



FOSTER CENTER FOR PRIVATE EQUITY

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Note on Angel Investing

Introduction

An angel investor is an individual that uses his or her own cash to invest in early stage companies. This note describes the fundamentals of angel investing, compares angels with venture capitalists, and offers suggestions for best practices among entrepreneurs and angel investors.

Company founders have a plethora of choices when they want to raise capital, including:

- Personal savings
- Credit cards
- Lines of equity
- Second mortgages
- Friends and family
- Government grants
- Asset based loans
- Accounts receivable factoring
- Business loans from banks
- Institutional investors (arranged through investment banks)
- Equipment lease financing
- Corporate strategic investors
- Angel investors
- Venture capitalists
- IPOs

Seedstage entrepreneurs, with very early stage concepts, products and companies, should weigh their options carefully in order to ensure the long term survival and optimal growth path of their startups. Founders can seek debt and/or equity investments. Debt-related capital most often requires monthly payments that can reduce the cash flow of a fast growing company. Some founders may ask for more equity capital than they really need and give up too much equity in exchange.

This document was developed by Professor Fred Wainwright and Professor Michael Horvath as a basis for class discussion rather than to illustrate either effective or ineffective management. The authors thank Frank Ruderman T'72 for his editorial comments.

Bill Gates, for example, still owns a substantial portion of Microsoft, whereas most founders see their percentage ownership diluted to less than 5% after numerous rounds of financing and public stock offerings. Fortunately, if the company has reached an IPO stage, the small slice of a very big pie allows those founders to achieve a multi-million dollar net worth.

Angel investors are so named because in the early 1900s wealthy individuals provided capital to help launch new theatrical productions. As patrons of the arts, these investors were considered by theater professionals as “angels.” Estimates of the number of active angel investors in the US vary widely. The SEC Rule 501 states that an “accredited investor” is a person with a net worth of at least \$1 million or annual income of at least \$200,000 or combined income with a spouse of \$300,000. According to Forrester consulting, the number of households in the US that fit that profile is approximately 630,000.

Angels fill a critical capital gap, between “friends and family” and VCs. When a startup requires more than \$25,000 but less than about \$1.5 million, angels are a viable source of capital. This level of funding is below the radar screen of most venture capitalists, although some VCs will occasionally fund a seed round of as little as \$500,000.

During the past few decades, VCs have raised larger and larger pools of capital and since the time and expense of reviewing and funding a company are the same, regardless of size, it is far more efficient for VCs to fund larger transactions. It is important that angels continue to be actively involved in investing because without seed stage financing, the country’s entrepreneurial force loses its energy.

Angels and VCs rarely compete for the same deals

Table 1 below compares and contrasts these two types of investors:

Table 1 – Angels vs. VCs

| | Angels | VCs |
|---|---|---|
| Funding amounts | \$25,000 to \$1.5 million | \$500,000 and above |
| Motivation to invest | Not just return driven, strong emotional component (“bragging rights”, psychological benefits of coaching, rush from being involved in fast paced startups) | Mostly return-driven with adjustments for relationships with other VCs and reputation among entrepreneurs |
| Accessibility | Prefer anonymity, reachable via referrals or through angel groups | Highly visible, usually will only look at business plans referred by their network of contacts (attorneys, etc.) |
| Geographical focus | Regional, within 4 hours drive time | Regional, national or international, depending on the firm |
| Key reasons to invest | Personal chemistry with entrepreneur, detailed market analysis, sustainable competitive advantages | Nearly developed product, operating history, strong and experienced team, sustainable competitive advantages |
| Term sheet issuance | Relatively fast (one day to three weeks), terms are somewhat negotiable (more than with VCs) | Can be fast, but usually is at a moderate pace (several weeks), terms are fairly standard and not very negotiable |
| Investment vehicle | Common or preferred stock, occasionally convertible debt (debt convertible to equity shares) | Preferred stock (convertible to common) |
| Equity percentage | 10% - 30% | 20% or more |
| Typical post-money valuation of startups* | \$250,000 to \$10 million | \$5 million and above |
| Due diligence | Relatively fast and light | Relatively slow and methodical |
| Funding process | Lump sum or milestone | Lump sum or milestone |
| Long term value added | Operational experience, common sense advice, specific industry expertise | Experience in managing growth, deep pockets, networks of additional sources of capital, rolodex, experience in managing IPOs and sale exits |
| Reaction to bad news | Roll up the sleeves and help solve the problem, open up rolodex | Intense communication and coaching; open up rolodex; help structure joint ventures, new financing rounds or mergers; fire management |
| Target exit time | 5 to 7 years | 3 to 5 years |
| Target IRR returns | 15% to 25% | 20% to 40% |

* For a description of basic valuation concepts, see the valuation section below.

Angels have a variety of individual and professional backgrounds

Angels can add tremendous value to startups. On the other hand, angels are humans and are subject to their personal idiosyncracies. One or more of these characterizations may apply to an angel:

Guardian angel

This type of investor has relevant industry expertise and will be actively involved in helping the startup achieve success. He or she has a strong rolodex of contacts and has the experience to add substantial value as a board member.

Operational angel

This angel has significant experience as a senior executive in major corporations. For an entrepreneur, this type of investor can add much value because he or she knows what the company needs to do in order to scale up operations.

Entrepreneur angel

An investor that has “been there, done that” is very valuable to a novice entrepreneur. For example, an entrepreneur can add perspective to the founders on what to expect from investors and how to effectively negotiate financing terms.

Hands-off angel

A wealthy doctor, attorney or similar professional must focus on his or her day-to-day career. This type of investor is willing to invest but usually does not have the time or specific expertise to be of much help to the startup.

Control freak

Some investors either believe they have all the answers because they have achieved certain wealth or they have the personality to convince themselves they know “everything.” Caveat emptor.

Lemming

Some angel investors will not make a decision unless an informal leader in the angel group invests or makes positive comments about a startup. Success breeds success - even a term sheet from one or two small investors can allow an entrepreneur to access larger investors, who usually become more interested when they find out that fellow investors have committed. Some lemming investors are particularly astute at leveraging the work of other investors whereas other lemmings simply trust blindly in the due diligence and term sheets of fellow investors.

Angels band together

Angel investors increasingly join one or more informal or formal groups. There are various advantages of working in groups:

- Social bonds and networking
- Access to prequalified deal flow
- Leverage intellectual capital and expertise of individual members
- Learn from each other regarding deal evaluation skills
- More extensive due diligence capability
- Alignment of members' interests

Angel groups can be structured in various ways:

- Each member owns a portion of the legal entity representing the group
- Limited liability corporations are formed by individuals to invest in specific deals
- The group is a non-profit entity and individual angels invest independently

Names and contact information, if available, of angel groups in the West Coast and northern New England are shown in Appendix 1.

Annual fees in angel groups are usually in the range of \$100 to \$1,000 per member. These fees cover meals, conference rooms and administrative staff.

Typically an entrepreneur must complete a questionnaire and submit an executive summary or a full business plan. A proactive entrepreneur will understand the angel investing process. A reading list is enclosed in Appendix 2 and a sample angel group questionnaire is shown in Appendix 3. Some groups require that a member meet with the entrepreneur and determine if the plan is viable before allowing the entrepreneur to present to the group. Other groups allow the administrative staff and managing director to review the plan and invite the entrepreneur to present without a "champion."

Once the presentation is made (usually in 10 to 45 minutes, including a question and answer period) the entrepreneur is asked to leave the room. The angels discuss the opportunity and, if one or more angels are interested then, depending on the group, either the entrepreneur is invited back at a later date for a more thorough review of the plan or an initial term sheet is developed within a week and presented to the entrepreneur.

Sometimes, if an entrepreneur presentation is weak but the idea has merits, the entrepreneur will be coached on what to do in order to be able to present in a future meeting. Occasionally, the entrepreneur is matched with an angel that is willing to coach the entrepreneur (informally or for a fee) in order to raise the quality of the business to fundable status. Some angels specialize in helping entrepreneurs write business plans and develop their strategy.

Angel groups occasionally band together with other angel groups to share due diligence and invest sufficient capital to complete a round of financing.

Evaluation of business plans uses several parameters

Companies don't build themselves. People build companies. Ultimately, an angel investor is selecting a management team. A great team can make even a mediocre

company achieve reasonable success, whereas a company with the best technology will not be successful with a mediocre management team.

Some of the key factors of a business plan that improve the success potential of a startup are shown below.

Table 2 – Success Factors

| Factor | Description |
|-----------------------|--|
| Management | <ul style="list-style-type: none"> • Years of operational experience in a similar industry • Startup experience with a similar business model that led to a successful exit • Willing to be coached |
| Market | <ul style="list-style-type: none"> • Addressable market that is fragmented and growing |
| Technology | <ul style="list-style-type: none"> • Patent protected • Creates strategically defensible position |
| Competition | <ul style="list-style-type: none"> • Shows that company has some competition, regardless of product or service • Clearly summarizes competitors and key threats |
| Business model | <ul style="list-style-type: none"> • Similar to one or more used by successful companies • Demonstrates that customers have real pain that product or service solves (“must have” vs. “nice to have”) |
| Exit strategy | <ul style="list-style-type: none"> • Identifies target acquirors • Shows deal history of acquisitions and IPOs with key financial multiples and ratios |
| Risks | <ul style="list-style-type: none"> • Objectively assesses risks and describes actions to reduce, mitigate or eliminate them |
| Financial projections | <ul style="list-style-type: none"> • Shows conservative, expected and targeted figures with assumptions for each • Focuses on cash flow and profitability |
| Capital structure | <ul style="list-style-type: none"> • Detailed • Preferrably shows ownership by founders and only small numbers of unprofessional or inexperienced investors |
| Investment desired | <ul style="list-style-type: none"> • Places an offer on the table - indicates valuation • Shows uses of funds in detail • Details expected future rounds and uses of funds from each round |

One thing is certain about any business plan: it will be wrong. Projections will change. Teams will change. Competitors will surge or fade. Most successful companies make radical changes to their business plans as managers discover the reality of their situation

versus their original expectations. Thus the experience of a management team is critical in order to handle sudden changes in strategy. Angel investors play a critical role in helping management teams make adjustments and prepare for venture funding.

Valuation is highly negotiable in early stage investing

Valuation is much more of an art than a science, especially for companies with no revenues or profits. In theory, a company is valued based on its ability to generate cash in the future. These future cash flows can be discounted using basic financial formulas in order to estimate the sum total of value today of all future cash flows.

For companies without positive cash flow but with revenues or net income, comparisons can be made with publicly traded companies in similar industries. For example, if ABC startup is in the medical software business, and publicly traded companies in the same industry trade for approximately 2 times annual sales, then it is reasonable to estimate the value of ABC as somewhat less than 2 times its annual sales. Usually a discount of 10% to 40% is made for private companies due to the fact that their stock is not publicly traded and the likelihood of matching willing sellers and buyers of private stock is fairly low.

Investors refer to the valuation of a company prior to receiving a round of investment as “pre-money.” Once funding occurs, at that instant, the value of the company rises by the amount of funding and the “post-money” value is determined. For example, a company valued at \$1 million “pre-money” will be worth \$1.2 million “post-money” after receiving a round of \$200,000 in funding. The investor in that round owns one sixth of the company (\$200,000 is one sixth of \$1.2 million).

If a startup has no revenues, then valuation is subject to much negotiation and relies more on common practices of angel and venture capital investors. A “hot” company with patents or competitive advantages and potential for hundreds of millions of dollars in sales will certainly command a larger value than one with tens of millions in potential sales, but hard rules are difficult to establish in the investing industry. Angels commonly value seed-stage, concept-type firms at around \$4 million while venture capitalists prefer to invest in early stage companies that they value at \$10 million and higher.

Latest developments in angel financing

Angel investor groups have had a difficult time since the stock market debacle in early 2000. Many early stage companies lost customers or ran out of cash. Of those startups that survived, many had to reach out to venture capitalists who insisted on significantly reducing the ownership percentage of previous investors, including founders and angels.

During times of major decreases in startup valuations from one financing round to the next, the VCs’ basic message to earlier investors was “if you can’t invest in the company

in this new round of financing to keep it alive, then you don't deserve to own much of it." This is similar to a poker game; those players who are unwilling to up the ante lose everything they placed in the pot in previous betting rounds. Tough, but fair.

Some of the larger angel groups have either formed their own funds or joint ventured with venture capital funds in order to ensure that young companies have the necessary funding in subsequent rounds to grow rapidly. Thus the angels are better able to monitor their investments as the startups achieve greater growth.

Tenex Greenhouse, for example, is an angel group in California that has launched a \$20 million (target) venture fund using angel and institutional capital to support successful angel-funded startups. Tenex Greenhouse also offers intellectual capital, leveraging its members' functional specialties and industry experience to provide support to funded startups.

The well known Band of Angels, started in 1995 in Silicon Valley, now has a \$50 million VC fund with capital from institutional investors. From another perspective, VIMAC is a VC fund in Boston that has a network of over 200 angels who can co-invest on select deals, especially ones that require more advisory work.

One of the results of cross-fertilization of ideas and organizational structures among angels and VCs has been the emergence of typical financing terms. Exhibit 4 describes common financing terms offered by investors to entrepreneurs.

Milestone financing is becoming more common. Investors mitigate their risk by setting operational targets for the startup that need to be met before another portion of funding is made. The pricing and terms of the milestone funding is pre-set to avoid excessive legal costs.

Suggested best practices for angels

Always be on the lookout for opportunities to help the startup. An angel often has industry networks that can be great sources of valuable information. Entrepreneurs can become so focused that they do not realize major trends are shifting or simply do not have time to network appropriately if they are deeply involved in product development, for example. Angels can be the eyes and ears of startups, and angels can help find good potential employees through social networks. Angels can also find other angels and venture capitalists for further rounds.

Diversify your risks by investing smaller amounts in more startups. Angel investments should be less than 10% of your portfolio, due to the risks of potential losses.

Set aside at least the same amount you invest in a startup so you can make follow up investments in future rounds. This will allow you to retain your percentage ownership or at least prevent it from being diluted too much.

Fund deals that you've shown to venture capitalists who have indicated they will fund future rounds if certain operational goals are met.

Know the ramifications of term sheet clauses in both upmarkets and downmarkets. Appendix 4 describes details of term sheets.

Angels that perform most of the detailed due diligence or long term management of an investment on behalf of an angel group should be compensated with a small percentage of equity.

Do not overcontrol the entrepreneur. There is a reason why the entrepreneur has started his or her own company: he or she prefers to run the show. Even though an angel has provided capital that does not give the angel the right to wrest control from the founder, except of course if the business is not meeting its operational goals.

Best practices for entrepreneurs

Only 1% to 2% of all business plans presented to either angels or VCs receive funding. Entrepreneurs need to read the necessary books and speak to individuals with financing experience or expertise so when the opportunity arises, they are fully prepared to present their concept to investors. Incomplete business plans are unacceptable in today's competitive environment.

Ideas are a dime a dozen. Fundable businesses are those that can demonstrate that they have the products and people to enter a market and either take significant market share or dominate.

Use informal networks to be referred to individual angels and VCs. It vastly increases the chances that your business plan will be reviewed.

Invest capital in your own startup. Not doing so is a major red flag for investors.

Do not refer to angel investors as "dumb money", regardless of who you are speaking with and especially in a public forum. Believe it or not, this has been done before. These kind of amateur mistakes will haunt you, because investors and VCs talk among themselves.

During the initial conversations with an angel group and during the presentation to the angels, it behooves the entrepreneur to find out which of the members are the real decision makers. This is difficult to ascertain but can be very valuable information because angels are human and they feel safety in numbers. The entrepreneur should focus on the more experienced angels and the managing directors of the angel group.

If groups of investors are interested, it is far better for them to invest as an LLC (limited liability company) than as individuals. VCs are weary of complex capitalization structures and an entrepreneur risks losing access to larger amounts of capital. In addition, major company decision making can become unwieldy if large numbers of investor/owners need to be consulting. This process can become like herding cats.

Finding an angel investor is like finding a spouse. Personal chemistry is critical because it is a long term relationship. This chemistry may take time to build so invest quality time in getting to know the angel. If you are dealing with a group of angels, it is the lead angel that will be on your board or that will manage the investment on behalf of others that should be your focus. It is far better in the long run for an entrepreneur to turn down an angel investment because of lack of chemistry and wait for a better match.

Keep the investor apprised of the company's progress at least quarterly if not monthly. If there are problems, alert the investor early about them. Involve him or her in developing possible solutions or finding the right people to help. Waiting until the last minute before disclosing major issues entails the risk of lawsuits from an angel for fraud or misrepresentation.

Conclusion

Angel investors provide significant value to the overall economy by fueling entrepreneurial activity. Angels are distinct from venture capitalists and, although the demarcation line is blurring, angels continue to be the true initial investors in great ideas.

Entrepreneurs are responsible for knowing basic financing concepts, preparing well for investor presentations and choosing their financing partners carefully. A company can sometimes survive operational mistakes, but running out of cash means the company ceases to exist. By having a good understanding the financing process as well as the pros and cons of financing methods, entrepreneurs will increase the likelihood of their company's survival and long term success.

Appendices:

1. Angel groups in the West Coast and northern New England
2. Reading list
3. Typical angel questionnaire
4. Typical financing term sheet concepts

Appendix 1 - Angel Groups In West Coast and Northern New England

| Name | Location | Website | Other Contact Info |
|----------------------------|-----------------|---------------------------|--|
| Acorn Investor Alliance | Hanover, NH | acorninvestor.com | Richard Green (603) 536-3743 acorn@worldpath.net |
| Angel Healthcare Investors | Boston, MA | N/A | Mary McNamara (617) 630-8081 hc_angels@yahoo.com |
| Angel's Forum | Los Altos, CA | angelsforum.com | Kimberlee Cerrone (650) 857-0700 inquiries@angelsforum.com |
| Band of Angels | Palo Alto, CA | bandofangels.com | JC Severeins |
| Breakfast Club | Nashua, NH | N/A | George Schwenck (603) 878-3081 |
| Common Angels | Boston, MA | commonangels.com | James Geshwiler (781) 274-9124 deals@commonangels.com |
| Gould & Co. | Merrimack, NH | N/A | (603) 429-1631 gouldcapital@aol.com |
| Launchpad | Boston, MA | launchpadventuregroup.com | info@launchpadventuregroup.com |
| Maine Investment Exchange | Portland, ME | maineco.org | (207) 871-0234 admin@maineco.org |
| North Country Angels | Montpelier, VT | N/A | (603) 252-6222 |
| Pasadena Angels | Pasadena, CA | Pasadenaangles.com | John Feeny |
| TCN (MIT) | Cambridge, MA | tcnmit.org | (617) 253-2337 info@tcnmit.org |
| Tech Coast Angels | San Diego, CA | N/A | Bill Payne bpayne@san.rr.com |
| Tenex Medical | Palo Alto, CA | tenexmedical.com | Norm Sokoloff |
| Walnut Ventures | Wellesley, MA | walnutventures.com | info@walnutventures.com |
| Vermont Venture Network | Burlington, MA | N/A | Ken Merritt kmerritt@merritt-merritt.com |

Appendix 2 - Reading List

The Angel Investor's Handbook: How To Profit From Early Stage Investing, Gerald Benjamin and Joel Margulis, Bloomberg Press, 2001

Winning Angels: The 7 Fundamentals of Early Stage Investing, David Amis and Howard Stevenson, Prentice Hall, 2001

Angel Investing: A Guide For Entrepreneurs, Robert Robinson and Mark Van Osnabrugge, Jossey-Bass Publishing, 2000

Every Business Needs An Angel, John May and Cal Simmons, Crown Publishing, 2001

Appendix 3 - Typical Preliminary Questionnaire From Angel Groups To Entrepreneurs

- Name of company:
- Year founded and legal structure (“C” Corp, “S” Corp, LLC, etc.):
- Who referred you to this angel group?
- Summary of business (in 3 sentences or less):
- What problem is your product or service solving?
- What is the size of the market, how much has it grown in the past few years, and what is its projected growth?
- Describe the competition (companies as well as substitute products):
- What are your company’s competitive advantages?
- Why will your company succeed in the long run?
- Does the company or its founders have any relevant patents or proprietary technologies? (please do not reveal specific proprietary information)
- What is the relevant experience of each member of the management team? Please enclose a one page resume of the CEO.
- What is the company’s sales and marketing strategy?
- If you have a website, what is the URL?
- What are the major short, medium and long range operational milestones you intend to achieve?

[continued in next page]

- Please complete the table below:

| | Last Fiscal Year | Projected This Fiscal Year (without investor funds) | Projected This Fiscal Year (with investor funds) | Projected The Following Fiscal Year (with investor funds) |
|-------------------------------|------------------|---|--|---|
| Revenues | | | | |
| Cost of Revenues | | | | |
| Operating Expenses | | | | |
| Interest Expense | | | | |
| Liabilities | | | | |
| Number of Full Time Employees | | | | |

- Are 50% or more of revenues generated from one or two customers?
- What are the 3 greatest risks of this venture?
- What is your capitalization structure? (How many shares are currently owned by founders and investors? How much capital has been invested so far, and by whom?)
- How much capital are you seeking, and how will this capital be used?
- How many rounds of investment and what amounts do you expect to need in total?
- What is your exit strategy?
- Please list the name and company of your professional advisors (attorney, CPA, and/or consultant):
- Who is the main contact person at the company? Please provide address, telephone, mobile phone, and fax:

Appendix 4 – Typical Term Sheet Clauses

| Clause | Sample Detail |
|------------------------|--|
| Type of security: | Convertible Preferred Stock (Series A) |
| Dividend: | 6% non-cumulative |
| Conversion: | Preferred shares are convertible at any time to Common shares at a conversion ratio of 1:1. Preferred shares are also convertible at an IPO of at least \$15 million. |
| Dilution protection: | Weighted average method. This method minimizes the loss of percentage of ownership of Company by an investor due to investments from other investors in future rounds. |
| Voting rights: | One vote per share as if the Preferred Stock was converted to Common Stock. A two thirds vote will be needed to amend the corporate by-laws, issue new stock, incur debt, sell the Company or shut down the Company. |
| Redemption: | Stock holder will have the right to force the Company to buy back the shares after 6 years. |
| Registration rights: | If the Company completes an IPO, shareholders will be able to register their shares for sale as allowed by law. |
| Pro rata share offers: | Investor can invest in future rounds of financing in order to retain the same percentage ownership in the Company. |
| Board participation: | Investor will have one seat on the board of directors. |
| Conditions precedent: | Funding will occur only if due diligence is complete, all legal documents are signed and any special conditions requested by investor are met by Company. |
| Covenants: | Company management agrees to provide monthly status reports and make financial records available for inspection at any time. Company agrees to abide by all laws and maintain proper insurance. |
| Expenses: | Company pays for all legal and due diligence expenses regarding this financing round. |
| Use of proceeds: | Hire CFO and Sales Manager, buy inventory, pay off accounts payable, meet other working capital needs |