Why won't angel investors provide funding?

Purpose of this article

This article has a two-fold purpose:

1) Help angel investors identify risks and issues to consider before making an investment.
2) Help founders understand how successful angel investors think.

What is a startup?

1) A startup is a temporary organization designed to search out a repeatable, scalable and profitable business model with lots of potential customers who are willing and able to pay to solve their problems and needs.[1]
2) A business model describes how a company creates value for itself while delivering products or services to customers. What are you building and for whom. What customer problems are your solving? What customer needs are you addressing? What benefits and value are you enabling customers to achieve?
3) "Startups are not building a solution. They are building a tool to learn what solution to build. "[2]

What is the context for this article?

1) Your startup is pre-revenue or has some revenue. You have already obtained funding from friends and family. You have made the decision not to bootstrap your business. This is the first time you're asking for funds from outside investors.
2) You are either an individual angel investor or an angel fund. You are focused on making money from your angel investments. The risks and issue may be addressed during the pitch process, due diligence, term sheet negotiation, as well as preparation of the closing documents. You may decide at any point to not invest.

The major reasons an angel investor will not provide funding.

1) This article outlines 11 major reasons an angel investor will not provide funding. These may occur at any point in the investment process, from someone recommending a founder through to the point of transferring money to the founders bank account.
2) There can be countless other reasons an angel may decide not to invest.

#1 The founders are not coachable

1) By coachable, I mean the founders are not able to learn and understand their customers, partners, employees, investors etc. Learning requires unlearning what is obsolete and being able to adopt new mental frameworks, new types of skills and new knowledge.
2) Founders who cannot learn and unlearn will likely fail. Success usually requires focusing on different target customers and multiple changes to the business model. The founders also need to learn many new skills, acquire new knowledge, and unlearn what is no longer appropriate.

Three ways to identify an uncoachable founder include:

1) When an investor, coach, or mentor provides advice, the founder immediately rejects the advice and tries to convince the other person they are wrong. There is no attempt and learning or understanding.
2) The founder is unable to explain what new things they've learned about their target customers and how the business models have changed.
3) The founder is unable to explain what new skills and knowledge they've acquired in order to search out a business model.

#2 The founders do not understand the customers and customer segments.

Customer understanding includes:

1) What are their problems?
2) What are their urgent problems?
3) What are the benefits the customer can achieve if their urgent problem(s) are solved?
4) Are the customers willing to pay for a solution?
5) Are the customers able to pay for a solution?
6) What does the customer journey or day-in-the-life of the customer look like?
7) How do the customers emotionally feel?

The most common reason startups fail is lack of a market. The founders build a solution before they understand whether or not there are potential customers. The analogy is that many startups first build a cattle ranch to sell meat, and then discover their customers are vegetarians.

#3 Founders do not have a fact-based understanding of customers.

1) There are little or no facts regarding who is going to buy the solution and why.
2) There is a limited, or non-existent, ongoing process for understanding customers and validating assumptions.
3) Before building a solution, there have been a limited number of potential customer interviews and surveys. If the customers are consumers, then there should be at least 100 potential customer interviews combined with several hundred surveys.

Other fact-based approaches to understand potential customers include:

1) Asking customers to buy.
2) What is the trend for potential customers signing up on a waitlist to be informed when your solution is available.
3) What is the trend for potential customers signing up for your newsletter
4) What is the trend for potential customers engaging with the thought capital on your website.
5) Using Google Keyword Planner to: See the historical volumes for keyword searches, the competition for those keywords, and estimate the cost per click.
6) Using Facebook Ads to estimate the number of people interested in key words in a geographic area.
7) Using Google trends to see how popular the key words for your problem and solution are
8) Looking for consumer reviews in places such as Amazon.
9) Creating a website that will allow buying, but when the actual purchase is done, there is a message such as "solution not available".

#4 Lack of trust and transparency

1) The angel does not feel that they can trust the founder or that the founders are transparent, especially regarding problems and issues.
2) All startups at the angel investment stage have major problems and issues. If the founder does not share these with the angels, then many angels will wonder: are the founders hiding their problems and issues OR are they unaware of them. Coachable founders can change their behaviour to be more transparent.
3) Founders should not make false statements to angels. Once trust is broken, many angels will immediately stop dealing with the founders.

#5 The founders' startup does not fit the angel's investment thesis

Founders should research the angels' investment thesis. Angel funds often publish this on their website. More effort will be required to understand individual angel thesis.

#6 There is no exit strategy for the angel investors.

The angel investors want to get a financial return at some point. Most successful startups are acquired. Few startups result in an IPO. The angel needs to understand:

1) Who are the likely buyers?
2) Why would they buy the startup?
3) At which milestones would they buy?
4) When will the milestones be achieved?

If the founders lack this knowledge, they need to have an advisor who can answer these questions.

#7 The startup will be difficult to scale if product market fit is achieved.

Example of these scaling difficulties include:

1) Needing significant amounts of expert talent for each unit of future revenue. Expert talent is often a scarce or expensive resource.
2) Needing significant amounts of capital for each unit of future revenue.
3) Future low gross margins

#8 The founders, management team, and advisors lack relevant talent

1) Thinking back to what a startup is, the talent pool is an organization designed to search out a repeatable, scalable and profitable business model with lots of potential customers who are willing and able to pay to solve their problems and needs.
2) The skills, experience, knowledge of the startup team is much different from a team that is successfully scaling a profitable business model.
3) Founders with deep experience in running a long-established and proven business may have to learn many new things in order to search out a new business model.
4) The skills to understand customers on an ongoing basis are very different from the skills to build a solution.

5) In addition to coachability, the founders need to be able to unlearn invalid assumptions and business models and create new business models. This is known as pivoting. I've seen too many founders try to sell a solution with little demand rather than create solution with massive demand.

#9 There is not a large potential market

1) TAM refers to total potential revenue assuming: 100% market share, all potential geographies, distribution channels and partners.
2) This revenue comes from customers who believe they have a problem or need urgent enough to pay for and are also willing to pay for it.
3) The customers must also believe the founders have a solution which better than the competition at enabling customers to achieve benefits. E.g. the TAM for smart phone is massive. The TAM for smart phone with a keyboard is tiny.
4) The common mistake I see is that the dollars numbers in their market size slide are unrelated to the market for their solution. The following is a made-up example: The startup wants to create a new type of brake light for cars. The market size slide has the total dollar volume for car sales, not for dollar volume for purchases of brake lights.

#10 Lack of an achievable go-to-market strategy

1) Unclear how the customers will find the startup and purchase from the startup?
2) Unclear what distribution channels and partners are required.

#11 The angel doesn't perceive a working-relationship fit.

1) The angel, for a variety of reasons, believes the working relationship with the founders would be too difficult or unenjoyable.

Your next steps

1) As a founder, have someone assess your startup using the above set of 11 items. You need the truth, so the assessment should not be from family, friends, or close colleagues.
2) As an angel investor, determine how the 11 items above fit into your investment decision making process. Which ones are deal-killers? Which ones fit your risk profile? Which one will you be able to mitigate over time, and how?

Footnotes:

[1] adapted from: Steve Blank, "What's a startup – first principles". https://steveblank.com/2010/01/25/whats-a-startup-first-principles/

[2] Alistair Croll, Benjamin Yoskovitz , *Lean Analytics – Use data to build a better startup faster,* Sebastopol, California, O'Reilly Media, 2013, Page 41