The Solari Report

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Start-Up Financing for the Rest of Us

with Peter Ireland

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C. Austin Fitts: Tonight it is my real pleasure to introduce to you Peter Ireland. Peter is an author and a serial entrepreneur. He has a fabulous website that I've used for many years, and I know lots of entrepreneurs who have as well. When you talk to people who are good entrepreneurs and support other entrepreneurs you'll always find out, one way or another, they are plugged into Peter

Ireland's work, or into his website. Peter has very kindly put out a special link for Solari people to go in and get some of his materials and I've posted it on the blog. I encourage you to take a look at it.

Peter comes to us from Washington. Peter, are you with us?

Peter Ireland: Hi Catherine. Yes I am with you. I'm glad I didn't get the buttons mixed up. I've been invited to these types of things before and usually I skip the preamble but that was just a fabulous talk. I'm interested in a lot of these things myself these days.

C. Austin Fitts: All of our guests get complimentary subscriptions and you have access to the full archives, so just dive in.

Peter Ireland: I'm going to be doing just that.

C. Austin Fitts: Every week I end up talking about the growing unemployment, and one of the things I know is that the only way to address that situation is with the kind of start up and entrepreneurship that you've been a proponent of your whole life.

One of the reasons I wanted to do the Solari Report is, how do we get thousands if not millions of people learning how to be successful entrepreneurs? There are so many great businesses. I was once in a restaurant in Cambridge and I said to somebody, this is such a wonderful restaurant how did it get started? He said, "Well we didn't want to start a restaurant but we had 25 people and we needed to create jobs for them, so we asked them what they all did, and we thought if we started a restaurant we could get them all working."

We're kind of in that situation.

I love the "Smart Start-up Guide." I think it's the best book that I've ever found in a lifetime of looking about what's the right model to start up a business and how to do with as little capital as possible.

If we could just dive in and if you could explain how you came to write the book, and then what the differences are between your smart model and the venture model that many of us have been talking about in our head. I would just love it.

Peter Ireland: Let me do this in a few quick minutes. It probably goes back about 10 years. I developed a fascination with the whole idea of being self-employed and having my own little company to operate and not having to go into the corporate world, which never really appealed to me. I started taking an interest in all matters that had to do with starting up your own business. Then, we'll fast-forward a few decades, it's the 1980s and I started reading Inc. Magazine. It usually had at least one annual article on boot strapping businesses and how their Inc. 500 list was all started with minimal cash. The articles never really went into that much detail. They had two or three pages covering a lot of companies, but without any detail.

It was around 1987 and I actually started calling up some of these companies that were in some of these articles, and occasionally I was given about half an hour to speak with the CEO, and I was able to dig into the details of how they got this company off the ground with zero outside capital and minimal internal capital. I just started collecting these different methods for getting companies off the ground when financial resources are very scarce or non-existent. I started realizing there is a way to do it with a lot of different businesses. As we talked about the other day, the sitting duck model; you shouldn't really put a lot of time and energy into that one. That's a start-up situation where you just require a huge amount of start-up capital from the get go, and I tell people to try and avoid those situations as much as possible and go for situations where you can start generating cash quickly.

"I started collecting these stories and there are all sorts of creative financing solutions to start-up problems and one of the keys to understand is you shouldn't be looking at how to finance a start-up but how to finance an individual asset that the business will need to operate."

So to wrap it up about how I got started, I started collecting these stories and there are all sorts of creative financing solutions to start-up problems and one of the keys to understand is you shouldn't be looking at how to finance a start-up but how to finance an individual asset that the business will need to operate. That opens up a lot of options for each type of asset and if you understand how all those individual assets can be financed, you can start coming up with ways to actually get the whole business up and running without waiting for individual investors to come along.

So, it's just an interest I developed in childhood. I didn't come from a wealthy family, I came from a middle class family and I realized if I'm going to do anything later on with a business I'm going to have to be creative. I have to use creativity to compensate for the lack of money that I could tap into. That sort of gives you an idea how this all came about.

C. Austin Fitts: One of the things I've found is the more money you have when you start a business, the more mistakes you make, and the more money you waste. One of the things I love about your presentation in the "Smart Start-up Guide" is you really do need a proof of product. You're almost better starting an operation that prototypes something because your customers will teach you an awful lot about whether the product and service you have in mind makes sense. A lot of great businesses emerge just from people responding to requests.

If you look at my business now, all the different parts of Solari came from people asking for our help, and the product emerged out of the requests. And when you do it that way, it's a much more intelligent relationship between you and the market than when you just have an idea and make it and sell.

A lot of capital can get burned before you sit down with a customer and see if this thing's going to go.

PETER IRELAND: Exactly. There's a joke about Bill Gates, that he never really had a good quality product to sell to the marketplace until version 3.0 came out. I've always used that law. Get the most basic, stripped down product into the marketplace as quickly as you can. Start generating some cash flow and gather feedback from the customers. Find out what kind of bells and whistles they want to see added on to it that they are willing to pay for, and just grow it that way.

C. AUSTIN FITTS: Another thing you focus on is what I call elasticity of demand. You want to make something where there is an interlastic demand. In other words you want to provide a product or service that is very important, not superfluous. Maybe you can go into that.

PETER IRELAND: Sure. That's actually really important that people need to understand. You have a lot of social networking websites these days and some of them have huge valuations despite the fact that they aren't making that much money. I always got to wonder what really gives them that value because the next social networking site that comes along is just a mouse click away. So when the next one comes along that's a little bit hotter, how can they maintain their customer base? They really can't.

About four or five years ago the hot social networking site was Friendster. It's still around but nobody ever talks about it and hardly anybody uses it. That one was followed by MySpace. I think it was Rupert Murdoch who paid like $600 million dollars for MySpace about five years ago. I don't know if you're aware of this it just got sold for about $35 million dollars a couple of months ago. The actor Justin Timberlake was one of the members of the group that bought it. So, Rupert buys it for $600 millions dollars roughly speaking, and five years later he sells it for $35 million dollars.

I've never really been impressed by Facebook. Maybe it's a generational thing. I don't even have an account there — I just don't see the point in it. I certainly don't understand the valuation they give it.

So, my recommendation is hope for the best in terms of the economy, but prepare for the worst. If you're going to start up a business you want something that's going to be selling a service or a product that people need no matter how badly things get. Examples would be food, energy, gas and other necessities. There are lots of things that people absolutely need. That's what I recommend to people.

I have a company that has a lot of websites and I'm fully aware of the fact that the competitors that we have to confront in the marketplace are just a mouse click away for our customers. They can see that the other site is selling the same widget for a buck less.

You want something that the people really need. I'm not too optimistic about the next few years in terms of the economy.

C. Austin Fitts: You want to be doing something that's useful.

In the "Smart Start-up Guide" you give tremendous number of case studies and examples of people boot-strapping and I won't ask to go through all of there but maybe you can give one or tow examples of your favorite stories.

Peter Ireland: The key is to find something—a situation where you can start selling something very, very quickly.

I'll give you the example of a friend of mine who runs a contracting business that does renovations in the Seattle area, Mercer Islands specifically, where all the Microsoft employees tend to live and he does renovation like when you want to improve your kitchen, or add a room to a house or whatever. He started off about 10 years ago. He was flat broke. He just had an old SUV that he was driving around in. He didn't have tools, but he wanted to work as a carpenter. He managed to find some work as a subcontractor where he was basically just banging nails. He would bring his own tool belt. With the first paycheck, he started buying additional tools which allowed him to do more complex work that he could charge more for. One of his first investments was a jigsaw. With the next paycheck it was a circular saw, then after that it was a table saw. And then, pretty soon he was on his own. He didn't have to work with a subcontractor under somebody else. He could go out there and solicit work himself.

And that's a very simple example of a service business but you use that same model to start up most businesses. You look at a potential business or services, and you strip it down to the bare minimum of what people need or are willing to pay for. Then you generate some sales, and then as you start to develop some cash flow you start to say, "How can I make this more profitable for myself? What if I add this particular bell or whistle to the basic offering, how much more would I be able to charge for it?" So you do that and then the cash flow improves a little bit more. Then you ask that same question again. "What else would my customers like?" Then you offer that, and you start charging them for that. And that's the way you do it.

C. Austin Fitts: It really is a continuous learning process.

Peter Ireland: Exactly. There is a wonderful quote in the "Smart Start-up Guide" that I attribute to this faculty member at Harvard or Columbia, because he's taught at both, Dr. Marv Byde. He's written a lot on entrepreneurship. He calls it the "try it, fix it approach." That's what entrepreneurship is. I absolutely love that way of summing it up because sometimes you will find out from your customers that's not what they really want, so you have to make some adjustments to it.

C. Austin Fitts: Another reason I like the "Smart Start-up Guide" is because I've always felt guilty about not doing better business plans, although I think it's very worth while to put together a business plan, my feeling about most business plans is that if we use this time to try and make our customer happy and see what happens, we'd be much better off. If we get in there and boot strap it the way you're describing instead of writing a big business plan. A lot of what you said about business plans relieves me of some my guilt about not being better with business plans.

PETER IRELAND: I just want to make a distinction between two types of business plans: The business plan that most people think of when anybody mentions those two words. What they think of is the fancy selling document that people have crafted to try and lure potential investors into giving them money.

And then there is the operating plan. With an operating plan you don't have to worry about grammar and punctuation. You can just basically do it all in bullet point form. You have a page in marketing, another page in operations, how products develop and so on. It's just for you to look at. It's a reminder; another key. Management staff, if you've got any partners; you're the only ones that have access to this thing. Whereas the external business plan that I first mentioned has to be grammatically perfect, it's got 40 or 50 pages usually, and a lot of people can take two to three months to write one up and during those two or three months, nothing is happening.

"With an operating plan you don't have to worry about grammar and punctuation. You can just basically do it all in bullet point form."

I want to make this really important point here. My philosophy has always been, Okay, it's going to take you a few months to start up a business, in most cases. And it's also going to take you months to raise money. So my philosophy is, why don't you take that time period that you have available, and try to use the bulk of it, say 80% of it, to try and generate some sales as quickly as possible, instead of making the mistake that I see a lot of people making here, which is to devote two or three months to write up a business plan and then another three months shopping the business plan around to potential investors. So in six months, nothing has really happened to show for all that time and effort.

So, whereas the person that says, "Well, I'm just going to draft together a quickie operating plan, in bullet point form, where I'm going to take two days to that instead of two months, and then get cracking and go out there and start selling things."

C. Austin Fitts: To understand if you look at the business you'd like to run, it is possible not to start that business but to start a business that will build one-by-one the different parts of the infrastructure you need to do the next business.

Peter Ireland: There's a fancy term for that. It's called a transitional business model and sometimes you can't step right into your ideal business. You're going to have to do some work before you can get there. To build up the cash flow that will then allow you to require the assets that you need that will allow you to run that tween business that you have. That's just part of being an adult. The things you need in life just don't fall out of sky. Sometimes you have to go on the layaway plan and save up to get that dream business, by doing something that will bring in some cash for you.

C. Austin Fitts: I want to talk about two issues that come up early on particularly if you do need some capital. One is the valuation issue. It's very easy early on to disagree about what this thing is worth. I know you have another book on royalty financing which is a very interesting work around of the valuation question. So maybe you could talk a little bit about valuation early on in the start up and then the ideas using royalty financing to deal with it.

Peter Ireland: Sure. I was involved with a lot of valuations because I was a business broker helping people buy and sell businesses for about 10 years. So valuations are always a problem even when you're talking about an established business with a history of five to ten years, when you can look at the financial statements and the tax returns. It's a challenge there.

But if you're talking about placing a valuation on a start-up where there's nothing to look at — it hasn't even sold anything yet, it hasn't left the starting block, so to speak, that's where you're guaranteed to have problems. Typically what happens is the rookie entrepreneur expects some significant amount of money in exchange for 10% of the company. On the other side of the table you have the investors, who even if they really like the idea, they expect to be given voting control of the company, 51% or whatever, so they can lay off the founder in case he's not doing a good job because they are just interested in protecting their investment.

So you quickly come to these serious chasms between the two sides, which are very frequently deal killers. That's why I don't really like to get involved with start-ups anymore. I get calls all the time from people doing start-ups who want me to act as their advisor and so on, and I just try to avoid those situations because they are really frustrating. The valuation is a real deal killer.

The revenue-based financing that you mentioned a moment ago, it eliminates the valuation problem. Let me just explain what revenue-based financing is. I first discovered this back in the 80s. Suppose you need a hundred thousand dollars to get a company up and running. What you can do is, once you've identified some investors, tell them this: "Look, I need you guys to give me a hundred thousand dollars and what I will give you is a royalty payment calculated on my top line. The revenue line on the profit and loss statement, so if in one month I make ten thousand dollars in revenues, you guys will get whatever the agreed upon royalty payment is. If it's ten percent, and I pull in ten thousand dollars, I give you guys one thousand dollars. You guys get paid first as investors and I'm going to keep making those revenue royalty payments until I've paid you back an agreed upon sum. That agreed upon sum is usually a multiple of the principal. If the company receives a hundred thousand dollars, it might agree to pay back two, three or four thousand dollars. Obviously, it's an open-ended thing. Nobody really has an idea how long it's going to take the company to pay back three to four times the original principal. It all depends on how well it's doing month to month in terms of selling."

Just to make it clear for people listening in, revenue based financing is different from a loan because a loan stipulates a uniform monthly payment, and that monthly payment has to be paid whether or not the company is doing well and can afford to make the payment, or if it's not doing well, you still have to make that payment. Whereas, with revenue-based financing, it's a little more flexible. They just want ten percent or five percent or one percent of each month, whatever that sum is. Those revenues might go up and down from month to month. It's flexible. Typically in a particular month where you didn't have any revenues there wouldn't be a royalty payment made that month.

So, to answer your question about valuation, because the investors know that they are being a party that's first to be paid each month from the top line, they don't really care about the valuation. It's no longer an issue; it's not even discussed. It just becomes completely irrelevant. They just know they are going to be receiving a certain amount of cash flow each month, which is a percent of the revenues, and that's all they really care about.

I should add quickly that another big thing is the fact that you don't have to worry about exits. That's the big deal killer. Investors want to know when they'll get their money out. The typical way they get their money, for the start-up, is to be acquired by a bigger corporation, or if it's really big, to do an IPO. The reason why a lot of investors will tell you after they've talked to you is that they are really not interested, is because they just don't see an exit. They don't see how they will recover their money. So with revenue royalties you will eliminate those two huge deal killers. You eliminate the valuation problem—it becomes totally irrelevant. And the exit problem is solved because they know that over the course of the next two or three years, they will recover an amount which is equal to three or four times their original principal.

C. Austin Fitts: What's the name of the revenue financing book?

Peter Ireland: I call it, "How Dealmakers Close Investors." It's specifically about how to use what I call revenue royalty certificates.

C. Austin Fitts: It has quite a bit of information on the documentation and the details. It's very useful from a practical standpoint. In both books, that one and the "Start-up Guide," you really help an entrepreneur understand an investor's point of view. They are not really looking at this as a company; they look at it as they put money into the machine and I get money back. It's a very different point of view. Whether it's an angel investor, venture capitalist, you really break it down and look at it from their standpoint. It's very good.

Another issue I wanted to talk about in addition to the valuation issue is one that's near and dear to my heart which is the control issue.

"We did a big study of media companies and we put that link up because it's very useful. You see the different A-share, B-share models used by media companies to protect editorial privilege."

In the last two years I've helped two friends capitalize businesses. One was a media company, and we helped them design an A-share, B-share model where the founders and the family controlled the A-shares and then everyone including the family makes their money on the B-shares. We did a big study of media companies and we put that link up because it's very useful. You see the different A-share, B-share models used by media companies to protect editorial privilege.

Caroline and I did a capitalization for a wonderful company that started up in Tennessee and we did an A-share, B-share model where the founders, which is essentially a family, controlled the voting shares and then turned around and gave themselves the B-shares and sold B-shares. We stripped out the names, but it's up on the link to help you understand what that model look like and how it works.

I come from a firm on Wall Street that used the A-share, B-share model early on in the old time, twenties and thirties. They cut their name on the A-share, B-share model; I don't know if you've ever used that at all?

PETER IRELAND: I've had involvement with companies that have used that. I've had a lot of experience with public companies, and so on. Yes, that's a very good way of maintaining control of the company. It's a little bit more sophisticated than the revenue-based financing which is pretty similar.

C. Austin Fitts: You could do the revenue and not worry about setting up the equity structure and keep all control of the equity. That's definitely one way to go if you can do it.

In this situation the family had reason to split up the equity among each other. So there was a reason to set up a corporate equity capital structure.

Peter Ireland: Lots of exciting things happening in terms of financing. The revenue financing models are really taking off. There a bunch of websites but most of them just do that type of financing for established companies that have a track record of at least three or four years. But if you are a start-up and you're looking at using this type of financing, it's still doable. You just have to find some individuals who believe in you and who would be willing to invest using that type of instrument.

C. Austin Fitts: Can you explain to us what an angel investor is and how you go about finding angels?

Peter Ireland: The way I like to explain the whole financing thing for companies that will go all the way. By all the way, I mean who will do an IPO, is think of a four-person relay team where they pass the baton. In this case the baton is the start-up. The first member of the baton team is the angel investor. Those are usually just private individuals who have small amounts of capital to invest. Small can be $10,000, it can $50,000, it might be $100,000. Usually they invest as part of a group, and they all believe in the company and they invest in it. They put in the same amount of money into it. They are always looking at their exit. The exit is number two runner on the relay team and that's the venture capitalist, who provides more capital. These are professional firms that have raised usually in the billions of dollars, and they have a portfolio of companies that they invest in. Then the third player the baton is passed to is the investment bank that starts prepping the company to do an IPO. They will inject some capital in there as well. And then the fourth player that picks up the baton is the public, once the company is listed on the stock exchange.

So, that's a way of looking at it that's helpful in understanding the whole financing process and an important point there is that everybody's looking down the road as to how they are going to exit and pass the baton off to somebody else, and recover their money.

As far as angel investors go, it's a matter of talking to people, they're all over the place, no matter where you live, and they are all over the place. They might be retired local business people. There are a lot of people who spent their lives running a business, they really enjoy the process but now they are retired and maybe they have some money. They might be willing to invest in a local company just to help the local community and so on. So, it's a matter of networking, going to Chamber of Commerce meetings, and talking to people.

You can also go to my website, if you click on the top for "angel investors" it will lead you to a national directory of angel investor clubs and chapters across the United States and Canada, and you might have one that's not that far off from you, possibly within a car commute. You can contact them, but they are usually interested more in the stuff that has the potential to really hit it big; a technology or software company, an internet company and so on. Something that can be passed along by all four members of that relay team, and hopefully publicly trading on the NASDAQ.

There are a lot of other angel investors who just want to help build up a local company. Maybe there's a crying need in a community that needs a certain type of business which just doesn't exist, and everybody knows the community needs this type of business and if you can connect with these people you may be able to put the capital together to start building this type of business.

C. Austin Fitts: I generally find most angels to be people who just like building, and they like helping other people build. They are wonderful people to hang around with.

PETER IRELAND: You can learn a lot from them.

C. AUSTIN FITTS: Yes, you can learn an awful lot from them.

PETER IRELAND: You and I had a great chat the other day about crowd funding.

C. AUSTIN FITTS: Yes, I wanted to go into that next. So tell us about crowd funding because I think one of the things that has really impaired the circulation of equity to start-ups is all the government laws and regulations and I find crowd funding to be a very clever leap frogging around a lot of the obstacles that are thrown up by the legal system. So why don't you go into it.

PETER IRELAND: Basically, you put up a page on an existing website and there's a whole bunch of these websites that do crowd funding, I will name a few in a moment, but it's a place where small investors and small companies come together and meet one another. These types of sites will attract people who have as little as $20, or $50, or $100 to invest, they are typically small sums but a site may have thousands of these members.

Then you have small companies come along and they open up an account at one of these websites and they pitch their deal. I've seen some of these pitches. They'll do a YouTube style video, demonstrating the product and introducing the founding team members, and there's a little bit of pizzazz added to these things—it's like an Executive Summary. If people like a particular concept, they like the product, they like the founder and so on; they can say, "I will commit $25 to this company." The way it usually works is that the money is held in reserve until all the capital required is raised. For example, if a company is looking for $50,000 and it only raises $45,000, well, then that money is not released. It's basically refunded back to the people who funded the capital. It's a way of protecting the investors because if a company claimed they needed $50,000 to do something and it doesn't raise all that money, then there is a risk involved there. Why give somebody just a part of the money that they really need.

C. Austin Fitts: I've participated in a couple of crowd funding syndicates. I just put in $100 on another one. The thing that I find very interesting is it will fund not just a company, but also a project. So a kick-starter does artists, or you can do a movie. Apparently some guy out of Boston University wanted to make a documentary on the history of the banjo and he was short $40,000 so he raised on a kick-starter, to his shock and amazement.

Peter Ireland: It's an absolutely wonderful way of funding small companies or projects that you believe in, and there are different categories of crowd funding sites. There are debt based ones, where you get the money in the form of a loan and then you have to repay that loan. And then there are equity based ones where people invest the money realizing they might lose their investment. There are also donation based ones, where people just say, "Hey, this is a great thing and I don't expect anything in return from you—here's my 25 bucks."

"It's an absolutely wonderful way of funding small companies or projects that you believe in, and there are different categories of crowd funding sites."

When I was about 10 years old I found out about this man called James Ling from Texas. James Ling used crowd funding to create his first business which was an electrical contracting business back in 1955. What he did was he sold shares of his company at various fairs in Texas. He would set up a booth at the state fair and pitch his company, and he raised a couple hundred thousand dollars. Then, in 1965 he had the fourteenth largest company in the United States. He was a financial wizard and he was very good at doing acquisitions of companies, so that's how he grew. His name was James Ling the Merger King. You can look him up on the internet. There is this great story about him on the New York Times website from back in 2002 when he died. He just set my imagination on fire. That's why I like crowd funding. We are going to see big things happening this way and part of the reason I like crowd funding so much is because basically it elbows Wall Street and the venture capitalists aside. You're getting rid of these people that really don't contribute all that much to the process of capital raising. One of the things that I've been meaning to do is to sign up with a couple of these sites, and put $100 or a few hundred dollars and just play around with supporting companies.

C. Austin Fitts: It's really fun to do.

Before we close, I just wanted to mention, in "Lets' Go To the Movies," I encouraged people to watch "Startup.com" which is a 2001 documentary film that describes the .com start-up by a former Goldman-Sachs employee. And it's really an example of the big venture model—the smart model is a way of getting out of that mode—but it really shows a group of entrepreneurs that get on the big capital treadmill.

Peter Ireland: I've got a copy of that. I bought it from Amazon years ago and I really love that documentary. The thing to be aware of is, you've got two partners. One loves schmoozing, doing presentations, the other one wants to be back in the office doing coding and building the website so there is this friction between the two of them. I've always been more like the second guy. I think his name was Tom, who wanted to be back building….

C. Austin Fitts: Tom really wanted the products to happen and for those things to work.

Peter Ireland: That's a good one to watch.

C. Austin Fitts: Peter this has been fantastic. Can you describe how we can access the materials? The link is up on the resource section of the blog so we can link to your website. Please walk us through your website and tell us how we can stay current on your work.

Peter Ireland: If you can go to antiventurecapital.com/solari/ sometimes you have to add .html after Solari, but sometimes you don't. There is a special offer there for anybody who is interested in the products. You can save about $60 on them.

I write a blog that's on the website itself. I have a reputation for not taking things too seriously. You will find a lot of humor there. Hopefully you like my brand of humor there, some people don't. It's just a way of keeping up with interesting ways of financing various projects. I try to put up a post or two every week that would be of interest to anybody who's looking into getting into business and becoming their own boss and building something up.

C. Austin Fitts: I've started many businesses and I've grappled with these issues many times, and every time I read it I learn something new. It's the best package of materials on how to finance a start-up that I know of. So I can't thank you enough for that, and for joining us on the Solari report. And when you do dive into the archives, I really want to hear some feedback.

Peter Ireland: You know that old Chinese curse, "May you live in interesting times." Well, we really do live in interesting times. It wasn't suppose to be this way, you know, when I entered my mid-fifties it was supposed to be all smooth sailing, but there's no way of telling where the world's going right now. So I will definitely be going through your archives because the material is extremely relevant right now.

C. Austin Fitts: Thank you so much, have a wonderful evening.