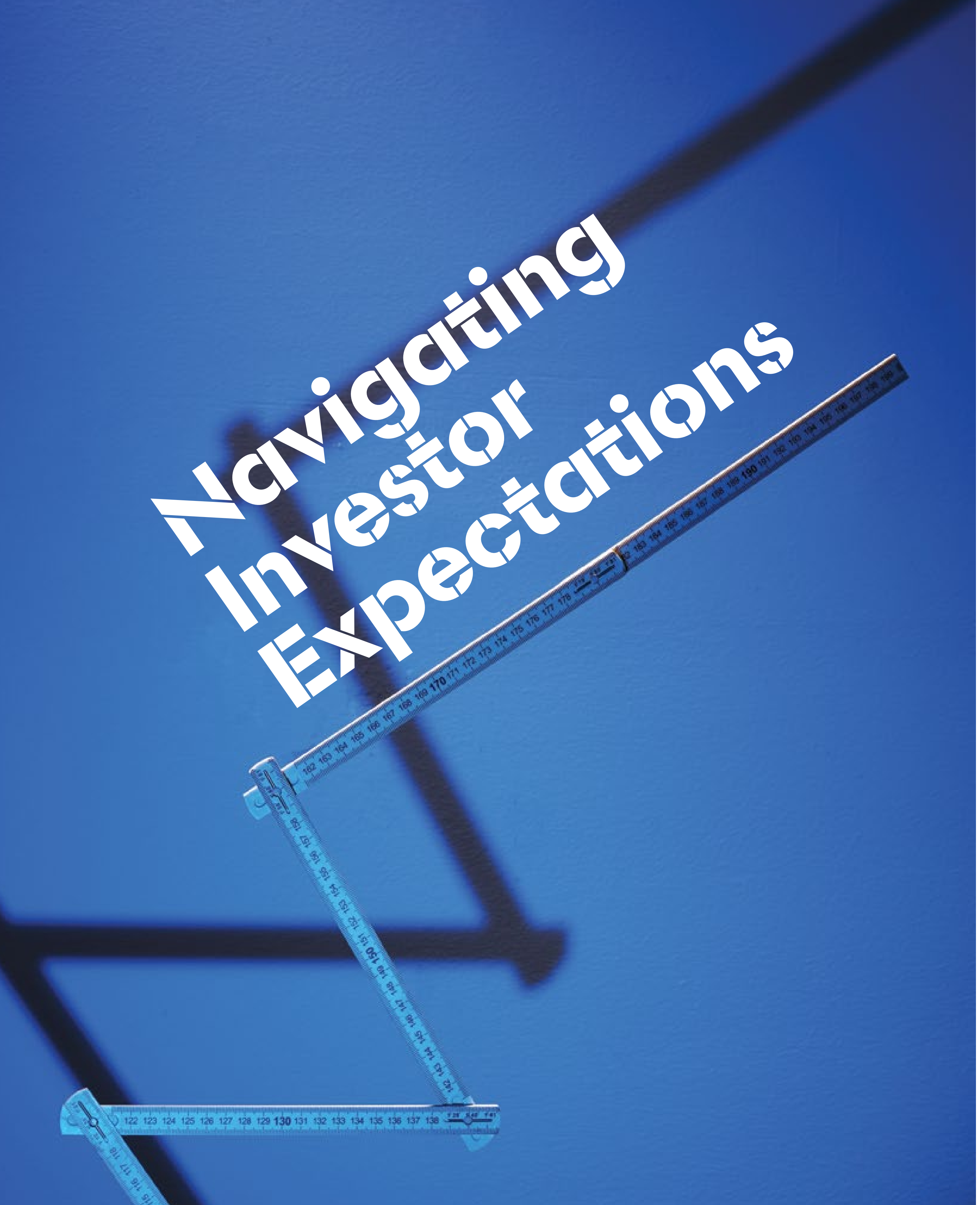

Navigating Investor Expectations

Why start-ups need to speak the language of numbers.

by Yong Hsin Ning and Yvette Lim

The number of start-ups in Southeast Asia has grown rapidly in recent years, with a young, tech-savvy and digitally-connected population creating an ecosystem for them to develop and grow. Additionally, the increased access to technology and digital infrastructure has fuelled greater innovation and entrepreneurship in the region, and most governments have provided support and funding to spur entrepreneurial endeavours, especially during the COVID-19 period. For example, in Singapore, the government announced a S$300 million support package for deep-tech start-ups in 2020.[1]

Amidst the pandemic in 2021, start-ups grew rapidly and received abundant capital, with a surge in Initial Public Offerings (IPOs) and non-fungible tokens[2] or NFTs.[3] However, after the 2021 liquidity glut, start-up investors around the world became more cautious with their investments due to rising inflation, tightening money supply, and uncertain politics.[4] They became more selective in their investments, seeking out start-ups with solid business models, particularly founders who can unlock the potential of their businesses.

Intuitively, when investors look for evidence of founders' ability to execute, they rely on past performance. However, this works against early-stage founders because they may not have a track record in their current business. Therefore, they need to enhance their ability to clearly articulate the implementation strategy of their business model. This implementation strategy is manifested in the cash flow projection of the start-up, which represents the 'how' and 'when' of the business.

In this article, we explore why founders of early-stage start-ups often struggle to speak the language of numbers and how this can impact their ability to attract investment. We then discuss a multi-pronged approach to changing the behaviour and mindset of founders which can lead to sustained advantages beyond just securing funding.

WHY START-UPS (STILL) DON'T SPEAK THE LANGUAGE OF NUMBERS

From our experience, most founders have no difficulty presenting a compelling narrative about the 'why' and 'what' of their business idea. This is to be expected as founders are passionate about showcasing their business potential to investors. However, we find that the commercial information underlying these pitches often does not align with the stories being told. As a result, investors quickly pass on such opportunities.

There are three reasons for this persistent misalignment between the story and numbers.[5] First, many founders, especially those who are not comfortable with numbers, believe that developing financial projections is complex and time-consuming. Second, they may also find it a cumbersome process because there is little or no historical data to rely on for projecting revenues and expenses. This is especially so for early-stage start-ups which often operate in an environment of unpredictable market dynamics and customer preferences. Finally, they may dismiss financial projections as unimportant because the figures are mostly based on assumptions. As a result, they may believe that they just need to tell a good story to secure funding, and that a well-thought-through implementation plan as represented by financial projections is secondary.

Consequences of ignoring the numbers

When founders fail to present credible and well-thought-out financial projections to investors, not only are their chances of receiving funding reduced significantly, but they are also perceived to be unprepared and lacking the necessary skills to become successful entrepreneurs. That said, does feedback from investors help start-ups improve their pitches over time? Sadly no, as we also realise that many start-ups do not have the opportunity to receive specific and constructive feedback from investors that could help them improve. This could be due to the investors having limited time or resources to provide detailed feedback, or simply not wanting to dampen the founders' enthusiasm. As a result, the start-ups may make the same mistakes over and over again, further reducing their credibility.

This situation also hurts investors. In an ecosystem filled with unqualified start-ups, investors waste time and energy evaluating pitches that do not lead to successful investments. This not only reduces the efficiency of the investment process but also increases the opportunity cost of time and resources.

How can the problem be addressed, and who in the start-up ecosystem is best placed to address it?

INFUSING THE LANGUAGE OF COMMERCIAL VIABILITY INTO A START-UP'S DNA

Authors Chip and Dan Heath highlighted that the way to change one's behaviour can be distilled into three key principles.[6] For the sake of simplicity, we shall call them 'Head', 'Heart', and 'Hand'. The 'head' strategy refers to the use of logic and facts to convince people when founders do not understand why there is a need for change, or when they feel overwhelmed by the perceived magnitude of change relative to what they may be capable of coping with. The latter may stem from founders receiving too much information without guidance on how to use them for decision-making. The 'heart' strategy covers techniques that appeal to intrinsic motivation or fears to create behavioural change. Finally, the 'hand' strategy relies on modifying the environment to facilitate the desired change.

Next, we elaborate on how the 'Head', 'Heart' and 'Hand' principles can be applied to address the resistance of early-stage start-ups and gradually get them to change their behaviour.

'Head' strategy 1: Help start-ups understand why investors are interested in the numbers

Investors looking at early-stage start-ups are not necessarily concerned with the exact numbers in the financial projections. Instead, they want to understand the thought process behind how the start-up plans to implement its business model. For example, if a start-up wants to expand into different countries, the investor would be interested to know the assumptions and rationale behind its growth projection. This includes how the start-up plans to target different customer segments in each country, and the strategies to reach them. Investors also want to know how the start-up plans to allocate resources to make this growth happen, since different strategies carry different costs and risks. For example, there are different costs and risks implications when carrying out market penetration through leveraging on local distributorship channels versus those for setting up local operations.

When start-ups can clearly articulate their assumptions, it is easier for investors to give them specific feedback and advice. This helps the start-ups better understand the areas where they need to modify their business model to appeal to other investors.

'Head' strategy 2: Help start-ups understand what investors are looking for

Many early-stage start-ups associate 'numbers' with multiple sheets of complex financial projections including income statements, balance sheets, and detailed sales data. Whilst these may be required at a later stage, providing them at the initial stages would be too much, too soon. Instead, they should make use of numbers to communicate a strategic story that aligns with their pitch.

Such a story should comprise the following four elements: evidence of traction achieved by the business, the vision of the growth trajectory, recognition of key risks (and associated mitigation strategies), and potential returns for investors.

Evidence of traction

Investors want to see evidence of traction because it reflects the ability of the founders to execute their plans. They can also obtain evidence about the viability of the business model and product-market fit through the insights gained.[7] Understanding the capability of the founder and assessing the viability of the business model are ways for investors to de-risk their investment.

The nature of the traction can be financial or otherwise, depending on the nature of the start-up and its stage of evolution, as well as the investment criteria of the investors. Start-ups can communicate evidence of traction quantitatively through various ways like the number of sign-ups from free and/or paid users, Net Promoter Score (NPS),[8] the number of signed Memoranda of Understanding (MOUs), and the quantum of investments already made by other angel investors.

For example, in the case of Careercake, a Cardiff-based online career learning platform that was eventually acquired by Irish firm SocialTalent, the founder chose to focus on measuring retention and engagement at the early-stage of the company as a demonstration of traction. Initially, the renewal rate was as high as 100 percent, but it eventually settled at 80 percent after the start-up fine-tuned its strategy to focus on customer segments that were a better fit.[9]

Vision of growth trajectory

If traction represents the past and present, then the growth trajectory shows the story of the pathway to the future. Here, investors are interested in two things: the size of the market and the corresponding growth potential of the business over time, and the market penetration strategy. Start-ups should provide representations of the market potential and their strategy to grow the business, both at the beginning and over time.

Our experience tells us that start-ups typically depict their growth visually through charts that show a progressive increase in revenue over a period of time. However, it is unclear what drives the growth. When growth drivers are unclear, investors may dismiss the representations as not credible.

To illustrate the misalignment between the growth trajectory and growth drivers, we use the example of a fictitious start-up called Silver Guide.

Silver Guide is an Artificial Intelligence (AI)-powered travel platform that connects affluent senior travellers from the US and Europe with local tour guides in Southeast Asia. Its target market seeks personalised and authentic itineraries conducted at a comfortable pace that is suited for the elderly. With a strong presence in Singapore, Silver Guide plans to expand to Malaysia, Indonesia, Thailand, the Philippines, and Cambodia over the next five years, with a target of 500,000 bookings per year by the end of Year Five. Based on the current traction, Silver Guide has approximately 1,000 inbound bookings in Singapore per year, primarily from Europe. In its pitch to investors, the year-on-year revenue growth is projected to be 20 percent based on the expansion plan, which looks very rosy. The strong growth is justified by strong retention strategies that proactively engage existing customers to continue using the platform.

However, upon closer scrutiny, the projected expenses dedicated to marketing, sales, retention, and referral remain consistently low at about five percent of total revenue each year. This begs the question of how Silver Guide intends to drive revenue growth with low investment in customer acquisition and retention. Furthermore, the technology spend as a percentage of cost remains almost constant over the five years, indicating that there would be no further investments to support the expansion and keep competition at bay.

In this example, although Silver Guide has clearly articulated its growth roadmap, there is misalignment between its growth aspirations and projected costs. This will raise concerns amongst sharp-eyed investors about its ability to deliver the promised returns. Therefore, start-ups should learn to correlate growth with credible projections of relevant growth drivers.

Recognition of risks

Projections of growth are, after all, guesses at best; there will always be unforeseen circumstances that impact the commercial viability of the business. For example, as Silver Guide expands to new countries, it may not have the same level of market knowledge as it does in Singapore, resulting in higher marketing costs and lower revenue growth. It may also face operational challenges such as language barriers, logistical issues, and the hiring and training of local staff. These challenges could reduce revenue growth and raise operating costs.

Investors would want to know if the founders have considered the impact of such potential risks and developed risk mitigation strategies. To prepare for these questions, founders should perform sensitivity analysis to stress-test the robustness of their business model. Whilst

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it may be difficult for founders to comprehensively consider all risks, they can surely simulate the financial impact of key identifiable ones. For example, they can simulate scenarios to test their business model's resilience to potential setbacks, such as a 50-percent increase in manpower costs or a 50-percent decrease in expected revenue. These simulations are useful for internal risk management and a demonstration to investors that the team is prepared to handle potential setbacks. It builds trust and shows the founders' credibility and competency as entrepreneurs. This is especially important, given the overconfidence bias that founders are prone to.[10] Demonstrating awareness of the impact of risks gives investors the confidence that the founders are mature enough to challenge their own assumptions.

Potential return on investment

Many founders make the mistake of focusing only on the quantum of investment they need from investors, without articulating the potential returns for the latter. They may overlook the fact that fundraising is a competitive process with many other start-ups vying for the same source of funds. Therefore, it is important to communicate credibly to investors "what's in it for them".

There are various types of investors who invest in start-ups, such as private equity investors, angel investor groups, venture capital firms, and strategic corporate partners. These investors have different expectations of what they want from the start-ups, including different levels of risk and potential returns.[11]

Hence, it is crucial for start-ups to know the potential returns their company can deliver when seeking investors. This knowledge helps in identifying the right investors to approach and increases the chances of obtaining funding. A mismatch between what a start-up can offer and what an investor expects can lead to a waste of time.

> What if making mistakes is perfectly acceptable? What if the purpose of the financial projection is not solely to obtain correct answers, but to reveal questions that need to be addressed?

'Heart' strategy: Help start-ups overcome their fear of numbers

Developing cash flow projections for early-stage start-ups can be a daunting task, especially for those without a background in accounting or finance. The fear of making mistakes or having one's ability doubted can discourage many from attempting to formulate these projections.

However, what if making mistakes is perfectly acceptable? What if the purpose of the financial projection is not solely to obtain correct answers, but to reveal questions that need to be addressed?

These thought-provoking questions challenge the traditional mindset that the founders must already be highly competent in financial literacy, and instead encourage them to embrace their mistakes and uncertainties as a natural part of the process. Founders need to understand that the most important takeaway in the process of developing the cash flow projection is not about the actual numbers but surfacing the logic behind the assumptions. For example, the simple exercise of estimating revenue requires founders to critically examine their assumptions of market size and average spend per customer. They would need to address difficult questions like: What would be the beachhead segment they can target which would give them a high chance of success? How much would such customers spend? How would these numbers evolve over time?

This 'heart' strategy that reduces the founders' fear factor can help them overcome their hesitancy to tackle financial projections and instead approach them as an opportunity for growth and learning.

'Hand' strategy: The role of accelerators and investors

The final question concerns who is best positioned to educate and influence the founders. This leads us to the 'hand' strategy, which involves embedding the enablers of behavioural change within the environment to make it easier for founders to make the necessary changes. Here, we highlight the role of accelerators and investors.

Accelerators play a crucial role in helping start-ups navigate the complex world of entrepreneurship, and one key area where they make a significant impact is in institutionalising the language of commercial viability. This means that rather than treating the development of financial projections and analysis as a one-off event, accelerators can incorporate financial literacy into their programmes from the very beginning. They can support and influence start-ups to pay more attention to the commercial viability of their business by requiring them to provide simple

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revenue and cost projections as part of their application process, in addition to their pitch deck. This sends a clear signal to start-ups that they must consider commercial viability even when the business is in the early stage of development.

This also allows the accelerators to provide targeted support for the start-ups based on the quality of their cash flow projections. Accelerators can use financial projection data as a guide to track the progress of the start-ups, helping them make informed decisions about their growth strategy and improving their commercial viability. By requiring cash flow projections throughout the accelerator programme, accelerators can ensure that start-ups gain a deeper understanding of the cash flow implications of their strategies and decisions, thereby preventing unrealistic projections or stories that do not align with their financial data.

The benefit of institutionalising the language of numbers extends to investors. By providing a standard structure for cash flow projections that communicates the business model strategically through numbers, investors can undertake the initial screening of all start-ups in a consistent manner, saving them time and resources while ensuring comparability. Institutionalisation of the language can lead to greater transparency and more informed decision-making, ultimately resulting in a better match between investors and start-ups, thus improving the success rate of such entrepreneurial ventures.

EVOLVING FROM FOUNDER VERSION 1.0 TO 2.0: A MINDSET SHIFT

Most founders will have more questions than answers when they first start making projections. However, over time, they will learn to refine their business models and projections as they obtain more information and insights. They will also gain clarity on how business decisions and judgements affect the bottom line, which will help them prioritise their effort and resources on activities that bring the greatest impact.

As start-ups go through the process of continuously reassessing their financial projections, they may notice subtle but crucial shifts in their way of thinking. First, they will realise that there are different routes to achieving their business objectives, not just the one that was initially projected. They will also become aware of the different business drivers that can potentially impact profitability. Second, they will become more perceptive about how changes in their assumptions could affect their initial projections. Their ability to rapidly evaluate whether these changes will have a positive or negative impact on profitability will improve. This mindset can help founders make more informed decisions about the strategies to pursue, resulting in a higher probability of success and long-term viability of their business.

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Endnotes

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