ACCESS TO CAPITAL

This paper is meant to provide insight and guidance for both Angels and Entrepreneurs. It begins by reviewing the historical context of startups and investment in order to provide an understanding of the importance and background of entrepreneurship and the importance of seed funding for our economy. It then details the functions and best practices of Angel groups with the intent that these ideas will provide the reader with a solid foundation for determining the key factors in the successful funding of early stage companies at the seed or pre-revenue stage.

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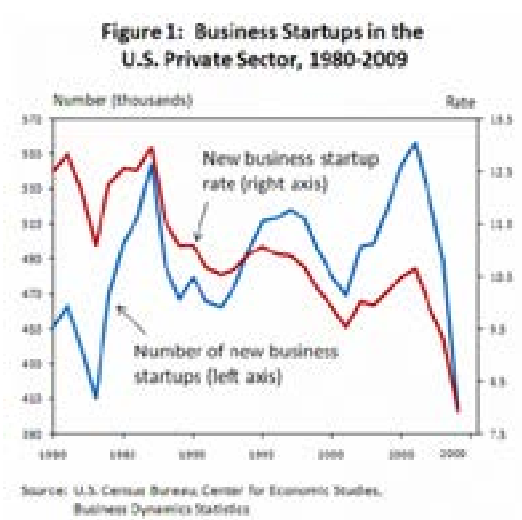
Chapter 1

Historical Overview

Where are the jobs?
Why startups and seed funding are essential to our economy.

Political scientists, economists and politicians have debated the source of job creation for decades. Recent research has helped clarify the factors most critical for generating the companies responsible for net new job formation. This data demonstrates clearly some vital labor demographics – where jobs come from, what types of business create the majority of all net job growth and maybe most important of all, why did the wellspring of job creation suddenly dry up in 2008?



The speed and magnitude of the decline in startup businesses and the corresponding impact on job formation is profound. Studies have revealed that in 2002 the United States entered a recession in which more total jobs were lost than in 2008.

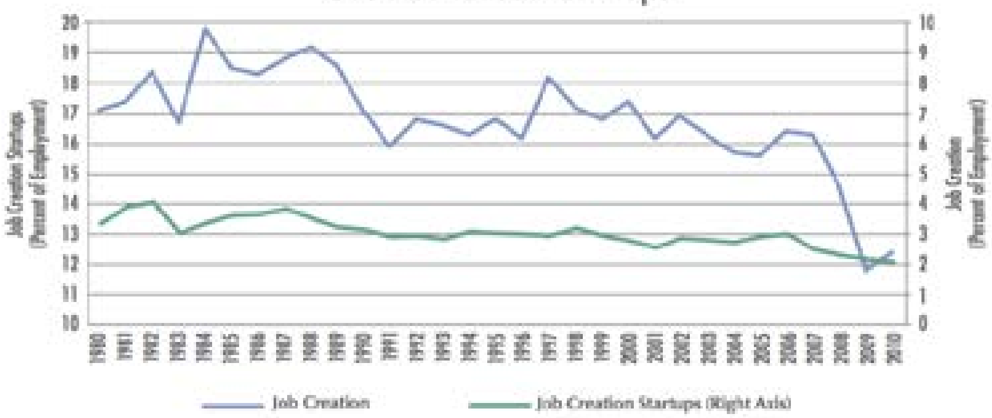
Somehow things were different just six years ago.

In 2002 there was no hangover. The prolonged economic impact of the 2002 downturn was trivial. The massive loss of jobs had little prolonged impact as new job creation rapidly absorbed the unemployed. This absorption came from high growth start-ups, the newly recognized source of all net job creation. Somehow, between 2002 and 2008 the mighty engine of millions of new jobs disappeared. To understand where the jobs have gone we need to know why there was a slow decline in the rate of start-ups, and why job creation collapsed in 2008 and has not recovered. (Doms, 2011, p. 1)

No startups, no jobs

The answer is obvious if we ask the entrepreneurs, and data backs up their claims. In 2002, we had a very healthy rate of startups because they had access to seed capital. They had the money that any start-up requires. The types of new technologies that create extraordinary new enterprises need more money than many small businesses that intend on staying small proprietorships. Just 1% of all start-ups account for over 40% of all new job creation and the characteristics of these companies are different. These “high-growth” companies need disproportionality more growth capital. They need money. They need complex production processes, new science, patents and ongoing research. They may need FDA or other regulatory approval. Unfortunately, they also are risky so at the stage of seed or pre-seed financing, there is still an extraordinarily high failure rate. (Haltiwanger et. al, 2012, p. 2).

Figure 1
Annual Job Creation in U.S. Private Sector–
Overall and from Startups



No funding, no startups

In 2008 the primary source of funding for all start-ups was from what we often call the three F's – family, friends and fools. These were the connections entrepreneurs knew and could solicit for funding. However, the savings and funds that were available for American's who wanted to engage in a form of direct capitalism has been shrinking rapidly as an unhealthy alliance of government regulators, politicians and massive (too-big-to-fail, too-big-to-jail) have consolidated control over these savings. Twenty-five years ago, local or regional banks redeployed a far greater share of American's savings. Indeed, the largest building in most communities was the dominant local bank.

Identifying the 1% that brings us the 40% of net new jobs remains a challenge but there are active agents in this market. Reaching nearly $23 billion, US organized angel investors are not only responsible for funding over 67,000 startup ventures annually, but their capital also contributed to helping to finance 274,800 new jobs in 2012 according to the Angel Market Analysis by the Center for Venture Research at the University of New Hampshire. (Sohl, 2012, p. 1). While Angels are seeking wealth creation, this correlates with job creation. That is, the 1% high growth firms are what both investors and economic policy makers seek to find and fund.

1% creates 40% of net new jobs.

Over the past century America became known as the caldron of technical innovation. In the words of Joseph Schumpeter, we were driven by the creative destruction of the free markets. (Shumpeter, 1942, p.83). The world has become envious of this ability and has captured our best practices and emulated our behavior. At the same time, America may have retained the destruction of the market but has damaged the creative side. Our largest firms lower the costs of goods by reducing the labor required. Indeed, that is the definition of labor efficiency – more output with less labor. The freed up labor historically was redeployed in the new high growth companies. However, this is no longer the case. (Dilger, 2013).

There is a single factor that stands out clearly that correlates with the long slow decline in start-ups and hits a cliff in 2008 – the availability of seed capital.

Only winners count

What we do know is that net job creation comes from a unique class of high growth start-ups. The problem is identifying the winners. The best we've been able to do is to provide capital to hundreds of thousands of startups. However, pouring massive amounts of service and support programs into start-ups, in an effort to rekindle the job-creation engine is much like applying massive amounts of fertilizer. Without adequate water, the added fertilizer burns the crops. Similarly, without adequate seed capital, these policies of entrepreneurial support may do the same. The expenditures on entrepreneurial support systems are growing rapidly but it has not had a positive impact on the ongoing decline. What is missing is capital. (Horn; Pleasance, 2012)

Recently far better (richer) data collection has begun to shed light on the critical factors. First, a great difference lies in job creation between large and small businesses. As companies grow and production process scales, focus is placed on improved efficiency; while this lowers the cost of the products we consume, it involves the reduction of labor used in that productive effort or industry. In other words, as large companies scale they bring us low cost goods and services but destroy jobs in the process.

Small businesses on the other hand fail at a much higher rate than large businesses, so the jobs created by small businesses starting are lost by other small businesses failing, leaving little or no net contribution in job creation from the small business. Economists next turned and focused on new businesses with detailed data on companies less than five years old. Again we found accelerated job creation paralleled by accelerated business failures. While almost all new jobs come from companies less than five years old there is still a small subset of new companies that represent the most significant share of new job creation.

The literature consistently shows that a very small number of all ventures in a region, account for the majority of net job creation. However, increasing the number of startups has not increased the number of high growth ventures. In fact, numbers of newly formed ventures and high growth firms seem to be negatively correlated. To quote a study of business ventures in the US done by Harvard Business Review: “High-impact firms …represent between 2 and 3 percent of all firms [in the US], and they account for almost all of the private sector employment and revenue growth in the economy.” (Isenberg; Brown, 2014).

This means that a miniscule portion of businesses make the difference between job loss and net job creation. It makes sense that significant public policy should be directed towards stimulating this sector of our economy yet we have done just the opposite since 2008. (Dilger, 2014, p. 2). Indeed we have destroyed this fountain of job creation. The data is clear that start-ups have stopped but little has been said about why. The answer is to follow the money. In 2008 it stopped flowing to start-ups and it has not recovered.

America’s economic recovery has failed to generate meaningful job creation because we are grossly under-investing in start-ups. Further, legislation designed to address the problem have only made it worse. An over focus on startups just doesn’t work unless the focus is placed on finding the true nuggets. The high-growth startups are where we need to channel the energy. Efforts to protect investors, over the past fifty years have channeled more personal wealth into narrow asset classes that end up inflated and volatile. Mandated custodial supervision of tax-sheltered retirements has bankrolled a financial industry that adds costs and thus lowers net returns for most Americans. It simultaneously has lead to the loss of local capital for start-ups. (Kedrosky, 2009)

In general, over-focus on startups is just bad policy. In fact, Scott Shane (2009) points out that there is no evidence that people create too few or the wrong businesses in the absence of government intervention, and a lot of evidence that these policies lead people to start marginal businesses that are likely to fail, have little economic impact, and generate little employment. He also points out that “investing a dollar or an hour of time in the creation of an additional average new business is a worse use of resources than investing a dollar or an hour of time in the expansion of an average existing business.” We have seen a plethora of startup movements around the world, yet very few show any concrete benefits. In fact, most of the small businesses are incapable of evolving into larger businesses. It can be argued that if anything, policy makers need to let markets play a much stronger role in choosing and nurturing early stage winners while letting losers fail, even in risky entrepreneurial ventures. (Shane, 2009, p. 2-4).

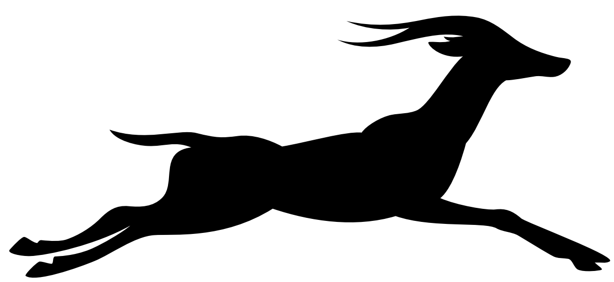
Clearly picking winners really matters and there is no better guidance then angel investors risking their own personal dollars.

Fostering high growth firms is not a ”numbers game.” In order to reap the significant economic and social benefits that entrepreneurship can deliver (under the right circumstances), private and public sector leaders need to get the facts right. To use a transportation metaphor: it is futile to jam the on-ramp of our economies with startup traffic without well-paved fast lanes, high powered cars, skilled drivers, good police, and lots of exit opportunities.

Bring forth the gazelles

High-growth entrepreneurship contributes disproportionately to innovation, job creation and long- term growth potential. High-growth enterprises, referred to, as “gazelles” are young companies that transform markets with radically innovative products, services and processes. Gazelles outperform all other businesses by generating consistent and extraordinary growth in employment and revenue. These companies start small but quickly grow to become global household names like Facebook, Amazon, and Starbucks. Gazelle-type innovation tends to be characterized by firms with high intellectual capital and low physical capital; a steadfast focus on getting products to market quickly and a high responsiveness to market feedback; high-risk, high-reward strategies; and global ambitions. (Wells; Hungerford, 2011, p. 1)

Gazelles contribute to the majority of new jobs and are more likely to create new markets and industries through exports than others. By creating new markets and industries, gazelles aid in diversifying an economy and are therefore able to reduce its vulnerability to economic shocks. Successful entrepreneurs and investors who have been involved in gazelle companies are more likely to create future successful ventures and are important role models and mentors for other entrepreneurs. Because of its transformative economic impact, high- growth entrepreneurship is gaining the attention of public policy-makers around the world. (Wells; Hungerford, 2011, p. 2)



The policy dilemma

Today, US public policy is trying to catch up. New high-growth enterprises or “gazelle’s” are the Holy Grail for job creation. While public policy should be focused on identifying the attributes of these companies and feeding them with all the supportive eco-system possible, the ability to reform the concentrated financial industry will likely take decades and require structural reforms in the intimate linkage of our regulatory systems with the institutions they regulate. The too-big-to-fail, too-big-to-jail institutions must eventually be replaced by more efficient means of converting savings into productive investments that grow the wealth of the vast majority of Americans.

The total number of start-ups went over a cliff in 2008, primarily due to the loss of startup capital that is essential for new business formation. Start-ups have been declining for decades paralleling the control of investment capital moving from the community based banks to massive too-big-to-fail/too-big-to-jail institutions constrained, by their very scale, to consolidate their investments in large, widely-traded financial instruments – bonds and major exchange stocks. This concentration of savings was driven by tax policies and regulations – 401k, IRA, etc. What was left was home equity. Until 2008, while start-ups were in decline, there was enough equity in homes for local banks to fund startups based on home equity lines, second mortgages or simple loan guarantees. In 2008 funding for startups stopped due to the loss of home equity. As home equity rebounded in 2010/2011, new banking controls put the final nail in local banking adding extraordinary controls on accessing home equity.

Efficient capital markets that took individuals savings and effectively invested them in high performing growth companies (the same companies that provided the highest returns also created the most jobs) suddenly was no longer.

Too big to fail Too big to jail Institutions

If you visit the mid-size cities of mid-America, if still standing, the tallest building in town is usually the empty hulk, the remaining remnants of the local bank. It is interesting to note that savings from the community, retirement savings, college savings etc., financed the rebuilding of America after the great depression until 2008. Studies indicate that in 2002 job losses actually exceeded the losses in 2008, but something big has changed.

What we need

We need to foster, through policy and practice, entrepreneurship ecosystems in which high growth firms can take root and thrive. In order to build an eco-system that supports high growth startups, we need to ensure that there is sufficient seed capital. New policies that support an eco-system organized and managed by successful entrepreneurs capable of mentoring is also a key ingredient. New government initiatives that provide further tax incentives and research and development grants and matching funds would go along way as well in providing additional capital.

Ideally, what is needed is a more efficient capital structure. Crowdfunding is just an example of the possibilities of new funding mechanisms that if supported can provide the necessary seed funding.

Also, while the goals of transparency and accountability drive corporate oversight they must be made relative to the size of the investment. Reg D exemptions should clearly be different for large hedge funds vs. entrepreneurial startups. With reasonable certainly, we can say that the US will remain a post entrepreneurial economy unless dramatic changes are made in the availability of capital for our entrepreneurs.

Chapter 2

Angel Foundations

Angel investors are a critical part of the startup ecosystem. They provide cash, make connections, and offer encouragement to help develop ideas into actual businesses, or at least into a business that can attract funding from venture capitalist firms down the road.

What is angel investing?

An angel is a wealthy individual willing to invest in a company at its earlier stages in exchange for an ownership stake, often in the form of preferred stock or convertible debt. Angels are considered one of the oldest sources of capital for start-up entrepreneurs; the term itself, by most accounts, comes from the affluent patrons who used to finance Broadway plays in the early twentieth century. There were over 258,000 Angels in the US in 2010. (Grant, 2013) These angels invest in approximately 60,000 companies every year with an average investment size between $10,000 and $100,000. (Grant, 2013; What are Angel Investors from Startup.co, nd, para: 6)

Angel investors are typically individuals that invest money in start up or small company growth investment opportunities. Often times these early stakeholders invest in ideas in the concept phase, well before there is a "company". Typically funds are invested in exchange for equity in the business or idea. In most cases, angel investors have little or no day-to-day management, nor do they necessarily participate at a board level.

The capital that angels provide can be a one-time injection of seed money (80% of angel investments are seed or early stage investments) or ongoing support to carry the company through difficult times. (Grant, 2013; What are Angel Investors from Startup.co, nd, para: 2)

However, Angel investments are high risk. Interestingly, if you compare this risk against the stock market on average, you may want to invest in a startup instead! The average return for an angel is 23% vs. the US historical stock market return at 10%. (Grant, 2013; What are Angel Investors from Startup.co, nd, para: 6)

Angels are often motivated by factors other than money (although this is, of course, a factor). They are often entrepreneurs and executives passionate about supporting the next generation of innovators. A study conducted by researchers from Harvard and MIT found that angel-funded startups are significantly more likely to survive at least four years and raise additional financing. (Yates, nd, para: 6)

What is Seed Capital?

Seed Capital is the earliest stage of capital investment for a start-up venture. Startup financing involves several stages of capital formation: seed capital, venture capital, mezzanine or bridge funding, and an initial public offering. The seed capital stage is the earliest stage of capital investment in a startup company. (Investing Answers, nd, para: 1)

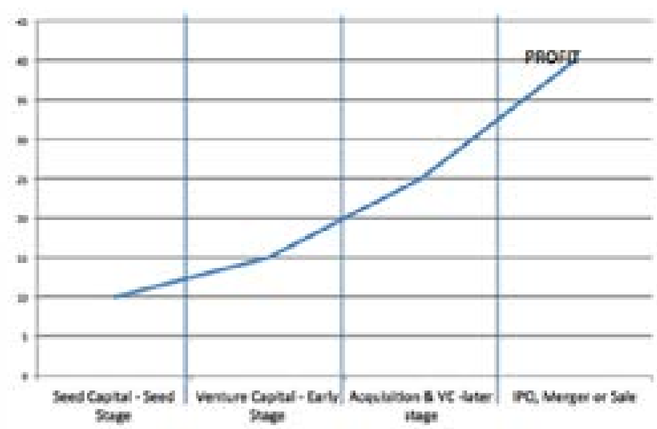
> The seed capital stage is the earliest stage of capital investment in a startup company.

Seed capital is money that is used at the beginning of a company's existence. It is during this period that the company is involved a variety of early operations such as market research, product development, or prototype production. It is during this stage in most cases that the company is not generating much revenue. (Investing Answers, nd, para: 1; Investopedia, nd)

Most businesses starting up will require seed capital. From an investor's perspective, this is a high-risk investment, but it is one that can have a major upside if the company experiences growth. Seed funding is usually exchanged for an equity position within the company but with far less formal contractual overhead than standard equity financing.
(Investopedia, nd; para: 1-3)

Why is seed important?

The amount of money is usually relatively small because the business is still in the idea or conceptual stage. Such a venture is generally at a pre-revenue stage and seed capital is needed for research & development, to cover initial operating expenses until a product or service can start generating revenue, and to attract the attention of venture capitalists. (Investopedia, nd, para: 1-3) Adapted from: Investing Answers, nd, para: 1



Organized Angel Clubs

Angel Investor Clubs are affiliates of angels that work together, and sometimes with other similar clubs, in an organized fashion to find worthwhile investments, which meet the financial risk objectives of the club's charters. (Temko, 2009, p. 3).

Prior to organized angel groups, raising money for Entrepreneur's meant they had to develop a large network of contacts which took a lot of time and resources and made it difficult to assess the suitability and credibility of investors. Single angel investors also found it difficult to independently verify the claims and assertions of entrepreneurs and devote the time and effort to doing a good job of due diligence. Unless the angel investor was writing a large check, he or she had little leverage in company valuation, board representation, or term-sheet negotiation.

By participating in an organized group, angels can do a more professional job of identifying and funding the most attractive companies. As part of a team, an angel investor has better deal flow, can perform better due diligence, can control the investment process, can negotiate better terms, and has access to additional capital. The knowledge and experience of a team helps the angel gain a more complete understanding of the investment. Another major benefit is the learning experience. As a result of participating, the angel investor learns a great deal about the market, the product, and the underlying technology of a given investment. At the same time, members strengthen and expand their network of contacts. (Yates, nd, para: 6)

According to the Kauffmann Foundation (2009), the increase in the number of angel groups that has formed has been a result of:

A desire to attract better deals and generate higher returns than angels acting alone;

The growth of venture capital funds and the attraction of venture investing;

A widening "capital gap" between individual and institutional venture capital investors that has created a need and an opportunity for pooled investments;

The legal and economic complexity of these investments;

A large increase in the number of self-made, high net worth individuals who want to be more involved in their alternative asset management;

The volume of deal flow; and,

Social camaraderie among investors. (Kauffman, 2002, p. 1).

Angel club processes

There are no set models for how a club functions. Minimally the participants of the clubs have regular meetings and at least loosely defined investment criteria. Angel clubs come in various forms, below is a brief overview:

Type of Club	Description
Unstructured angel clubs and individual and/or loose affiliates	This is strictly opportunity sharing there is no staff and no club fees are collected. (Seth, 2009, p.2)
Structured angel clubs	Structured angel clubs typically have an executive director. A formal process is put in place that includes breakfast meetings where prospective companies present and there is typically one lead due diligence person from the group for each deal being considered. (Seth, 2009, p. 2). Pay a fee to be a member and then if you like a deal you invest.
Managed Angel Fund	Similar to a small venture fund, this type of angel group is a type of limited partnership where the members pledge a certain amount – typically 100k. Each member is then assigned units and each member pays a proportionate share on each deal. Members sign a commitment to the fund or a pledge.
Kieretsu	Keiretsu is a Japanese term describing a group of affiliated corporations with broad power and reach. Keiretsu Forum is a very large angel network described as a conglomeration of individuals or small companies that are organized around private equity funding for mutual benefit. Keiretsu Forum believes that through a holistic approach that includes interlocking relationships with partners and key resources, they can offer an association that produces the highest quality deal-flow and investment opportunities. (Seth, 2009, p.2)

chart continued:

Type of Club	Description
Sidecar funds	A sidecar fund is a pooled investment vehicle that invests typically along side an angel group. The sidecar fund opens angel investing and the activities of the group to persons who want to be passive investors or who do not feel qualified to invest on their own. The fund gives those persons access to the asset class, and may lead to new active members for the group. The sidecar fund provides a way for members of the group to allocate part of their funds to angel investing in a balanced manner across all of the group's investments. This can supplement their personal active portfolio. The sidecar fund gives the group additional "critical mass" when it invests with institutional investors or leads rounds of investment itself. The ability to invest more money through the group may give it a seat at the table in negotiations with institutional investors or governance or enable the group to lead a somewhat bigger investment round than the group members themselves could afford. Investors in the sidecar fund typically are charged a management fee with respect to capital under management. The fee can be used to defray costs of the angel group (such as salaries of an executive director and other staff or costs of group meeting) and to lower dues. (Seth, 2009, p.2)
Community	A nationally based community of investors. Professional managed network fund that is similar to a venture club in that each member puts in a specific amount (typically around $50,000). The club has regular dinner/breakfast meetings to conduct deal reviews, etc.

The most highly effective Angel Investor Clubs are like a business. There are application processes by which investors join the clubs. Staffs and committees with business and investment backgrounds work with the clubs. In these cases there are established rules and procedures both for companies seeking funding, and investors who wish to participate. Investors may pay annual fees or dues to participate in the club. Prospect companies, who wish to be considered by the club, go through a vetting process in which they fill out applications, which follow pre-defined and standardized description and presentation formats. Standardization allows potential investors/club members to quickly assess and evaluate a candidate company's position and attractiveness as quickly as possible. (Temko, 2009, p. 3)

Companies seeking investments may pay a presentation fee (typically $3,000 - $5,000). The fee offsets the cost to administer and vet the companies and also weeds out "conceptual" or poorly founded businesses from strong candidates for investment. Typically there are regular investment presentation sessions in which companies have 20 minutes to present (in a defined structured format), 10 minutes to answer questions, followed by a coffee or cocktail mixer where they can then mingle with investors and answer more individual and specific questions. (Temko, 2009, p. 3)

At the end of presentation sessions, investors submit a list of companies they are interested in learning more about, and a diligence committee member or club administrator makes contacts available to the presenting companies to discuss next steps. (Temko, p. 2)

Some clubs create standard investment documents that investors have access to, but largely, individual investors work with the prospect companies directly because often companies seeking investment will have their own offering documents and investment contracts. (Kaufmann, nd. para: 4)

The following provides an overview of a structured angel clubs processes:

Standardization helps members consistently benchmark their evaluations against the club's pre-defined investment objectives, minimizing emotional reactions to particular presentations.

Membership and Membership Dues

As a baseline, each member must be financially capable to make investments in early-stage ventures. Many organized groups require angels to complete legal documentation confirming their status as an “accredited investor” or “qualified investor” to meet regulatory requirements. Additionally, groups may seek members with industry or functional expertise, a willingness to be actively involved with the angel group or its portfolio of investments, successful entrepreneurial experience, access to deals and networks, or some underlying shared beliefs or values. The most suitable members bring some combination of these attributes to the organized group. (Kaufmann, nd, p. 3-4)

Angel groups were found to have either open membership or a fixed closed, membership structure (i.e. the member-led or manager-led models). Typically groups charge their members dues ranging from a few hundred to a few thousand dollars a year to cover administrative costs. In addition to providing compensation for overall management and administration, organized angel groups may also support other general operating expenses (meetings, mailings, technology, legal, tax, and accounting at an organization level) and deal-specific expenses (due diligence, professional services). Payment of these expenses depends on the organizational structure and the financing model. For some groups, the organization covers both operating and deal-specific expenses, drawing fees from a fund, member dues or both. Other groups cover operating expenses, but charge specific fees to investors on a deal-by-deal basis. This typically is either a fixed amount per deal or proportional to the capital raised. A lot of the angel groups have local and state sponsorship as well; these could be accounting firms, law firms or larger corporate or state grant sponsorships. In most cases, the sponsors had some kind of strategic alliance with the group or its activities. (Kauffman, nd, p. 4)

Investment Requirements and Expectations

Investment requirements and expectations are settled before a member joins the group. Members typically invest a minimum amount each year in companies presented to the membership either as a group or individually and they also pay a yearly membership fee that ranges from 1-3,000 dollars.

In manager-led LLC groups, members often commit a fixed amount, drawn down over time. Research finds that this amount has varied from $50,000 to $150,000 over several years. (Kauffman, nd, p. 4)

Often members invest anywhere from $10,000 to $100,000 in each deal with the ability to utilize their network and contacts to raise additional financing if necessary.

Management & Administration of the Angel Group

Groups either have hired professionals or managing members selected by the membership that administer and manage the group. Many have a hired dedicated managing director who is in charge of the day-to-day operations of the funds. The director/manager usually has a full or part-time administrative assistant and/or an MBA student or intern. The director is typically compensated through salary, incentive fees and a carried percentage on investment gains or a combination of these. Member managed groups may also elect to rotate the position among members and have little or no compensation model. This is rare however, since there is a lot of work to do in managing a club.

Club Meetings

Most angel groups organize regular monthly breakfast or dinner meetings where members attend to hear two or three company presentations. Presenting companies are often sponsored by a member, and prior to the meeting, members usually receive a summary about the company and some preliminary due diligence on the opportunity. After hearing the entrepreneur's short pitch (less than 30 minutes), there is a question and answer period allowing members to ask questions of the management team (another 15 - 20 minutes).

Typically in a manager-led club, members put the decision to a vote after the presenting company leaves. If the members vote to pursue the opportunity, volunteers from the club work with the managing director or other members to complete the due diligence on the company. The due diligence is then presented and communicated at a follow-on meeting. In a member led group each investor may make their own investment decision but most often members collaborate on deal negotiation and due diligence.

Deal Flow

Organized groups find deals either through club members, traditional networking or through web site lead generation or other crowd platforms like GUST. A lot of angel groups also actively pursue deals through events such as pitch nights, conferences, university liaison's, etc.

Selection/Screening Process

The selection process usually consists of a screening committee that comprises a sub-set of the membership of the club and includes members who may have expertise in areas of interest to the club - i.e., life science or technology. Individuals review a brief summary on the company and then assess it in terms of the memberships interest in the sector, stage or size of the deal or the geography.

Due Diligence Process

Due diligence is essentially an audit of a potential investment that makes certain all facts provided by the company are confirmed. It is the investigation of information that should be taken before entering into an agreement or a transaction with another party. (The Business Angel, nd. para: 1). This section will touch lightly upon the subject of due diligence with further detail being examined in the section on Due Diligence.

The depth and extent of that due diligence varies both by group and by specific opportunity.

However, there are some commonalities:

1. Background checks on the management team
2. Legal checks on the status of the company and verification of intellectual property ownership
3. Understanding the market
4. Accounting checks on the finances presented
5. Factual checks on the statistics or figures given. (The Business Angel, nd, para: 4)

The process typically has a leader or champion appointed by the membership who takes responsibility for circulating documents, scheduling conference calls, negotiating terms, collecting checks, etc. This process can be time-consuming but is the most important step in the screening process. In most cases the due diligence leader will become the primary contact to the company after the investment is made, acting either as a board member/observer or advisor. (Kaufmann, nd, p. 6)

Follow-up

After a funding decision, angel groups tend to follow up with a company in three ways:

1. Oversight and advice for the business
2. Observer status or seat on the board of directors
3. Assistance with additional fund raising

Angel groups typically will appoint one of their members to a company's board of directors. Typically it will be the member that was either involved in the diligence process or was championing for the company. The appointed member then provides regular reporting to the group on the status of the company and their investment. (Kauffman, nd, p. 7)

Syndications

Angel groups also may syndicate the investment at the time funds are committed, or as part of a subsequent round, as a way to share due diligence and provide additional expertise and capital. Syndication with other organizations with additional funds helps strengthen the investment and share risk. Other angel groups or venture capitalists are involved in the syndication and these groups do not view themselves as competitive but rather complementary in that they bring different skills or relationships, such as with investment bankers or strategic partners, further benefiting the company and the investment. (Kaufmann, nd, p.7)

Investment Approaches

Angel groups may adopt a number of investment approaches that fit with their structure and funding models. In most cases one approach is adopted and applied to all the group's investments. These models or approaches may include the following:

- Individual members write checks directly to the investment entity
- Members individually write a check into a single purpose LLC that is set up for each investment and the LLC invests into the entity;
- Individual members invest through the group's umbrella membership organization as part of a larger fund, which may or may not include outside partners or limited investors.
- A combination of the above methods which may also include specific deal investments, referred to as side-by-side investing, in the single investment entity models. (Kauffman, nd, p. 8)

Groups that have chosen not to lead investments but instead co-invest on terms determined by other investors also have developed a set of standard and acceptable terms as a threshold for their investments. Most angels are business people who understand the need for alignment between all the investors and the founders of the company. (Kauffman, nd, p. 8)

Deal Terms

Terms of the deal will also vary depending upon the angel group and their level of domain expertise, the amount of capital raised, the urgency of the investment, their relationship with the company, etc. Those that lead the investment round will typically draft the terms of the deal, which include:

- Valuation
- Security
- Right and provisions
- Term setting with the company and other investors

Most term sheets developed for seed and early-stage companies have a predetermined valuation, however, some angel groups instead choose to set the valuation as a discount to the valuation of the next financing. For example, there may be a set percentage, for example 75%, or it may be a sliding scale, increasing the discount and decreasing the valuation depending on the time elapsed to the next financing or the failure to achieve milestones. Most angel groups seek co-investors to share the risk of financing early-stage businesses. Often, the release of investment funds from the angel group requires the company to receive commitments from co-investors. (Kauffman, nd, p. 8)

Expected Returns

Every major study that has been conducted to-date has placed the Internal Rate of Return for angel investors between 18-38 percent. That is about 2.5x returns overall (Wiltbank, 2012). Granted, the data on these returns has been difficult to obtain, analyze and verify which makes it very difficult to rely upon. However, even if there is bias, the median IRR is still higher than any other asset class. Indeed, this does not mean that all angels make this rate of return bur rather that professional angel groups and institutional investors definitely do better than the average investor.

The most reliable studies in this area use the Kauffman Foundation's Angel Investor Performance Project (AIPP) dataset and place angel IRRs north of 30%. For angel groups to reach this IRR, studies have indicated that the bare-minimum level of diversification needed to get these good returns as an angel investor is 20 companies. Taking on 20 companies as an individual angel investor would take an inordinate amount of time, which ultimately is why formal angel groups are growing in numbers. Formal angels groups have been shown to increase returns for their members. (Teton, 2013; Wiltbank, 2012)

The following items are key to crafting a term sheet that is suitable:

Creating terms that are understandable and acceptable to subsequent investors;

Confirming that the original capital structure is clean and will remain so as a result of the financing;

Accounting for any future options pools;

Including provisions if required for milestone payments, which creates a staged investment, releasing specified amounts following the completion of agreed upon milestones.

Regulation D or “Reg D”

Reg D is a Securities and Exchange Commission (SEC) regulation governing private placement exemptions. It allows usually smaller companies to raise capital through the sale of equity or debt securities without having to register their securities with the SEC. Reg D offerings are meant to be advantageous to any private company or entrepreneur because they allow an entity to obtain funding faster and to avoid the costs associated with a public offering.

However, the Securities and Exchange Commission issued final Rule 506 permitting startups to use general solicitation when raising funds from accredited investors. As required under the JOBS Act, issuers under 506(c) must “take reasonable steps to verify” that all purchasers are accredited investors. The rule is effective as of 09/23/2013. (Securities and Exchange Commission, 2012).

The SEC did not define “reasonable steps to verify,” stating instead that whether the verification requirement is met would be a case-by-case, objective determination of “facts and circumstances.” However, the SEC did provide four alternative, non-exclusive “safe harbors” issuers may rely on. Under these, an angel investor would have to provide an entrepreneur (or permitted third party) detailed personal financial data on income or net worth -- including paystubs; IRS forms 1040, 1099 or W-2; bank and brokerage statements; appraisals, and/or credit reports. These materials must be current within 90 days prior to an investment. (Angel Capital Association, 2013, p.1)

Experienced angels who are active in the startup ecosystem will not willingly turn over confidential financials just so they can invest their own money. In fact, these “safe harbors” are highly unsafe: they invade investors’ privacy, raise concerns about confidentiality, and impose costly and unworkable burdens on startups for retention of sensitive investor data. (Angel Capital Association, 2013, p.1)

In addition to the final rule, the Commission also proposed new rules for Regulation D and Form D, which impose tremendous burdens on startups. Under the proposed rules, issuers using 506(c) would be required to: file a Form D at least 15 days in advance of any general solicitation; electronically furnish to the SEC all general solicitation communications no later than the date of first use; and require lengthy legends on all solicitation materials. If they don’t meet these filing requirements and deadlines, they are barred from any Rule 506 offering for a year. (Angel Capital Association, 2013, p.1)

The reporting process has not been finalized. With billions of dollars of financial at stake one can be certain that there will be a lot of activity in this area in the next few months as the markets respond aggressively to meet these new needs.

Chapter 3

Risk Mitigation Strategies And Term Sheets

Out of every 10 deals, only one or two will result in positive ROIs. As well, breaking even and returning a profit might take several years. (NAO, nd, para: 1).

Risk Mitigation Strategies

Angel investing can be both financially and personally rewarding but it is not without its risks. The opportunity costs of the investment along with the risk of negative ROI could be financially daunting. Acknowledging these risks allow for ways to mitigate them. According to Network of Angel Association of Ontario, the statistics seem to be against Angel investing. This means that Angels need to realize extraordinarily high, expected returns but for the entrepreneur, indicating that they might be a risky deal means a lower valuation of the company.

Mistakes that increase the risk profile and limit returns

Using a highly disciplined approach to investing is how Angels can mitigate risks and increase their returns in early stage companies. Experience has shown over and over that developing an effective discipline and adhering to it, is key to generating consistently superior returns. (Engler, Robinson, 2009, p. 1). Effective discipline ensures that the investors do not make any of the following classic mistakes that limit their returns:

1. Insufficient deal flow (ie. selecting from a broad enough group of companies thereby increasing the chances of finding the "gems".) Adequate deal flow is the first step in driving superior returns. If angels do not have access to the best deals, they will not be able to drive the best returns. (Engler, Robinson, 2009, p. 2; NAO, para: 1-7)

2. Do not use sufficiently rigorous selection criteria. Investors need to seek companies, which can benefit the most from their capital and expertise, offering them a chance to deliver the most value to each company. Good selection criteria will ensure that angels only invest in companies that have a good chance to meet their investing goals. (Engler, Robinson, 2009, p. 1)

3. Conduct insufficient due diligence. Effective due diligence is key to ensuring investment in only the highest quality opportunities thereby driving the best results. Due diligence covers all aspects of the company from the management team to customer relationships, the market, competitors, intellectual property, etc. The topic of due diligence is covered in this book in the next chapter in detail. (Hull, 2013, para: 10)

Mistakes that increase the risk profile and limit returns (continued)

4. Allow emotion to override their discipline and/or get excited by the entrepreneur and/or the technology. (Engler, Robinson, 2009, p. 1)

5. Have insufficient domain knowledge to accurately assess a company's prospects. Angels need to understand what kinds of deals are appropriate for their expertise, amount of capital, timeframe for exit and ability to engage with portfolio companies. Angels need to pick a venture in which they have both expertise and industry experience. This provides the ability to not only properly assess the product and market opportunity, but also provide insights to keep the business on course or avoid it from veering off course.

6. Lack of understanding or knowledge in what terms to ask for when making an investment and/or have insufficient capital to demand the best terms. Coming to terms with an entrepreneur is often the most challenging hurdle once a potential investment has been identified. If the company needs an amount of capital similar to what the angel is offering, the angel will have an advantage in setting terms because the entrepreneur can then cease seeking investment funds and fully engage in the job of building their company. Angels offering amounts substantially less than what an entrepreneur needs will typically be along for the ride on whatever term sheet the entrepreneur or lead investor has offered. In circumstances where entrepreneurs have written the term sheet, it is in their interest to avoid giving investors the best possible terms. A strong lead investor can counter this situation effectively if they know what terms other companies are getting in the current market and how this company compares to others in terms of potential returns to investors. Getting the right terms on an investment is critical to getting the best returns on investment. Just like real estate, the Internal Rate of Return of any deal depends greatly on the price paid at the outset.

7. Do not oversee their investments closely enough. Angels also need to be aware of a company's timeframe for providing liquidity, which can vary dramatically in terms of form and timing, and select investments that are compatible with their goals. Angels need to help our their portfolio companies as much as possible by providing their expertise and connections/contacts to aid the company in obtaining additional sales or by bringing in further investment. (Engler, Robinson, 2009, p. 1; Hull, 2013, para: 7)

8. Reserve insufficient capital for follow-on rounds of financing. Angels need to select companies that are seeking an amount of capital, both in the present and the future, which is compatible with what they are able and willing to invest over the company's full funding lifecycle. All companies, even the best ones, will struggle at some point and it is during these difficult times that most angels chose not to re-invest in their portfolio companies. Yet, it is precisely during these times that those who do re-invest can obtain the largest amounts of equity.(Engler, Robinson, 2009, p. 2)

Mistakes that increase the risk profile and limit returns (continued)

9. Not preparing the entrepreneur for follow-on rounds.

For Entrepreneurs this stage in their lifecycle is problematic because it means further dilution and giving up more control, which they are typically not prepared to deal with. In other words, they have to take a bigger hit and sell more of their company than they planned. Often the company's over projected their growth rate and underestimated their expenses so when they fail to hit milestones they end up in a down round of funding, the risk to entrepreneurs is a down-round which is painful but necessary. The angels are also not prepared to help or have not put aside additional funds to help out.

If the valuation becomes combative all of the energy that should have been put into market development instead gets diverted into raising capital. Further eroding the ability for the company to reach their milestones.

10. Do not diversify over enough companies. Angels need to diversify their portfolios by spreading investments among a number of ventures and industries. The positive ROI obtained from one to two businesses out of 10 tend to exceed the negative ROI obtained from the unsuccessful ventures. Unlike conventional investment instruments such as stocks or mutual funds, Angel investments are illiquid. An Angel investor cannot usually sell their stake in the business to minimize loss. (NAO, nd, para: 1; Engler, Robinson, 2009, p. 1).

In a broad sense risk mitigation comes down to lowering the overall core risks. The risk of whether or not the management team can carry the company, the risk of the technology and the risk of the market being willing to pay for what is being developed.

Although there are a variety of ways to mitigate the risks and maximize the rewards for angels, there is the possibility of a complete loss of capital. It I nearly impossible to tell which companies will have dramatic growth in value and which will end up in bankruptcy. To achieve the best chance of success an angel needs to be able to choose from and invest in a fairly significant number of deals, be rigorous in its due diligence process, aggregate capital to a sufficient enough extent to be able to negotiate the best terms and personally assist the portfolios companies in achieving their goals. Angels who invest on their own will have a difficult time reaching these risk mitigation goals, which is why we see tightly coordinated and organized angel groups or why they employ fund managers and other financial professionals to assist in the process. (Engler, Robinson, 2009, p.3)

Term Sheets

Part of mitigating the risks for Angels and Entrepreneurs both, is making sure the term sheet that the parties are using to transact a potential deal contains the necessary elements to protect everyone involved.

The term sheet is the most important part of the investment process. It summarizes the critical principles for a business transaction and therefore must reflect the understanding of the parties in a comprehensive, concise and complete manner. It is essentially where the investment survives or fails, where protection against untoward dilution is solidified and where valuation is laid out. The Angels' understanding of both the deal and the desired outcome should inform the document.

> With the growing importance of seed capital and early-stage investments it is vital that efficiencies in transactions be developed. Standard term sheets provide a starting point for this process but bring with them preconceived notions of how the deal should be done.

The purpose of the term sheet is to outline a framework that helps define and protect the investment. It outlines the proposed terms under which an investment will be made. It is essentially a mechanism that summarizes the key financial and legal conditions under which a deal could be done. It serves to solidify the foundation of negotiations and prepares both the Angels' and Entrepreneur on the items that need to be addressed prior to a deal being formulated. The term sheet also establishes the relationship between the parties.

A term sheet can be thought of as a synopsis of the parties' intent to conduct business. At this point the discussion around valuation and an understanding by the Entrepreneur that the company is ready to be a share shareholder owned and operated business has been completed and understood by the parties. In most cases, the founder will remain the majority shareholder. However, the Entrepreneur needs to understand clearly that the board will govern the company. In many cases, this is a difficult cultural transition for the founder to make. The founder needs to clearly understand that they don't own the company anymore; essentially the new investment board will own it. This needs to be part of the outcome of the term sheet. It is this fear by the founder – the loss of controlling interest that has driven the increase in convertible debt as the investment vehicle of choice. However, using convertible debt while providing the short-term avoidance of governance issues also does not equip the founder or the investor for the inevitable eventuality of transitioning to shareholder control.

Although the term sheet is not a legal document it does provide the basis for the legal documents in the investment package. If the term sheet is well formulated and executed it can save legal costs. (Mothersill, et. al. nd. p. 65.)

Each deal is unique however, making it hard to develop standardized processes. That said, without simplified processes the transactional cost for early stage investing is prohibitively high.
Term sheets are a widely used approach throughout the industry to establish the points of agreement for a transaction. Term sheets and term sheet templates are a specific tool used to establish the framework for angel or venture investments. Term sheets take quite a bit of time to complete primarily because the process involves a fairly large learning curve for the Entrepreneur. However, caution should be taken when using templates. Often templates are too rigid to provide the optimal investment structure – there is a danger about getting too rigid about the terms sheet.

Items Needing Coverage in a Term Sheet

The following are the minimum items covered in a term sheet:

1. The valuation mechanism that will be used during the current round of negotiations and/or at the next round of financing. Not dealing with the valuation now leaves it in the hands of the Angel investors rather than it becoming a decision of others who may not have the interest of the Angel investors in mind.
2. Determination of the financial structure of the investment – in other words, will it be debt or equity, common shares, preferred shares, convertible debentures, etc.
3. Size of the deal – the amount that investors are putting in and the minimum raise necessary to close.
4. Pre-money valuation and price per share, who will be participating and the structure of the investors (i.e., individually, voting trust or special purpose entity LLC, etc.)
5. Comprehensive Capitalization table referred to as a “cap table”. A capitalization table is a record of all the major shareholders of a company, along with their pro-rata ownership of all the securities issued by the company (equity shares, preferred shares and options), and the various prices paid by these stakeholders for these securities. The table uses these details to show ownership stakes on a fully diluted basis, thereby enabling the company’s overall capital structure to be ascertained at a glance. (Capitalization table, nd, para: 1)

6. How the funds will be used and any milestones that need to be achieved in order to receive the funds if the fund will be staggered based on objectives/milestones reached. This is also referred to as a "takedown". This provides the investors with an extra measure of risk mitigation and control over the funds. Once the overall size of the investment has been determined, the Angels need to set specific tasks that the Company must accomplish before all the money is handed over. While there is an initial cash infusion, the rest is doled out in sizeable allotments on a milestone basis. These milestones can relate to sales, R&D goals, staffing, or any element that the Angels see as key to the company's growth. Terms should be laid out clearly, with dates specified as appropriate.
7. Liquidation/Sale protection terms and conditions.
8. Deal negotiation expenses and who will absorb the costs.
9. Closing conditions should include an exclusivity clause and a firm closing date that provides assurance the deal is not being shopped around to other investors. It should also include the provision of legal documents, IP ownership, due diligence completion information, non-disclosure and non-compete agreements by employees.
10. While most elements of a term sheet are non-binding if a lock-up or break-up fee is included that section would remain binding.

Term Sheet Detail

Below is a standard outline of the details included in a term sheet:

Basic Information

- Date – term sheet date
- Company Name/Location:
- Introduction – an opening statement that summarizes what is being asked (ie. the amount) and indicating that the document is non-binding but sets the framework and outlines the terms and conditions.

Proposed Investment Details

- Amount of Investment - Amount should include minimum and maximum possible investment.
- Investors - Investors' name should also include note as to investors' accreditation

Types of Security

The investment can be structured in a variety of ways, based on the Angels' needs and the company's requirements and ability to repay. While convertible debentures are often used, they are debt instruments. Since most start-ups are strapped for cash, they don't have the financial ability to make interest payments on a regular basis. As a result, interest is often converted to common shares, which builds animosity between founders and investors as founders see their share of ownership eroding. It is better to start off with preferred shares that provide Angels with a measure of investment protection, more control over decisions, and result in better economic terms. . (Mothersill, et. al. nd. pgs. 67-72.)

Debt financing: Typically, private debt financing involves the loan of capital at a fixed or variable rate of interest for raising capital from friends and family but is not typically utilized by Angels. When traditional debt is employed, Angels typically will co-sign a bank loan rather than providing capital directly.

Convertible Debt: This is basically a debt instrument (secured or unsecured) that may be converted into equity under specified terms and conditions. Until converted, it offers the investor a fixed rate of return and provides tax advantages (for example, deductibility of interest payments). Some venture capitalists and industry specialists have positioned convertible debt as particularly useful for Angel investment in pre-revenue companies as a way to avoid valuation issues. However, often what happens is follow on potential investors do not accept the return premium set by Angels resulting in the inability to raise follow-on funds. Except in cases of bridge financing, where the next round is imminent, convertible debt is considered to provide unacceptable limitations to the potential for higher returns. . (Mothersill, et. al. nd. pgs. 67-72.)

Interest or Dividends within preferred or convertible debt: This typically is around a 6% dividend. After 3 years this mechanism can start to see substantial dilution of the founders if they are not able to reach milestone and achieve higher valuations. Essentially, this mechanism is meant to keep the clock ticking – interest/dividends lose value if the company does not keep moving forward.

Equity: This is the typical type of securities selected. The structure of the transaction will usually fall into one of the following categories:

Preferred Shares:
This is the most typical form of security issued in connection with an Angel group financing of an emerging growth company. This is because of the many advantages that preferred shares offer an investor - they can be converted into common shares, and they have dividend and liquidation preference over common shares. They can also provide anti-dilution protection, mandatory or optional redemption schedules, and special voting rights and preferences. Properly structured, a preferred equity term sheet will provide incentives for the management team to achieve high rates of return while limiting the returns to founders only in the event of modest outcomes. . (Mothersill, et. al. nd. pgs. 67-72.)

Common Shares:
While common shares are suitable for friends and family, they offer the Angel investor no special rights or preferences, no fixed return on investment, no special ability to exercise control over management, and no liquidity to protect against downside risks. It has frequently been argued that common shares provide a share structure that is “fair” to all stockholders, and the basis for best practices tends to favour the option that is considered to be the most fair to all parties. However, we strongly believe that the efficiencies provided to the entrepreneur through an organized Angel group structure, including accessing multiple investors and negotiating a single set of terms, can merit preferential terms. . (Mothersill, et. al. nd. pgs. 67-72.)

Pre-Investment Valuation:
Valuation is the most important issue that Angels face when negotiating a term sheet with company founders. Often founders will place too much emphasis on sweat equity when determining their own valuation. Founders often erroneously believe that they should be setting the value. The value in fact has to be fair for both the Angel – in terms of obtaining sufficient equity interest to reward his investment and the Founder – who needs to retain enough shares to keep him motivated to get the company to the next performance level.

Valuation is more often that of an art than a science, however any preconceived feelings need to be backed up using industry comparables as well as validating the numbers provided. . (Mothersill, et. al., nd. pgs. 67-72.)

Capital Structure Following Private Placement:

Generally, depending on the size of the investment, for a first Angel round the goal is to have founders retaining a majority hold, ie. 51%. The size of the option pool also needs to be put into the agreement. Setting limits prevents the percentage of options getting out of control and diluting all investors. A typical structure may be demonstrated as follows:

Existing holders of Common Stock:	xx%
Option pool:	yy%
Holders of Preferred Shares:	zz%
Total:	100%

Use of Proceeds
This outlines the Angels' understanding of the company's needs – working capital for ongoing operations, a sales and marketing program, technical support for expanded operations, a full-time CFO, and so on.

Takedowns
Angels must reach milestones. Once the overall size of the investment has been determined, the Angels need to set specific tasks that the Company must accomplish before all the money is handed over. While there is an initial cash infusion, the rest is doled out in sizeable allotments on a milestone basis. These milestones can relate to sales, R&D goals, staffing, or any element that the Angels see as key to the company's growth. Terms should be laid out clearly, with dates specified as appropriate. (Mothersill, et. al. nd. pgs. 67-72.)

Anticipated Closing Date
The closing date should be clearly stated, but may stipulate that there are requirements that must be fulfilled before closing.

Conversion Features
Preferred stock always has the right to convert to common shares at any time and will convert into common stock automatically at the time of an IPO or at the time of agreed events – a takeover bid, or various financial targets. If the agreed dollar thresholds are not achieved, any IPO would require approval by the holders of preferred shares. It is important to note that the special rights that are given to preferred shareholders could create problems for a public company. Multiple classes of voting shares in a public company discourage institutional investment and confuse the average investor. It is more difficult for brokers to attract a following in a company that gives preference to some shareholders and not others. (Mothersill, et. al. nd. pgs. 67-72.)

Stock Option Plan

Option pools are great for startups to attract key management and employees and can be a key incentive in driving milestones and rewarding employees for efforts. However, the size of the pool needs to be limited to prevent dilution creep.

Right of First Refusal

This clause gives holders of preferred shares the right to participate in subsequent stock issuances. They can also have the first right to buy any founder and management stock being sold, on the same terms as the proposed sale. Often this clause is put in the term sheets as a mechanism for keeping options open regarding further participation in equity of a company. While they are not required to invest, many have found it to be a useful as in reviewing their ongoing commitment to the Company. For that same reason, many Angel deals are now beginning to employ a Right of First Refusal clause in their agreements since it allows them to maintain their interest. However, this provision can cause some concern on the part of common shareholders, and especially founders, because it limits their ability to bring in funding from other sources. . (Mothersill, et. al. nd. pgs. 67-72.)

Anti-Dilution

This provision is key for an Angel deal. If the Company issues new shares at a price below the conversion price of the preferred stock, the conversion price is adjusted to eliminate the dilutive effects of the new stock. This results in more shares for the Angel on conversion. There are basically two kinds of anti-dilution provisions: a full ratchet and a weighted average provision. Angels tend to favor the weighted average since they are less dilutive to Founders. (Mothersill, et. al. nd. pgs. 67-72.)

Voting and Veto Rights

Voting rights provisions are key to providing a measure of control. It is critical for an Angel to have a role to play in decisions made by the Company. Provisions to protect Angel voting rights can range from limitations on the amount of money the company can spend, to control in a dissolution situation, to control over share re-purchasing. Depending on the type of company and the management team, these provisions can and should be tailored to each Angel deal. . (Mothersill, et. al. nd. pgs. 67-72.)

Redemption
This gives the right to the Angel to achieve liquidity in the event that the Company is not sold, or does not goes public through an IPO within a stated period of time. Since the Angel investment is made on the understanding that there will be a liquidity event, a timeframe should be clearly stated. Typically the time period stipulated for redemption is between three-and-six years. . (Mothersill, et. al. nd, pgs. 67-72.)

Liquidation Preference
The liquidation preference can enable the Angel group to head the list of debtors in the event of dissolution, thereby protecting the investment

Board of Directors
Boards are critical to the success of a start-up. Since most Angels invest not only their money but their business, domain, or operational expertise, they need a "seat at the table" in order to help guide the ongoing operations of the Company.

Founding Options and Vesting
Vesting periods are always included to encourage key players in the Company to stay. If a Founder or others who may own options elect to leave, they lose the unvested shares.

Expenses
Expenses incurred on preparing legal documents should be estimated and the costs built into the term sheet.

Governance
Often there are protected provisions which prevents the company from doing certain actions, such as sell shares, etc., without angel permissions.

Chapter 4

Due Diligence

What is due diligence?

Due diligence is the process by which an investor researches an organization's financial and organizational health to guide an investment decision. The decision to fund or not to fund is based upon a balance of objective data analysis, insight into the general state of organizational health and stability, and intuition. A sound and thorough due diligence review is the process through which all the factors that make up that equation are uncovered and understood. (Kulick et. al., 2004. p. 2)

The high cost of evaluating pre-seed and seed investments is understanding the relative risks of the investment and then creating an appropriate investment structure based on what is known about the company.

Knowing that the best investments require 60 to 100 hours of diligence, following best practices in diligence remain the greatest source for creating a more efficient micro capital market.
Due diligence incorporates investigation, audit and analysis of a potential investment that confirms all the material facts so that an investor is able to determine if that particular investment opportunity meets his/her criteria for funding. For angels as well as venture capitalists, the primary objective of due diligence is to mitigate investment risk by gaining an understanding of a company and its business as well as determining the suitability of the investment for the portfolio. (Eyler, 2007, para. 1)

What does it consist of?

Due diligence can be separated into basic tasks. It is often useful to organize these diligence tasks around the competencies best suited to preform the assessment

The questions on the right are in addition of course to the normal questions and your judgment on the attractiveness of the business. If you are entering into due diligence you should already believe from what you have found out so far that the business is sound, it's market growing, products/services good and so on. Due diligence is to confirm this and make sure that there are no nasty surprises. (Due Diligence, nd, Para: 4)

The Need for Due Diligence

Angel investors need to vet the companies they want to invest in by going through a due diligence process. Due diligence can be boiled down to validating the plan, uncovering the missing pieces and defining the unknown to contain and define the risk of an investment. Having an inherent good feel for the entrepreneur and team, as well as the market, can definitely help with due diligence.

So why does due diligence need to be done? A Kauffman Foundation study on angel group returns showed that the returns for deals increased with the hours of due diligence invested. The mean time spent on due diligence was around 20 hours and the returns for deals with less than 20 hours of diligence was around 1.1X on average. Deals with more than 20 hours diligence had a 5.9X return and for more than 60 hours spent on diligence the return was strikingly higher – 7.1X. The process is heavily dependent on the type of deal (industry, stage and amount), potential and/or existing investors in the deal, and industry knowledge or expertise by the angel(s), along with their individual skills. . (Investment Valuations of Seed and Early-Stage Ventures, 2007, para: 4.)

Core Areas of research usually include:

A broad assessment of the management team

An evaluation of the technology

A test of the market viability

Assurance that adequate capital is available to carry the company to the point of cash-flow break-even.

Background checks on the management team involved

Legal checks on the status of the company
Accounting checks on the finances presented
Factual checks on the statistics or figures given

Relationship checks (both internally and with customers)

Defining the Risk of the Investment Opportunity

It is extremely important to identify the risks of a venture because even in optimal conditions, many elements are required for success. The greatest barrier to expanded investing in micro capital markets remains the relatively high cost of rigorous evaluation.

In the event that even one of these risks is not assessed correctly, and the chance of success is actually 50 percent, the overall probability of success is reduced to 27 percent. Clearly every risk must be kept to a minimum. These issues are even more important to angel investors than to venture capitalists, because of the early nature of the ventures. While most deals that VCs see are fairly far along, angels and angel groups bear a much greater risk of catastrophe.

Any efficient approach to the diligence process will involve quickly identifying the most serious threats to the business plan, such as: what assumptions are being built into the plan and what are the sensitivities of the plan should an assumption prove faulty? The “what if” outcomes, that would prove devastating should be tested first. The “deal killers” are usually easy to identify but hard to fully evaluate. The seed investors need to have comfort with these issues.

There is a second class of issues that may be addressed in the terms of the investments. These secondary risks can be mitigated by representations, warranties and the structure of the governance process (e.g. bard seats). Properly addressing the secondary issues might not differentiate survival from failure but they are important enough to dramatically effect the overall valuation and thus the return on revenue for the investment.

Clearly every risk must be kept to a minimum. These issues are even more important to angel investors than to venture capitalists, because of the early nature of the ventures. While most deals that VCs see are fairly far along, angels and angel groups bear a much greater risk of catastrophe.

When to do Due Diligence?

An angel club should do due diligence when the proposed company meets an agreed upon set of criteria that the club has outlined. This can differ between angels and clubs, but some examples include:

Deal/Investment Size

1

When the size of the investment suits the interest of the angel club. In other words, when the entrepreneur is able to demonstrate a defensible plan to reach x million in typically a 5-10 year time span.

2

When the concept is easily scalable, yielding revenues of US $100 million by Year 5

3

When the entrepreneur can demonstrate that the business is likely to grow rapidly and reach at least $15-30 million in revenues in the next 3-7 years. (Eyler, 2007, p. 2)

Geography

In many cases angels prefer to invest in their own local communities as it allows them to play a part in building their communities as well as they are to meet with the management team easily and frequently to gauge their progress. (The Essential Components that Appeal to Angel Investors, nd, para: 2)

Management team

The management team appointed by the company's founders must be solid, balanced, and experienced. They should be able to demonstrate their ability to execute and have a proven track record and show their company is already making revenue. (The Essential Components that Appeal to Angel Investors, nd, para: 5)

Market/industry influence

The company should already demonstrate vast growth potential. A growing market is the key to profitability. Early-stage companies should always provide goods and services that reflect uniqueness, a competitive edge, and consumer needs in a growing market. Companies that are expected to grow to $100 million can realistically garner 10% of their industry need to be in a $1 billion sector. (The Essential Components that Appeal to Angel Investors, nd, para: 7)

Sustainable Competitive Advantage

The company needs to convey the extraordinary, distinctive qualities of their company to their investors and why their enterprise possesses a competitive edge.

Potential Rate of Return

Angels recognize that start-up companies are high-risk investments and will want to justify that risk by seeking commensurate (very high) rate of returns. Rates of return vary as to the time span; however, a 5-7 year time span with an average return on investment of around 34% is the noted average. (The Essential Components that Appeal to Angel Investors, nd, para: 11).

Reasonable Financial Assumptions

The financial models need to be tightly integrated with the business model and assumptions. Key elements include adequate growth potential, margin improvements with scale and appropriate levels of sale, marketing and customer acquisition costs.

Exit Strategies

The company needs to demonstrate that they have thought about the exit for the investor. In other words, they need to include a liquidity event, an occasion or time during the company's development at which the investor can obtain their rate of return. It should provide the best estimate of time for exit and liquidity for all potential investors. Acquisition of a company or a company merger is the most probable exit strategy unless the company revenues and market sector strongly suggests an IPO opportunity. (The Essential Components that Appeal to Angel Investors, nd, para: 13)

With all of these considerations, there are also issues regarding the "chemistry" of the company's management team, the specific risk profiles and very basic expectations regarding governance and valuation. On one side is the need to know what is being offered in the term sheet so some investors complete a reasonably in-depth evaluation before they draft a term sheet. Others do just the opposite based on the strategy that they will not waste resources on diligence unless they already have a meeting of the minds on valuation and general terms. Since the term sheets are non-binding and subject to completion of diligence, having the term sheet gives a starting point. Many investors however found that once a valuation is proposed in the term sheet, it is far more complicated to adjust it, even when based on substantial findings in the diligence process.

Chapter 5

Due Diligence Process

Angel investors and groups may not have the same amount of time to allocate for due diligence as professional venture capital (VC) firms. This is where tiered due diligence is important – where you hit the high points of the deal before diving into extensive due diligence. This approach helps make the process more efficient and effective. First do an analysis of the market opportunity and then check if it fits with your investment thesis as an angel investor or angel group. Some questions to ask include:

1. Does this meet your investment goals?
2. Are there any conflicts – portfolio or personal?
3. Where exactly can I add value to this company?
4. Can you work with these people?

This helps a due diligence plan to find the details you must confirm, unknowable items and the risk of not knowing them, cost of confirming and the major risk factors and deal killers. Due diligence is also a progressive process. Key issues in the plan:

- Management
- Market
- Model
- Money
- Numbers

The process for due diligence is generally as follows:

- Business plan review
- Management presentation
- Site visit(s)
- References
- Competitive analysis
- Financial analysis
- The Deal

The entrepreneurs' credit score needs to be checked as part of the due diligence process to bring up any potential red flags. Impact investments need to be compared against mainstream products and services as a benchmark during the due diligence process (Angel Investing Series Part II: Due Diligence, Sealing the Deal and Post-Investment Relationship, 2011, para: 3)

Arguably the most critical item that is indicated by all angels and angel networks is the importance of a strong management team with leadership that can execute. A lot of the success attributed to successful startups is the entrepreneur/CEO. She/he has to have an incredible work ethic combined with integrity and a strong mental attitude. (Ask an Angel: What is the "Right" Amount of Due Diligence? 2012, para: 6.)

Creating a due diligence plan

The following are what needs to be considered when putting together a due diligence plan:

1. Set aside a budget. You will need a lawyer to review your diligence term sheet and/or an industry expert to validate the market/demand for a new technology or improvement.
2. Define acceptable risks. Risks the club can and can't live with.
3. Validate assumptions. In order to validate an investment, angels need to identify and confirm any assumptions.

These include:

1. Intellectual Property Validation – identify and validate and patent claims
2. Market Demand – being able to validate that the market and the demand actually exists for an improvement or new technology and ensuring that the potential market is willing to pay the price warranted to manufacture.
3. Client relationships – validate any established client relationships and a funnel of potential clients that have been identified as prospects with a need for the solution. The entrepreneur as validation of potential revenues and demand should have touched a minimum of 100 clients. (Eyler, 2007, p. 2.)

The Non Disclosure Agreement (NDA) Requirement

There are a myriad of thoughts on whether or not an angel investor needs to sign an NDA. Unless the investor is privy to patented technology or code, or some other form of "secret sauce" there really is no reason to sign an NDA. As an angel you are interested in supporting and investing in the company not stealing their idea. (Eyler, 2007)

Deal Rejections

Deals are rejected for various reasons, but primarily it is due either to the management team or the market within which the company will operate. The following is an overview of the top items:

Required Item	Explanation
	TEAM
Management mindset	The team must be willing to put in the effort and time required – that means a mental toughness to deal with the long days and countless issues that occur with startups
Ability	The management team has to have the background, education, and proven past ability to ensure that they can make the business a success
Judgement	Background checks can often come back with evidence indicating a lack of judgment and/or reference checks might be able to provide evidence of the teams judgment ability.
Integrity	A thorough reference check of existing clients, past work relationships, etc. of the management team can often assess the level of integrity of the team.
Leadership Ability	A proven track record of leadership ability can be assessed through past work positions and/or whether or not the CEO has been able to successfully run a previous business.
Background Checks	If the CEO can't manage his own money or has had any DUI's, it is time to walk away.
	MARKET
Target Market	The management team needs to have a deep understanding of their market and a very good idea of the size of that market and its segmentation. They should be able to provide evidence that they have talked to at least 100 potential customers/clients – the more the better.
Value Proposition	Is the value proposition understandable, clear and concise? Does it provide economic value to the client and company?
Competition	A thorough understanding of their top 10 largest competitors, the market share, strengths/weaknesses, product features, financial viability and if they have a relationship with them.

Deal Rejections (continued)

Required Item	Explanation
	MARKET
Differentiation	Is there a competitive edge to the product they are going to market with? The solution/product needs to address a market segment in a way the competition is not.
Channels	What is the plan to get the first reference customer and then next 100? What are their overall marketing/sales strategy including pricing, distribution, and partnerships?
Market Entry Barriers	IP is good but not enough, what is the current and long term sustainable advantage.
Growth Strategy	What is the working capital plan to sustain growth?
Capital Requirements	Does the company expect to look at subsequent rounds in order to succeed? Why? Is there going to be enough revenue to attract later stage investors? Will the company equity be sufficient for all investors?
Recurring Revenue	Recurring revenue is key to justify any investment, if there is none, walk away
Deal Structure	An equity split that can provide adequate return for angels and yet is sufficient to keep management energized as well as a reserve for options for future employees should be built into their plan.
Exit Strategy	What is the exit strategy? IPO or Acquisition? They should be able to identify who the buyer might be and/or provide comparables for IPO
Reasonable Expenses	Salaries should be realistic for a cash-strapped startup and there should be no inappropriate expenses – i.e., new furniture, etc.
Management Salaries vs Equity	Investor money should be going toward product development, sales and marketing efforts not hefty management salaries. Salaries have to be realistic.
Cash Flow Management	Is there a plan to manage the burn rate?
Margins	Is the business model profitable? If the margins are too slim then an investor exit will be far too long to make the investment worthwhile.
Financial Statements	Has the company had previous investment from friends and family? This indicates that the management team will potentially have more skin in the game. Review of assets and liabilities are key. The liabilities should be minimal – any personal loans should be converted to equity.

(Table adapted from: Eyler, 2007, p. 7)

How much detail is required for due diligence?

The level of analysis appropriate for due diligence is a difficult one to assess. Investors have varying levels of comfort which is why angel clubs with formal processes typically have a standard checklist they use that suits the club membership in terms of risk mitigation and comfort with the potential company they are considering investing in.

In other words, the diligence process will vary depending upon whether you are talking about a structured fund, an angel group operating as a network, or an individual angel investor. A structured fund has fiduciary responsibility and therefore requires rigorous analysis of every detail of the deal. Some structured clubs produce large 60+ page reports that detail the management team, market opportunity, competition, barriers to entry, business model, financial analysis, and exit strategy. The report contains all interviews and a legal review of the intellectual property. This report is bound into a book like format and provided to its members. (The right amount of due diligence, 2012, para: 16)

Evidence indicates that more diligence is not necessarily better and there has never been a proven correlation between the amount of diligence and probability of success.

Some angel clubs leave it up to the individual angels to make the decision on the level of diligence since the individual angels vote individually with their own money. The diligence ranges depending upon the investment comfort level of the individual. Other unstructured clubs or networks will have standard due diligence processes and establish due diligence team among those interested in the opportunity and others whose expertise is related to the deal. (The right amount of due diligence, 2012, para: 17.)

However, due diligence analysis should be proportionate to the size and stage of the deal and the type of club you are involved in. If this is a small investment that is very early in the lifespan of the company, then financial projection analysis may not be as necessary as an understanding of the market and market demand. Having a formal process in place that is stage-based and relies on the expertise of the angel club members who have experience in the market/technology that a potential company is in will be critical. (Eyler, 2007, p. 14)

Exit Strategies

The exit strategy is arguably the highest level of strategy in the organization. In fact, it is considered the foundation for the entire company plan. It aligns the team on the most important goal, aids in ensuring shareholder values are maximized and determines the optimum timing of its monetization. Therefore, it is essential that the exit is planned strategically.

Exit for the founders or management may be retirement after forty years with the company. It DOES NOT mean the company must eventually be sold. It DOES mean that the founders, managers and investors need a means of liquidating their positions in the company. For many of this group, their equity in the company may be their single greatest source of wealth. Their equity will need to provide liquidity for college tuitions, retirement or even medical expenses.

The most important concept is to understand that all of this talk about EXITS is better addressed as a discussion of liquidity. The real goal is a state where the founders, investors and managers can convert their stake in the company to cash when desired.

The most important concept is to understand that all of this talk about EXITS is better addressed as a discussion of liquidity. The real goal is a state where the founders, investors and managers can convert their stake in the company to cash when desired.

Throughout this section, we will continue to use the common expressions of exits, exit strategies and we will consider the traditional exits, acquisitions or IPOs before going in to some less traveled roads to generate liquidity for the stakeholders.

Entrepreneurs rarely start with the exit in mind when planning. However, the plan should always start with the end goal in mind. The reason the entrepreneur must start with the exit strategy is because different types of investors are compatible with different types of exits. Compatibility between the entrepreneur and the investor needs happen in order for an exit to be successful.

An exit strategy can be as simple as: Our exit strategy is to sell in about x years for x amount. We plan to execute the strategy by engaging with a mid-market M&A advisor by x date. Once the exit strategy is determined, ensure that that there is consensus and alignment between all stakeholders and have everyone sign off and then check the alignment every year. Most angel investors need exits and returns on their investment. This is so they can redeploy the capital and the gains in other investments. So consideration of the exit and their investment should be front and center in the planning process. Angels can easily help with this process and Entrepreneur's should engage with their investors early in order to assess compatibility and also to provide guidance in preparing an exit strategy. (Peters, 2012, para: 1)

Types of Exits

Merger or Strategic acquisition – In a strategic acquisition, another company purchases your business, either with cash or stock in the acquiring company or with some combination of stock and cash. The acquirer may or may not retain you and your management team, and may or may not make substantial changes in your company's operations, staff, and business lines. The benefit is typically liquidity because if you sell the company to a strategic acquirer you might be able to sell most or all of your stock. The disadvantage of this exit strategy is that you are likely to lose operating control. Acquisition is one of the most common exit strategies: You find another business that wants to buy yours and sell.

In an acquisition, you negotiate price based on the market and the perceived value. If you choose the right acquirer, your value can far exceed what would be reasonable based on your income. The key is to look for a strategic fit, where the acquirer can buy you to expand into a new market, or offer a new product to their existing customers. If you're thinking of acquisition as your exist strategy, make yourself attractive to acquisition candidates, but don't go so far as to you cut off other potential options.

According to Basil Peters (2013), A common misunderstanding about M&A exits in particular, is that you have to grow the company to be profitable or grow it to be larger than $X millions of revenue. The real threshold is to 'prove the business model.

In a recurring revenue business, for example, you have a spreadsheet that clearly shows actual results for:

1. Gross margin per customer
2. Customer lifetime (or churn)
3. Cost of customer acquisition

In other words, how much is a customer worth and what do they cost to acquire? Some businesses have slightly different metrics to prove the model. But when you prove the model you can build a credible projection that shows:

1. If new owners added $X millions of capital,
2. The business would have Y customers
3. And be worth $Z millions

There are often additional factors like competitors and market changes. But the important threshold to determine when you can sell is when you have proven the model. This is when you can have a reasonable negotiation on value and sell the company. You do not necessarily have to be profitable. Today, even pre-revenue exits are possible. (Peters, 2012, para: 1)

Management buyout – Management buyout is when you decide to recapitalize and sell the company to another owner or managers. This transaction is typically financed through some combination of debt and/or private equity investment, with the debt collateralized by the assets of the company. It provides immediate liquidity to the owner and early shareholders, and allows the company to continue as a private enterprise. The benefit is that you usually have a smoother transition. The founders most likely are not managing the company on a day-to-day basis, ceding that to the management team, which is now buying the company. This exit strategy marks a change of ownership, gets the shareholders some liquidity, yet provides a seamless transition for the company and employees and other constituencies. (How to Choose and Exit Strategy, 2010, Para: 4-6)

Revenue take - Some owners simply take revenues of the company on a daily basis or monthly basis. In other words, they pay themselves a salary and bonuses despite actual corporate performance. This type of company is not typically invested in by Angels, but it could be if the dependence on the investor is minimal and the structure allows a cash draw out when required. This type of business is referred to as a “lifestyle company”. Rather than reinvesting money in growing your business, in lifestyle companies, things remain small and the entrepreneur simply lives on the income. If this is the type of business you desire, then an entrepreneur needs to minimize dependence on other investors and structure the business to allow cash draw outs when needed.

IPO - In an IPO, you tell a portion of your company in the public markets. The management team typically will remain in place for a period of years, the investors and managers are typically able to sell some stock, and the company continues to operate much as it has in the past. That said, the company becomes subject to regulations like Sarbanes-Oxley and your quarterly performance will be under a microscope by analysts and institutional investors.

An entrepreneur should also keep in mind that there are millions of companies in the U.S., and only a fraction of those are public. And many public companies weren't even founded by entrepreneurs but rather were spun out from existing large companies.

An entrepreneur who has successfully taken a company public before has more success typically at doing another. If the goal is to be funded by professional investors, you want to keep in mind that they will probably dilute your shares to the point where you own only a fraction. It is good to keep in mind that IPOs are rare, and due to their complexity, should not be the only exit strategy considered. (Robbins, nd, para: 3-29)

Valuation

We have talked about valuation in depth in a previous chapter, but it is good to note that an essential element in the exit strategy is valuation. This is another area where almost every company needs knowledgeable, objective external input. Look for an investor or previous entrepreneur who has completed a few exits and is willing to become a coach. The right "coach" can often give the CEO and board a more accurate estimate of the exit valuation.

Liquidity - Exploring possible strategies for investor exits

One of the most common axioms of angel investing is that extraordinarily high rates of return are required to offset the high risk associated with any portfolio of investments in start-ups. The Angel Capital Association overview of angel investing points out that eight out of ten angel investments are likely to fail.

However, if we take time to dig a little deeper that number changes depending on which study you read. The radical disparity in these views lies in understanding of what we mean by "failure". Failure to venture funds means not being able to make distributions to the funds investment partners on a given timetable, typically around ten years. If a company is still alive, maybe even growing, but is not a target for acquisition nor big enough to go public, it's shares are not suitable to distribute to the funds investors.

This problem is so common the companies are frequently referred to as the walking or living dead. But they are not dead and finding a way to create liquidity for these holdings has a dramatic impact on the overall return to the investors.

The solution is to provide means for liquidity to the investors for positions in these portfolio companies. Below are three simple ideas that can have a profound impact on angel investing by providing liquidity:

1. Create liquidity for founders and investors by ending the culture of "it all stays in until the exit". This point is simple. Much of the illiquidity in angel portfolios is self-created by an unspoken but widely enforced rule that all money remains in the company. This idea is derived from the concern for adequate funding for the company. Money spent buying existing shareholders shares does not provide any capital to the company but by allowing some portion of each round, say 15%, to be spent buying shares or notes from founders or other angels would likely create far more investors going forward and provides a way to ease-out founders that no longer fit in.

2. Convert back to a note at some pre-defined date; say five years into the deal. BlueWater Angels uses this kind of "put" with a 3.7x on paid in capital after five years, which amounts to a 30% annual rate of return. The note is a fixed principal repayment with a predefined rate. This allows both parties to have a predefined exit option from the beginning.

3. Explore the emerging private exchanges and encourage share trades amongst existing investors. (Liquidity strategies, 2014, para: 1-4)

The exit strategy is really the foundation for the entire company and should be front and center in the planning process for the entrepreneur as it ensures that not are the company's objectives aligned it helps maximize shareholder values. Planning for the exit also helps the entrepreneur locate the right investors and helps the investors as well as the entrepreneur plan for future liquidity.

Tools and References

Sample Due Diligence Checklists

1. A simple list of considerations in a diligence check from PitchStreet.com August 2012 - Angel Investors 101 http://pitchstreet.blogspot.ca/2012/12/due-diligence-checklist.html

2. Due Diligence Checklist Table
An excellent table developed by the Angel Resource Institute. Extremely detailed but an excellent review of what should be considered in a thorough diligence check.
http://www.angelresourceinstitute.org/resource-center/~/media/ARI/Files/Non%20Research/Angel_Guidebook_-_Due%20Diligence_Checklist.pdf

3. Indiana Angels Due Diligence List – a sample of what the Indiana Angels list looks like. http://www.indianaangelnetwork.com/due-diligence.aspx

4. Kauffman Due Diligence List courtesy of the Wisconsin Angel Network – 2004 Edition – a detailed list of considerations in the due diligence process.
http://www.wisconsinangelnetwork.com/uploads/resources/due%20diligence.pdf

5. An incredibly detailed table from A3 Angels which takes the due diligence checklist to another level. http://wiki.epfl.ch/a3-angels/documents/information/dd/a3angels-dd.pdf

6. An extremely simple due diligence list from NACO https://nacocanada.com/wp-content/uploads/2012/12/Due-Diligence-Checklist_May-2013.pdf

Term Sheet Samples

1. Great basic term sheet with helpful annotations throughout. Model Term Sheet for Angels – ACA Institute - http://www.angelresourceinstitute.org/resource-center/~/media/ARI/Files/Non%20Research/Draft%20Term%20Sheet%20for%20Alliance%20of%20Angels.pdf

2. Sample detailed term sheet from MarS in a doc format making it easy to edit and make your own. http://www.marsdd.com/mars-library/term-sheet-template-for-angel-or-venture-capital-investors/.

3. European Business Angels term sheet - http://www.angelcapitalassociation.org/data/Documents/Resources/AngelCapitalEducation/EBAN_Term_Sheet.pdf

4. National Angel Association of Canada term sheet sample – pdf download - http://nacocanada.com/knowledge/angel-resources/

5. National Venture Capital Association – download - http://www.nvca.org/index.php?searchword=term+sheet&ordering=&searchphrase=all&Itemid=1&option=com_search

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