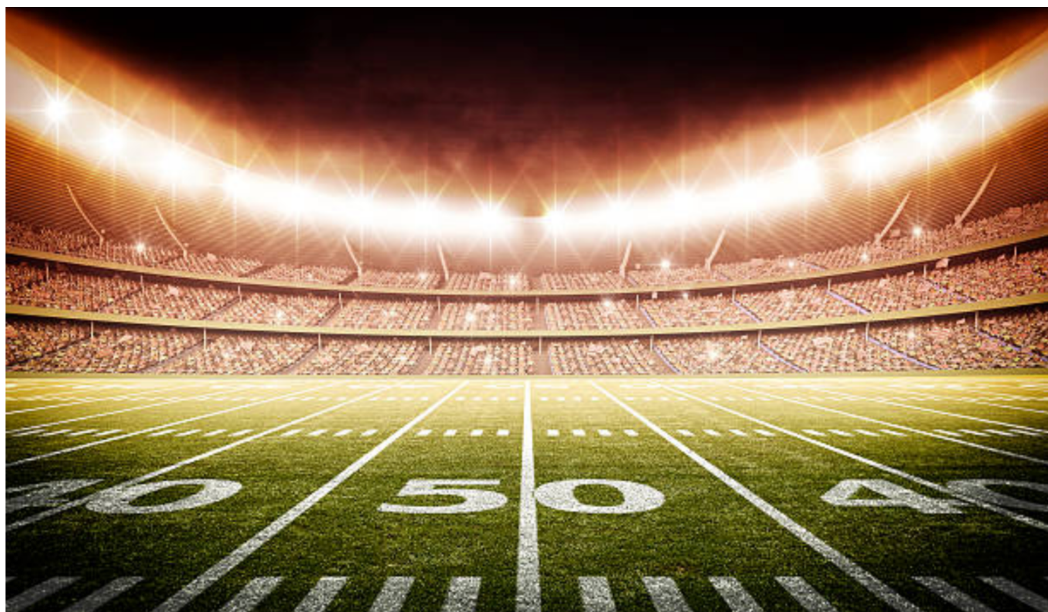
Gaining a sponsor. The elevator speech must be succinct and have a clear connection to the firm's capabilities and knowledge and looks immediately attractive relative to the mass of new opportunities seen by the firm. The new idea will already stand out (in a bad way) by being different, so it must also stand out (in a good way) by addressing the investor's natural greed instinct.

- "I know your firm and what it likes and think this opportunity is worth spending some time investigating" – the "why" needs to be clearly stated.
- "In an industry you know, there is a problem, and this opportunity addresses it with a novel approach."
- "The new approach is more profitable, and this investment will generate an attractive return" (the return must be higher than the investor would expect from an investment that fits perfectly in the investor's box). Greed can draw interest to investigate.

Path to due diligence. This might be the highest hurdle because due diligence is the activity where data is gathered to prove the pattern. For businesses operating in existing markets, historical data gives the investor something to measure and evaluate. When the future is not as directly related to the past, due diligence is a challenge. Following are some tactics that have proven to be useful.

- Compare entire value chains (new and old) with focus on the bridges between different segments of the chain to narrow the parts that can't be measured historically;
- Recognize the risks of the venture and address them early;
- Employ managers who have had success in this industry and therefore add credibility to claims; it is even better if they have had previous success employing new ideas successfully;
- Use "experts" where judgment or leaps of faith are required;

- Be very conservative in making projections of achievement - if the new opportunity can't show an attractive investment return while employing conservative assumptions, it might not be as attractive as originally thought; and
- Anchor tenant – put initial effort in gaining a recognizable name as an early investor as investors prefer company in new idea investments.



A common statement heard in the investment world is that capital is in long supply, and it is good ideas that are in short supply. This is largely true, but the statement implies that capital will flow to the good new idea. That is not necessarily true. Good new ideas represent opportunities to generate high rates of return for investors, but they bring along with them additional real or perceived risk. To be successful in attracting capital, the risks must be vigorously analyzed and have plans to mitigate some or all the risk, and the returns, after building in margins for error, must be high. To be funded by sophisticated investors, there must be a clear path around all land mines to go from thesis to execution.

ZacharyScott.

1200 Fifth Avenue, Suite 1500 Seattle, WA 98101

o: 206.224.7380

zacharyscott.com