Investment Risks and Returns (*Entrepreneur* Magazine – January 27, 2003)

Q: How do I establish the risk and expected return for investors in my business?

A: Several entrepreneurs have been asking about how risk and return relate to investment in their companies by outside capital providers. Thanks to 36 months of very poor performance in the stock markets, risk and expected return are once again very much on the minds of potential investors when they screen business opportunities. In order to put together a mutually agreeable funding deal for your growing firm, you need to understand how investors are thinking about risk and the prospects for returns on their investment.

The best place to start is to define risk. There's no such thing as absolute risk, only relative risk. In other words, an investment can only be ranked as more risky, less risky or about the same risk as a competing investment. For entrepreneurs in today's very tight funding market, capital providers are weighing competing alternatives when they look over your venture's investment opportunity. Putting $100,000 into a start-up business is certainly more risky than parking it in the money market or buying some shares in a bond mutual fund, but the expected return on these alternatives will in most cases be much lower than the upside of the new firm.

If investors compare buying stock in your company to buying stock in a publicly traded firm, then you might be on better footing. The relative risk of owning stock in your small manufacturing firm vs. being a stockholder in a NASDAQ technology firm may be somewhat negotiable for most investors.

As an entrepreneur, your objective should be to present your venture in a very professional manner, with a complete financial and product-marketing disclosure and a business model that makes sense to investors. After all, they'll be examining your forecasted position in the target market.

One way to deal with relative risk is to outline clearly the specific types of risk being faced by your company. If there's a major technological hurdle to overcome, be sure to describe this in detail and address the various ramifications to the company at various levels of success in dealing with it.

Another strategy is to lay these risks side by side with other comparable investments and their respective risks. For example, if your small manufacturing enterprise is faced with the risk of having to break into a fairly established product distribution network, present similar business risks that come with competing investment opportunities. You could secure a favorable review from investors if your risks are viewed as more easily overcome given a certain strategy that you plan to employ. A $200,000 investment in a public company's stock might have comparable risks to your distribution-network hurdle. The question for investors is typically focused on how management will deal with the risk. The public company may not have as strong a plan as your firm, and the likelihood of being successful could more strongly favor your emerging start-up because you have a clearly articulated plan in place that has a reasonable chance of working.

Remember, public companies are like your private firm in many ways. They face competition, technology limitations, product differentiation, labor and management concerns, various regulations and legal issues, cost concerns on materials, and a wide variety of questions about the long-term financial stability of the asset structure and cash flow. Many smaller start-up companies could actually have an advantage over competing investments in public stocks or mutual funds because the investors can meet face-to-face with the entrepreneur and senior management team to discuss risks and appropriate strategies for dealing with these. That option is often not available for publicly traded securities.

Having dealt with the risks and relative concerns with competing investment opportunities, the matter of return presents two specific issues to deal with. On the one hand, expected return in two or three competing investments is a very difficult metric to nail down. Investors typically gauge expected return based upon a range of outcomes that could happen under different scenarios in the company's operations. If too much optimism is factored into these possible results, the expected return will be too high. If too much pessimism is used, the expected return will be far too low. Again, the entrepreneur may be in a better position than the public firm or mutual fund to compete for investors' funds because of the proximity of the firm's owner-managers to the capital providers. Face-to-face meetings, solid dialogues about probable sales and profit outcomes and sharing ideas on how to manage and navigate the market and its potential customer base are all solid advantages for many investors.

Given the current climate for truth in analysts' reporting and disclosure for public companies, many angel investors are more likely to get behind an investment in a firm where they can personally check things out and where they have direct access to the senior management team. Rather than rely on some stock report circulated throughout a nationwide brokerage, investors in smaller, private firms often tend to have a better understanding of return potential when compared to analyzing a public company.

Once the meaningful discussions have opened up with a potential investor, be sure to directly address the issues of risk and return in a very specific manner, drawing potential investors into the dialogue about the venture's prospects. This kind of personal contact can often present your firm in a more favorable light when compared to competing investments.