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Susan L. Preston

Angel Financing for Entrepreneurs

Early Stage Funding for Long-Term Success

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More Praise for *Angel Financing for Entrepreneurs*

"Angels are, by far, the most important source of funding for start-ups in the U.S. *Angel Financing for Entrepreneurs* provides the best insights on how to effectively access this critical but elusive pool of capital. Written by a consummate professional and longtime insider, Susan Preston, the book contains all of the details you need to know to attract the best angel funding for you."

—Jennifer McFarlane, CEO, Women's Technology Cluster

"Through its remarkably clear and well-structured explanations, this unique book definitively explains the world of angel investors and their expectations to entrepreneurs and policy makers. An effective angel-entrepreneur relationship brings the greatest value to innovation at its earliest stage of development: how to get it right is the fundamental thesis of this must-read for us all."

—Tom Sweeney, general partner and managing director,
Garage Technology Ventures Canada

"Not only an insightful guide for anyone who is looking to invest at the early stage of a company, the book is also a road map for entrepreneurs considering an approach to the private equity markets. Susan Preston relies on her unique experience and credibility when it comes to advising investors and entrepreneurs."

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"Many entrepreneurs underestimate the challenge relative to accessing capital. *Angel Financing for Entrepreneurs* provides an excellent understanding of the steps required and is a must-read for entrepreneurs to become students of the capital process and to approach the angel market with credibility."

—Tom Walker, CEO and executive vice president, i2E, Inc.

"*Angel Financing for Entrepreneurs* is a comprehensive collection of the latest information on angel investors and a valuable source for entrepreneurs seeking angel capital. It provides entrepreneurs with information they should know about angels before they begin their search for angel capital."

—Jeffrey E. Sohl, PhD, professor of Entrepreneurship and Decision Sciences; director, Center for Venture Research, Whittemore School of Business and Economics, University of New Hampshire

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CONTENTS

Foreword

There are many business books out on the market that give great tips on building your business. Books can be great tools, but they don't match up to the most important tools in your toolbox—people. People are what really help your business move ahead—successful, well-connected people who are willing to share their expertise, their capital, and their connections with you.

Susan Preston is an entrepreneur's most valuable tool. Through her books and her speaking engagements, she willingly shares her expertise and connections with companies seeking capital, with policymakers seeking to attract capital, and with national organizations looking to build an industry.

Angel investors know how to build successful businesses. Susan has firsthand experience as a talented entrepreneur and as a founder and participant in an active Seattle-based angel network. As an attorney with one of the West Coast's leading law firms, she has helped countless companies reach their full potential. In this book, she opens the window to the "inner circle," so we can see into the mysterious world of what investors are thinking—and what we need to do to get access to their capital and their connections.

Honorable Lorrie Keating Heinemann
Cabinet Secretary under Governor Jim Doyle
Wisconsin Department of Financial Institutions
Madison, Wisconsin
September, 2006

To my remarkable children, Michael and Kelsey:

If I have given you one characteristic, it is my passion for life that drives one to seek out life's adventures, big or small.

Always strive to step out of your comfort zone, set high expectations for yourselves, make mistakes, and get messy: some of life's greatest rewards and memories are those experienced on the edge.

I love you.

CHAPTER ONE

Introduction

The greatest challenge for entrepreneurs in starting and growing a company remains simply *money.* Though easy to state, financing your venture is a time-consuming, complicated, inefficient, and frustrating process. Entrepreneurs have often compared it to Winston Churchill's line, "A riddle inside a mystery wrapped in an enigma." This book attempts to provide you with information, guidelines, and resources to take the mystery out of the process. Don't be fooled, however. Raising capital is hard work and you must be well-prepared for every opportunity to pitch your company, either planned or unplanned. Remember the age-old adage: You can only make a good first impression once. It is infinitely true in raising capital.

Traditional funding sources—angels, venture capitalists, commercial banks—have a plethora of investment and funding opportunities. Your ability or inability to clearly and succinctly communicate your market focus and financial projections can make the difference between bringing your dream to life and shelving your brilliant idea. Therefore, preparation is key. This book will help you understand how angel investors think, how to identify their expectations, understand their investment analysis process, and prepare for post-investment requirements.

Just as no two people are alike, no two angels or angel groups will have the same hot buttons or demands. Through this book, you will gain a broad understanding of angels and angel investing. Be mindful that angel investors have varying degrees of sophistication and experience. The book will prepare you to deal with the most knowledgeable angels. Even with experienced angels, preferences on investment terms, depth of due diligence, and post-investment involvement will vary. Therefore, you will learn about multiple scenarios to minimize surprises you may encounter in your dealings with angel investors.

You can use this book as a reference guide for understanding and preparing yourself and your company for the mysteries of angel fundraising. If there is only one message you take away, it must be this: *passion*—every successful entrepreneur has passion. Investors look for passion in entrepreneurs; the willingness to take risks with life savings, to work nights and weekends, to see their idea become reality. It has to be more than excitement. So never lose the passion for your company, and show it each time you speak about your dream.

You also need to understand that professional angel investors are interested in companies with great growth potential; companies with a large market potential and a strong path to profitability. They do not invest in lifestyle companies, small retail operations, or other companies that, while profitable, lack room to expand. In addition, angel investors are interested in companies where the founder has a desire to grow the company. For example, if the entrepreneur only wanted funding for a chain of three boutiques, angel investors would probably yawn and look elsewhere. However, if the entrepreneur wanted funding for a chain that would start with three boutiques and then expand nationally over ten years, angel investors would be likely to take a real interest. Professional angel investors look for entrepreneurs with the drive and capability to build a great company. Angels are looking for strong exit opportunities to realize significant gains on their investment. These are important factors to keep in mind when you think about the possibility of pursuing angel financing for your company.

Over the last several years, private equity financing has created a lot of misunderstandings. During the dot-com bubble (from 1997 through 2000), many companies received massive amounts of financing on little more than an idea (see Figure 1.1).

Webvan.com (1999–2001)
Online grocery store that undersold its products in an effort to gain market share. It expanded too quickly and had no way to get to profitability.

Amount Lost: $1.2 billion

Pets.com (2000)
Quirky commercials could not help the online pet supply business figure out that you cannot make a profit subsidizing the shipping charges on fifty pounds of dog food.

Amount Lost: $282.5 million

Kozmo.com (1998–2001)
An online convenience store that made deliveries to your home, but never figured how to make the costs of the infrastructure work.

Amount Lost: $280 million

Boo.com (1998–2000)
A fashion Web site that attempted to start a global brand in several countries at once, and got hung up on a poor business plan and the technical limitations of the time.

Amount Lost: $160 million

Freeinternet.com (1998–2000)
A combination of excessive spending, poor management, costly lawsuits, and a business model that just didn't make any sense sank this Internet service provider right after its IPO.

Amount Lost: $86 million

Figure 1.1 Examples of Failed Dot-Com Companies

We still have many young entrepreneurs who think venture capitalists are the primary source of financing, even at the very early stages of a business. They also naively believe they need merely slap an executive summary together and the money will beat a path to their door. Well, here's a dose of reality:

- The vast majority of venture capitalists do not invest in seed or start-up financing rounds.
- Most investors require seasoned management, with successful start-up experience, before they will sit down and talk about providing capital.
- To arouse any interest in your proposal, you must have skin in the game; in other words, you have invested your own money.
- Your business plan must be well-written, with detailed financial projections that extend three to five years.

- You are prepared for due diligence and are able to answer any question posed.
- Your corporate structure is clean and uncomplicated, without multiple layers of ownership.
- You own all necessary intellectual property, which has been properly protected.
- Many investors prefer to see completed prototypes, which are already being test marketed or sold.
- Many angels require a board of advisers along with a board of directors.

These are just highlights of what you may encounter as you step into the financing arena. As stated before, angel investors display an almost infinite variety of needs and approaches, so few absolute rules exist. But there's one absolute fact: you can never be too prepared.

CHAPTER TWO

The Basics About Angel Investors

So what is an angel investor? The term has its origin in Broadway plays. Several decades ago, those who funded this form of entertainment were referred to as *angels.* William Wetzel, former director of the Center for Venture Research at the University of New Hampshire, is credited with first applying the term to business, where the financing of early-stage enterprises can feel like "money from heaven" for entrepreneurs. However, like any other financing, angel investments do not just fall from the sky, unencumbered; they are not gifts. These investments come with terms, requirements, and an investor. Much of this book describes the characteristics of an angel investor, as well as ways of finding the right one and assessing the potential value an angel investor can bring to your company—which is far beyond just financial support.

Just as entrepreneurship has many meanings, angel investing has yet to find a definitive definition. For purposes of this book, the term *angel* refers to an individual who typically meets the definition of an *accredited investor* (as defined in the Securities Act of 1933: a natural person whose individual net worth or joint net worth with that person's spouse exceeds $1,000,000 at the time the investment is purchased; or a natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and who reasonably expects to reach the same income level in the current year). In addition, angels actively participate in their own personal investment decisions.

Statistics from the Center for Venture Research at the University of New Hampshire indicate that in 2005, angel investors poured an estimated $23.1 billion into approximately 49,500 deals. Not all these deals involved separate individual companies; they may have been for initial or subsequent rounds of financing. This investment amount and number of deals is fairly constant from 2004, in which $22.5 billion was invested in an estimated 48,000 deals. Most important for young entrepreneurs, 55 percent of angel deals went to seed/start-up ventures, compared to 3.3 percent in 2005 for venture capital funds. In addition, according to a survey by PricewaterhouseCoopers MoneyTree, venture capital firms are averaging around $7 million per deal, while simple mathematics indicates that the average investment amount per deal for angel investors is much lower, around $470,000. Clearly, $500,000 reflects a more appropriate investment amount for the first round of outside or third-party financing when your company's product is still being tested and no proven market exists. Seed/start-up companies garner modest valuations (often $1 million to $3 million). So an initial investment of $500,000 can give you much-needed capital while allowing you to retain majority ownership.

ENTREPRENEURS DEFINE "ANGELS"

Brannon Lambert, founder and COO of VHT, Inc., describes an *angel investor* as "a high-net-worth individual who takes a big risk on one or two people at the beginning stages of a company. They invest locally and provide consultation, direction, and advice." Asked if he would do angel financing again with a new company, he answered quickly, "Absolutely."

Lon McGowan, founder and CEO of iClick, says he prefers "angel investors who have been involved in successful start-up companies of their own." As a result, "They have money to invest in young companies, and enjoy being part of the entrepreneurial process without the daily requirements."

How are the various stages of company development defined? One common definition is from the PricewaterhouseCoopers MoneyTree survey, which uses the following definitions for stages of private company development:

- *Seed/Start-Up Stage.* The initial stage. The company has a concept or product under development, but is probably not fully operational. Usually in existence less than eighteen months.
- *Early Stage.* The company has a product or service in testing or pilot production. In some cases, the product may be commercially available. May or may not be generating revenues. Usually in business less than three years.
- *Expansion Stage.* Product or service is in production and commercially available. The company demonstrates significant revenue growth, but may or may not be showing a profit. Usually in business more than three years.
- *Later Stage.* Product or service is widely available. Company is generating ongoing revenue; probably positive cash flow. More likely to be profitable, but not necessarily so. May include spin-offs of operating divisions of existing private companies and established private companies.

THE ESSENCE OF AN ANGEL

What are the attributes of angel investors? Angel investors have one essential and primary goal identical to venture capitalists—they are in the business of making money. Angels invest with anticipation of a healthy return on their investment. They tend to have among the most lucrative returns, which matches the high level of risk they take for providing the earliest professional investment dollars in a company. Angels have an expectation of financial return just like any other investor. But they also have many attributes invaluable to young companies that can set them apart from other types of investors. Angels typically

- Have a sense of social responsibility and enjoy community involvement.
- Take a role in the entrepreneurial process.

- Act as mentors and advisers to the entrepreneur.
- Provide early-stage investment dollars.
- Invest regionally.
- Invest smaller amounts at a time.
- Invest their own money.
- Are able to tolerate the loss of their entire investment.
- Have a diversified portfolio.
- Take a long-term view of their investments—which are often referred to as "patient money."

Participation

Angels typically desire to pass on knowledge. Many entrepreneurs say that once the thrill of building a company is in your blood, you never get rid of the thirst for that emotional roller coaster and thrill of watching an idea grow into a real company, with real customers, providing jobs for others and adding value through innovation. Angel investing becomes an effective means for these "recovering entrepreneurs" to remain engaged but not consumed through the necessary fourteen-hour days and seven-day weeks. These entrepreneurs are the most likely people to seek out new companies and fund them as angel investors. Many angel investors choose to remain involved with their investments out of an active desire to grow companies and act as mentors and advisers to young entrepreneurs.

One of the most important attributes of angel investors is the willingness to bring knowledge to companies during their start-up phase. Many angels are successful entrepreneurs, having prospered in their community often because of local support for their own business. They now have the opportunity to contribute to the wealth of the community through the support of other young, hopeful companies. Angels typically invest in industries they understand, which very often means investing in the same field as their earlier successful endeavors, and they thus bring the benefit of connections to potential customers, vendors, and other resources, as well as possible additional financing sources. Of course, the fit must be right between you and your angel investors. With this match accomplished, angel investors bring experience of having been in your shoes and knowing how to build a successful company, along with industry and professional knowledge and wisdom. Remember, many angels want to be engaged as mentors, advisers, or board members, so take advantage of the opportunity to gain an interested and vested partner.

Consistent with an interest in participating in their community, angel investors typically invest near their home. A sense of connection to the company is important to an angel investor, as well as the ability to keep up on company activities through personal visits, local media, and regional discussions.

Availability

Angels provide early-stage investment. Another feature of angel investors is the focus on early-stage investing. As the statistics bear out, angels are the primary source of outside capital for very young companies. Because other investors such as venture capitalists are not providing investment dollars for seed/start-up companies in any real way, angels provide the first outside professional capital to entrepreneurs at this critical stage of growth when products are being finalized and first customers are being wooed.

Angels cannot invest the large sums of capital that venture capitalists have at their disposal. Some "super angels" do make investments

ANGEL OVERVIEW

Angel investments may be small when considered individually, but collectively, they're big business. Here are some overall statistics for the last few years:

- 2005 Angel Investments: $23.1 billion (49,500 deals)
- 2004 Angel Investments: $22.5 billion (48,000 deals)
- 2005 active angels: 227,000
- 2005 Distribution:
  - 20% health care and medical devices and equipment
  - 18% software
  - 55% seed/start-up
  - 43% post–seed/start-up (10% increase over 2004)

of $250,000 to $2 million a deal, but those are rare. The vast majority of angel investors invest between $25,000 and $100,000 at a time. These smaller sums fit well with the needs of young companies, and may very well have the reciprocal effect of focusing angels on this early stage, where they can play a real role in financing and supporting entrepreneurial growth.

Remember, angel investment does not equal philanthropy. Because of the high risk of investing so early and their interest in helping entrepreneurs, angels can leave the impression of just giving money away. Certainly, even as recently as five years ago, many angels did not understand the finer aspects of intelligent, thoughtful investing, particularly during the Internet bubble, when many people were rushing into the market in fear of being left out of seemingly limitless riches. The bust of 2001 left many angels licking their wounds, in a state of shock or dismay and without the financial wherewithal to continue investing. What seems to be emerging out of these roller coaster years are angels with experience and a cautious approach to investing. So while the bubble-and-bust cycle left an impression of angel financing being "dumb money," active angels who remember those times and the ones joining their ranks now are sophisticated investors, with many of the deal requirements and attributes of the venture capitalist—and first and foremost, they invest to make money.

Investing at the start-up/seed stage carries a very high risk of loss; no prospect has much history or assurance of success. As a result, angel investors must be able to tolerate the complete loss of any or all of their investments. Certainly, this tolerance of loss does not mean that an angel investor goes into a deal expecting to lose the money—quite the contrary. But investing money critical to a comfortable retirement or standard of living is foolhardy at best, and not an indication of a true angel. Angels typically diversify their portfolios so their lifestyle will not be damaged by any problem with their investments.

Conducting intelligent start-up/seed stage investing requires the ability to invest in a number of companies to spread the risk and hedge the investment bets. Venture capital statistics show that the majority of VC investments never show a return despite investors' best efforts in selecting and supporting young companies; the same is true for angel investors. According to professor Robert Wiltbank of Willamette University (2006), the majority of angel investments result in losses. These statistics were collected from 121 angel investors to a detailed survey reporting on 1,038 new venture investments and 414 exit events from those investments:

Angel Exits in Each Internal Rate of Return Category

Total Loss	200
Large Loss	33
Small Loss	27
SUBTOTAL	260
0 to 25% Gain	29
26% to 49% Gain	25
50 to 100% Gain	18
100 to 300% Gain	33
> 300% Gain	49
SUBTOTAL	154

As a result of the broad spread of results and the sheer number of losses, angel investors need a whole portfolio, rather than making only two or three total investments. As the statistics show, the likelihood of failure is so great for any given investment, it's better to take a wide range of relatively small risks than to put a large proportion of available funds into a small number of investments. Angels should also be diversifying through the stage of investments as well as industry.

Because of the early-stage nature of most angel investing, patience is key. The primary exit strategy is a merger or acquisition, providing the investors with cash or liquid stock, or both. Getting a young company to the point of being acquisition-ready takes maturation of products, market, and management; none of these happen overnight. Therefore, most angels anticipate a three-, five-, even seven-year holding period before they can recover their investment, let alone profit from it.

Investment Preferences

Angel investors typically invest in industries similar to the ones venture capitalists choose, which seems logical, since angels and venture capitalists alike are looking for high potential returns (which accompany large potential market caps) in growing, prosperous, and future-oriented fields. Figure 2.1 shows a compilation of survey results conducted by the Angel Capital Education Foundation (currently a

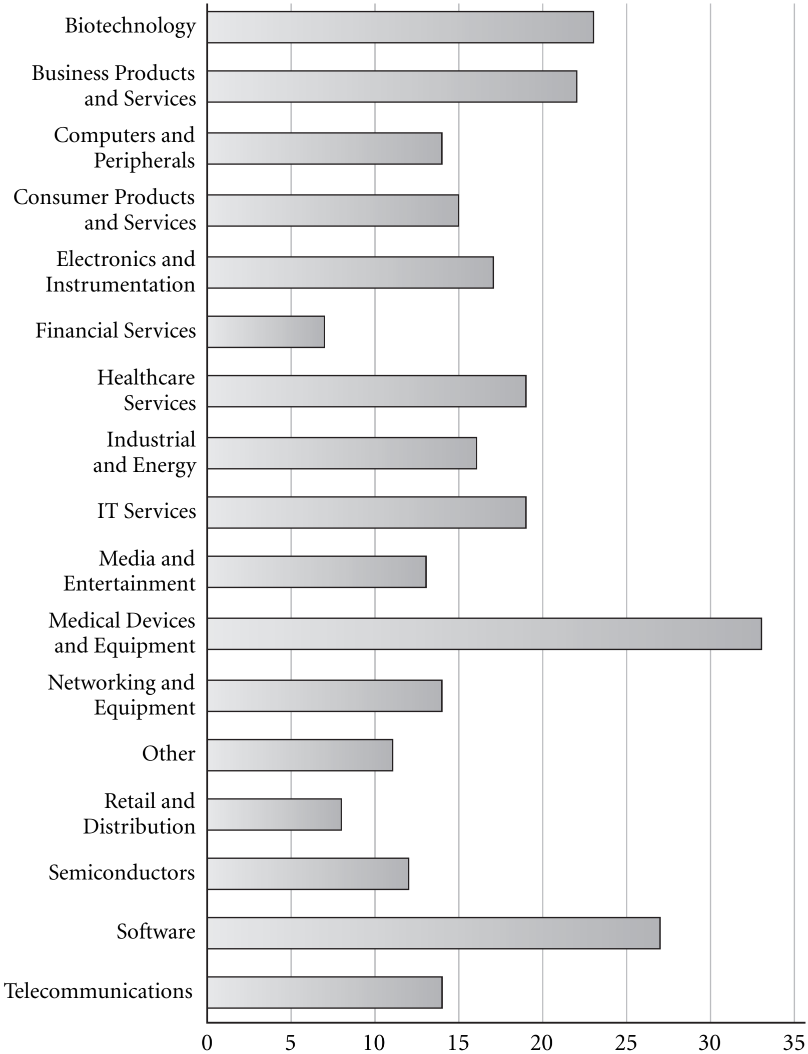


Figure 2.1 Investment Preferences in Percentage for Angel Investors

program of the Ewing Marion Kauffman Foundation) with Angel Capital Association member groups (forty groups reporting).

If one compares these statistics with venture capital investment focus as reported in PricewaterhouseCoopers MoneyTree survey for the period from January 1 to March 31, 2006, shown in Figure 2.2, the similarity of investment preferences is obvious, with the major differ-

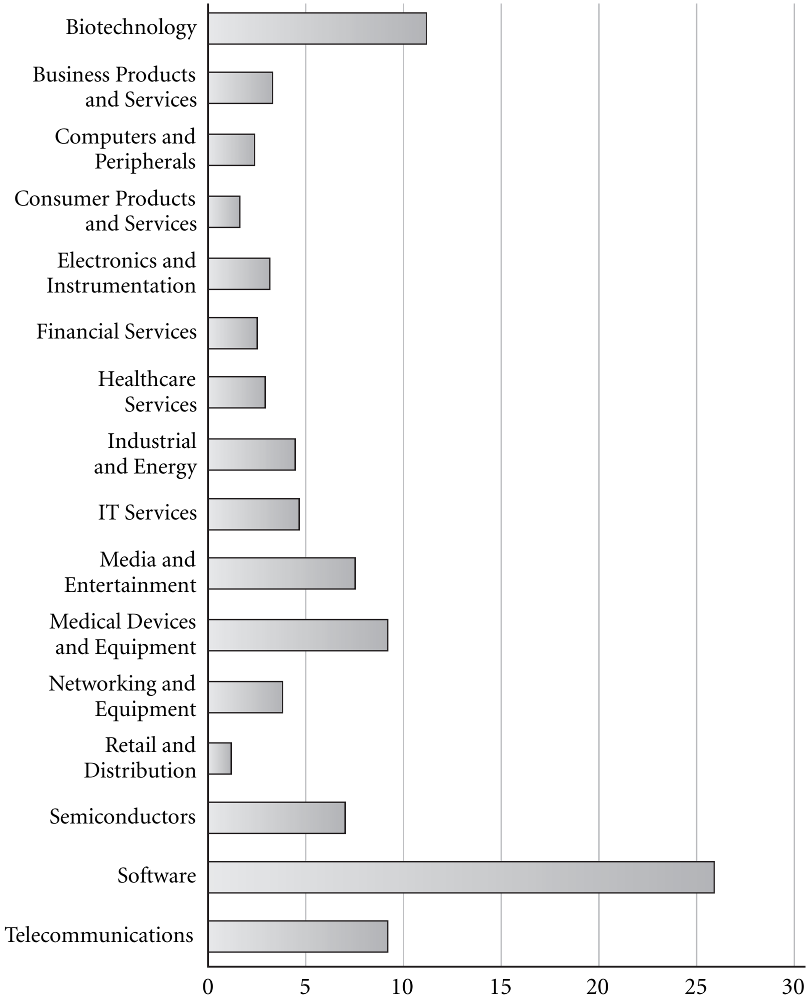


Figure 2.2 Investment Preferences in Percentage for Venture Capitalists

ence being the flip in preference between medical devices and equipment and software, and more diverse investment interests by angels.

ANGEL DEALS

Many companies never need venture capital financing to achieve positive cash flow and eventual liquidity for investors. Software companies are often started in someone's spare bedroom or the proverbial garage and grown organically. In such cases, the entrepreneur may need only minor amounts of cash in the early stages of building the product and launching an initial market push. If the young company has an interesting but limited market capitalization potential, or if the company can create an interesting market niche that generates strong margins, setting up as a limited liability company (LLC) may be preferable to a corporation or sole proprietorship. The LLC structure allows the business to provide investors a return on their investment through the sharing of profits, though they also share any losses. It can work particularly well for companies with low acquisition or merger potential and high cash flow opportunities.

Many deals are simply not appropriate for venture capitalists. Looking at informal statistics compiled and averaged from various sources, it is clear that few companies receive even angel investment dollars and far fewer venture capital dollars for myriad reasons:

- Less than 1 in 100 start-ups obtain angel financing.
- Less than 1 in 1,000 start-ups are venture capital financed.
- Less than 1 in 10,000 new companies go public.
- Less than 1 in 25 angel deals see venture capital money.
- Less than 1 in 100 angel-funded companies go public via IPO.

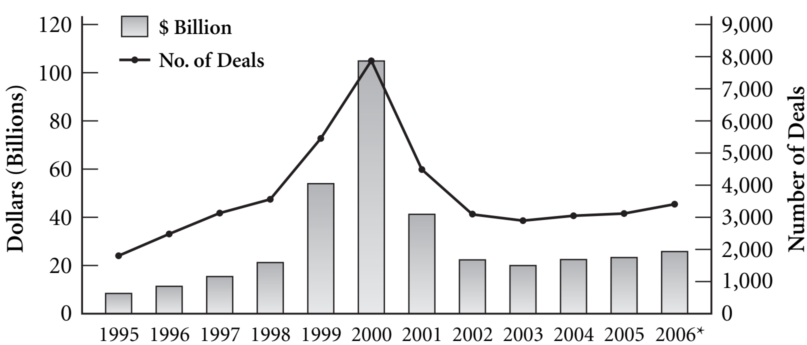
Because many companies never meet venture capital investment thresholds, angels are beginning to retain a calculated amount of their investment capital for an anticipated second round of financing, by way of "keeping their powder dry." As well, angels often invest in *traunches,* deals in which an investor will agree to a designated amount in a particular financing, contingent on the company's reaching certain milestones or meeting certain preset obligations. For instance, an angel investor may agree to invest $300,000 in a series A preferred stock round, but provides only $100,000 upon completion of the financial documents. The company's receipt of the second $100,000 is dependent upon completion of the first product, and the third $100,000 dependent upon securing the first customer. These investment preconditions typically have other requirements such as timing or size of customer, and are agreed to by the parties as a condition to financing. In addition, these traunch requirements are usually taken from the company's business plan as projected accomplishments with the funding—putting the angel's money where the entrepreneur's mouth is. Staged investment also protects the angel from throwing good money after bad when an entrepreneur cannot deliver on the initial promises, or when conditions arise outside the entrepreneur's control, such as a market shift or a big player entering the market before the small entrepreneurial company gets off the ground, making the prospective investment no longer viable.

Angels' Vital Role in Early-Stage Funding

To appreciate the vital and essential role that angel investors play in early-stage financing, you need only look at the current statistics on venture capital financing and compare those to angel investing.

According to the PricewaterhouseCoopers MoneyTree survey of venture capital investments, venture capitalists invested $21.7 billion on 2,939 deals in 2005. This demonstrates a fairly flat trend line from 2004, when venture capitalists invested $21.6 billion in 2,966 deals. Figure 2.3 shows the recent trend in venture capital investments with the bubble aberration right in the middle (a trend we hope never to witness again, though history suggests we are doomed to repeat it).

While these trends are interesting, a more detailed analysis provides important insight for young entrepreneurs on the source for early-stage financing. The majority of 2005 venture capital dollars went into late-stage investments, 45 percent to be precise, which is the highest proportion in the eleven-year history of the PricewaterhouseCoopers MoneyTree report on venture capital trends. Contrast this percentage in late-stage investments with the venture capitalists' investment in



*2006 Estimated value

Figure 2.3 Venture Capital Investments, 1995–2006

VENTURE CAPITAL STATISTICS

Here is a further overview of VC funding and where the money is going:

2005—invested $21.7 billion (2,939 deals)

Average post-money valuation: $81.9 million

2004—invested $21.6 billion (2,966 deals)

2003—invested $19.6 billion (2,865 deals)

Increase due largely to late-stage investments:

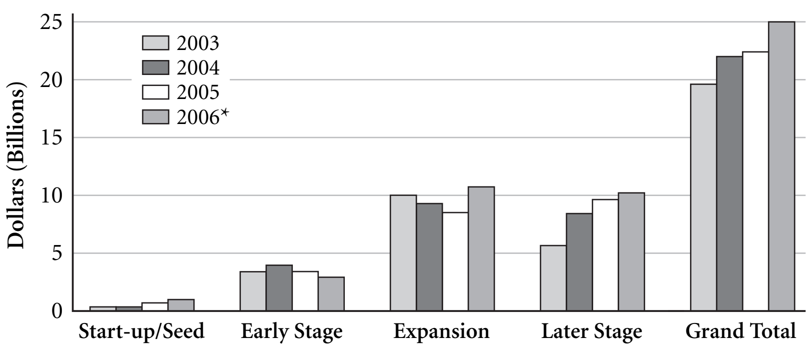
- $9.7 billion in 2005
- $7.2 billion in 2004
- $4.9 billion in 2003

In 2005, later stage = 45% of dollars (highest proportion in eleven-year history of MoneyTree)

Only 3.3% in seed/start-up stage

First quarter 2006: $5.6 billion (761 deals)—if this trend continues, 2006 will finish with a higher total investment amount than 2005

First quarter 2006: $187 million in seed/start-up companies (53 deals)—still 3.3% of the dollars and representing 7% of venture capital deals



*2006 Estimated value

Figure 2.4 Venture Capital Investments by Stage of Development ($ Billion)

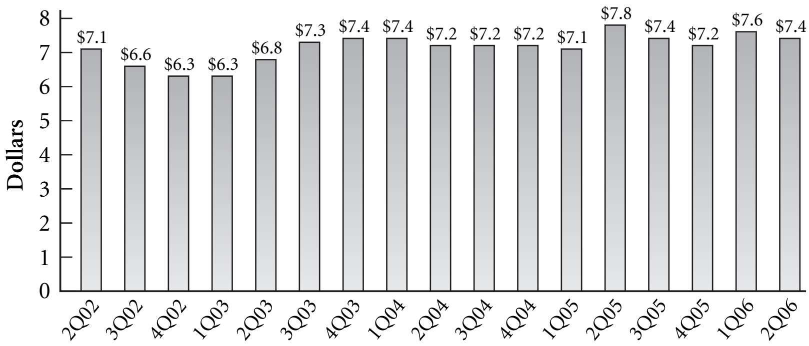


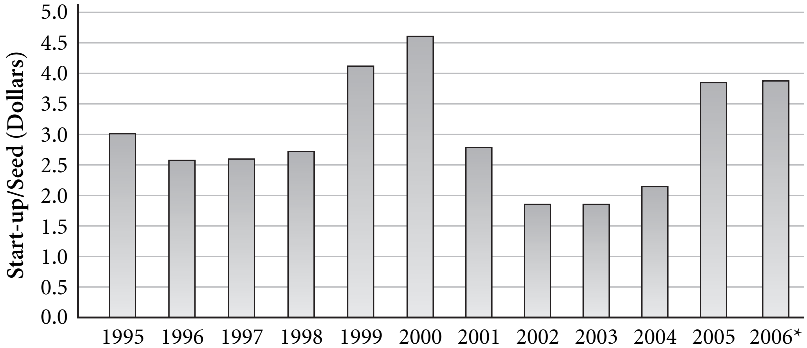
Figure 2.5 Average VC Deal Size per Financing Round ($ Million)

the seed/start-up stage in 2005 (only 3.3 percent), and it becomes clear where the vast majority of venture capitalists focus their investment activities. This reflects a consistent trend by venture capitalists to invest in more mature companies. Figure 2.4 illustrates this point (from PricewaterhouseCoopers MoneyTree).

Further evidence of venture capital migration up the investment and financing chain includes the average venture capital investment amount (see Figure 2.5, from National Venture Capital Association) and the average post-investment valuation for early-stage companies, which was $14.06 million for the twelve months ending with the first quarter of 2006 and $59.16 million for expansion-stage venture capital rounds, according to the National Venture Capital Association. These statistics represent investing patterns well beyond investment needs of early-stage companies. These statistics bear out the need to identify, foster, and expand other sources of early-stage financing—that is, of angel financing.

Even looking at just venture capital seed/start-up round financing investment averages shows numbers above most entrepreneurs' needs, with an average investment amount of $3.9 million in 2005 (in 204 deals), and trending the same in 2006 with $3.8 million in the first quarter (58 deals) and $3.9 million in the second (74 deals). These investment amounts represent the acquisition of a significant percentage ownership on the part of the venture capitalists. Likewise, the relatively small number of deals clearly indicates that traditional venture capitalists are not serving the vast needs of seed/start-up companies.

What investments venture capitalists are doing in seed/start-up companies is at a relatively conservative valuation reflective of the multiple unknowns and uncertainties for success accompanying any



*2006 Estimated value

Figure 2.6 Valuations of U.S. Venture Capital Seed/ Start-Up Rounds ($ Million)

seed/start-up company. Figure 2.6 shows a trend between $2 and $4 million in the last decade for venture capital investments in seed/start-up companies. These valuations are likely high for the general population of seed/ start-up companies. Because of venture capitalists' adversity to risk, seed/start-up companies they are willing to invest in are typically by seasoned, successful entrepreneurs whom they know; thus, this reduces the risk and comparatively slightly increases the valuation.

The picture for angel investors is very different from that for venture capitalists. For example, the GEM Report (the largest annual measure of entrepreneurial activity worldwide, compiled by more than 150 scholars from 35 countries, under the direction of Babson College and the London Business School) concludes that angels fund a hundred times as many high-tech seed-stage companies as venture capital firms do in the United States. This prevalence of angel investors is uniform throughout the countries the GEM Report analyzed. Figure 2.7 provides a global look at venture capital as a percentage of all investments. Clearly, informal investors, which includes angel investors, are the main source of capital for start-up companies.

In addition, venture capital fund size trends do not speak well for any reversal of the move toward larger investment amounts per deal. According to the National Venture Capital Association, far fewer VC funds exist today, but the average amount of financial resources per fund is steadily increasing, as illustrated in Table 2.1. With so much capital to invest, venture capitalists cannot afford to spend time on

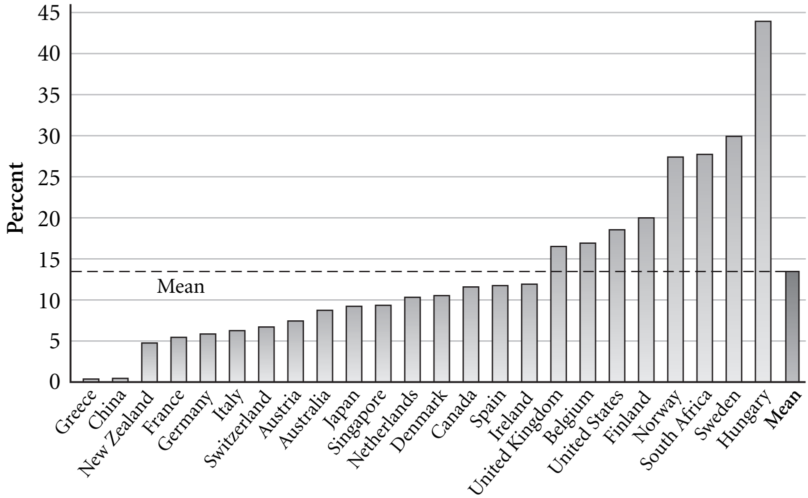


Figure 2.7 Venture Capital as a Percentage of All Investments (2005 GEM Report)

deals as small as $1 million or $2 million (frequent first-round funding needs), when these deals take as much time in due diligence as a $10 million investment; the latter is a more efficient use of human and financial capital for those who have it available.

Why Not Try for VC Financing?

You might look at the statistics demonstrating that venture capitalists need to dispense lots of money at a time and conclude that the best approach is to go for venture financing and obtain all the funding you may need up front and thus avoid the distraction of fundraising in the midst of the serious business of growing a company. Unfortunately, this approach is illogical and often fruitless for many reasons.

Year	Number of Funds	Total $ (Million)	Average $/Fund
2000	637	106,734.4	167,557,928
2001	308	37,718.7	122,436,312
2002	172	3,862.1	22,454,070
2003	141	10,648.6	75,521,986
2004	187	16,986.6	90,837,433
2005 (Q1–3)	130	17,370.2	133,616,923

Table 2.1 Fewer Venture Capital Funds; More Money per Fund

Say your company is valued at $3 million; an investor who puts in $7 million will thereby gain a 70 percent ownership stake, leaving you as the founder with at best 30 percent. (At best, because most professional investors will require the establishment of an option plan before investing, further diluting your founder interest upon their investment.)

When you lose ownership percentage you lose control, and that's far more than a matter of terminology. Even if you don't mind having 30 percent of something great, you stand a good chance of getting forced all the way out if you accept loss of control.

And in any case, you won't often find $7 million just lying on the table these days. The risk of loss is just too high for most venture capitalists at the seed/start-up stage. Remember, venture capitalists are investing someone else's money (not their own like angels), so they have obligations to make the highest possible return on their investments, meaning large return multiples (billion-dollar projected market cap companies) and minimal risk of loss.

Thoughtful growth and creative financing make for better companies and better leaders. The dot-com bubble was a clear lesson that injecting lots of capital into a company at a very early stage does not increase its odds of success—and may, in fact, have the opposite effect.

COMPARISON OF ANGELS TO VENTURE CAPITALISTS

The most usual comparison to angel investors is venture capitalists. Because the two groups are involved in similar businesses and in similar ways, the comparison is natural, but they have some very large differences. It can be helpful for someone starting a new business and seeking funding to have a firm grasp on these similarities and differences.

Similarities

These two investor groups have much in common:

SELECTIVE INVESTMENT. While historically called sources of "dumb money" for investing in ideas with little understanding or up-front analysis, angels are becoming increasingly sophisticated through trial and error, angel organizations, educational programs, and the like. As a result, most angels now go through investment due diligence processes very similar to those of venture capitalists. Therefore, just as venture capitalists are highly selective about investments fitting into their investment profile for maturation stage, industry focus, portfolio compatability, investment terms, and other criteria, angels will often have similarly individualized investment selection requirements. This tells you as the entrepreneur that knowing your audience's interests, preferences, and investment criteria is important if you want to avoid wasting your time and that of the investors by promoting a deal that is ill-suited for your audience. As noted earlier, on average, less than one in a hundred start-ups receive angel investing—and less than one in a thousand receive venture capital financing.

REQUIREMENTS FOR AN INVESTABLE COMPANY. An *investable* company is not just one with a good idea. Investors must see numerous other attributes—a great management team, a realistic exit strategy for themselves, an attractive multiple on the investment, a simple, straightforward ownership structure, innovative technology, and clear intellectual property ownership for starters, and the list goes on.

EXPECTATION OF RETURN ON INVESTMENT. Investing is not a philanthropic activity (though the typical investor will see a strong multiple return on only three out of ten investments, so the effort may seem like charity). Investments by friends and family are often called "love money" because the basis for investment is apt to be affection for the entrepreneur rather than any sort of critical analysis. An angel or venture capitalist is a third-party, professional investor with no established affection for the would-be entrepreneur. Without a reasonable expectation of return on the investment, such an investor simply will not risk putting capital into a company.

SIMILAR INVESTMENT TERMS. Even up to five years ago, angels accepted common stock in return for their investment—then found themselves at a distinct disadvantage when venture capitalists came in and received preferred stock with rights, preferences, and privileges far superior to those of common stock, despite the angel having invested at a time of greater risk of loss. Though some angels still consciously select common stock for investment, most have learned their own lessons or learned at others' peril, and now insist on preferred stock (or debt conversion into preferred stock), placing them on a level similar to that of venture capitalists, who invest after angels and therefore at a less risky time in a company's development.

PROFESSIONAL ATTRIBUTES. Regardless of size, professional investors should bring three attributes to a company, and only the third of which is money. The first is experience and knowledge in their particular field of expertise, which adds value to the company and entrepreneur, and the second consists of connections to potential customers, vendors, resources, and follow-on financing.

Differences

Despite the similarities between venture capitalists and angel investors, significant differences abound. These differences not only involve priorities and deal structure, they involve the preferred stage of investment and the investors' importance to entrepreneurs.

PERSONAL WEALTH INVESTMENT. One of the most significant differences between venture capitalists and angel investors is that the former are investing third-party money and the latter their own personal wealth. As a result, venture capitalists have a fiduciary obligation of maximizing investor returns, and the continued viability of any venture fund depends to a great extent on outperforming other venture funds. Therefore, venture capitalists tend to invest on the home-run theory—that is, they choose high market cap companies at a point in their maturation that minimizes the risk of loss. Because of the size of venture capital investments and the need to create a greater assurance of success, venture capitalists often insist on being more actively involved than angels do, frequently requiring one or more board seats to gain control of corporate decisions.

INVESTMENT FOR REASONABLE RETURN. Many angels do not invest on the home-run theory at all. Instead, they look for more modest returns over their entire portfolio. Because angels are investing their own wealth, they don't face time constraints on showing a handsome profit; the resulting patience allows for the early-stage investing strategy. The social or community involvement aspects of angel investing also provide for involvement in a company at less than a controlling level.

CONTROL UPON INVESTMENT. Unlike venture capitalists, angels are unlikely to take a board position and more likely to play an advisory role for the founder and management team. Many angels refuse board positions because of the potential liability, an unfortunate consequence of the litigious current environment and new laws such as Sarbanes-Oxley. Many angels invest for the enjoyment of being part of a company, being part of the entrepreneurial process.

TIME OF INVESTMENT. As noted, for the most part, angels and venture capitalists invest at different times in a company's maturity. Angels invest at an early stage in a company's growth, taking a very high risk on the entrepreneur, management team, and innovative technology. In contrast, venture capitalists have continuously moved up the investment food chain for the multiplicity of reasons previously articulated, and now invest primarily in later-stage companies with market-proven technology, established sales, and a complete management team.

TIME TO INVESTMENT. While negotiation time varies greatly among investors, on average, angels progress more rapidly to investment than venture capitalists. This does not reflect any less care on the part of angels. Instead, because angels typically invest individually and use their own money, they have the freedom to choose their level of due diligence as well as comfort with sixth-sense feelings about a founder, management team, and company. Venture capitalists have limited partners to whom they owe a fiduciary duty of maximizing investment return and minimizing risk.

A WHOLE WORLD OF ANGEL INVESTORS

If angel investors are high-net-worth individuals (HNWIs) who invest their personal wealth primarily in early-stage companies, are there really enough of them to make a difference? How many individuals are both willing and able to be angel investors? No definitive study has been done on the actual number of angel investors in the United States and elsewhere, but the Center for Venture Research estimates the number of angel investors in the United States at around 126,000 (for the first half of 2005). The number of individuals with sufficient wealth to qualify at an "accredited investor" level under Regulation D of the Securities Act is known, and this forms the pool of potential angel investors. (See Appendix 3 for the full text of Regulation D.) Some estimate the ratio of active to potential angel investors in the United States to be as high as 1:10.

According to the *2006 World Wealth Report* (WWR) by Capgemini and Merrill Lynch, the population of HNWIs has grown steadily in the last ten years, nearly doubling in sheer numbers worldwide from 4.5 million in 1996 to 8.7 million in 2005. HNWIs are defined in the WWR as those having financial assets in excess of $1 million. The aggregate wealth of HNWIs doubled during the same period, from $16.6 trillion in 1996 to $33.3 trillion in 2005. The Ultra-HNWI population—those with individual financial assets in excess of $30 million—continued to grow in 2005 with a 10.2 percent increase to 85,400 individuals, with North America having the highest overall percentage of Ultra-HNWIs, undoubtedly fueled by soaring gas prices and the high profit return of Canadian oil sand fields. What may surprise many is that South Korea, India, Russia, and South Africa witnessed the most growth in HNWIs. The United States still has the greatest overall population of HNWIs and the greatest distribution of wealth, but the aggressive, entrepreneurial nature of foreign markets such as China and India (and Eastern Europe to some extent) are making the distribution of HNWIs a truly global phenomenon. The WWR shows that emerging markets continued to outperform other parts of the world, adding wealth in those countries. Figure 2.8 from the WWR shows comparative HNWI population growth for selected markets from 2004 to 2005.

Savvy entrepreneurs understand the global nature of business today and also understand that an aspiring young business does not compete for investment dollars only with other U.S. companies, it now competes with most of the rest of the world. Part of this broader thinking is

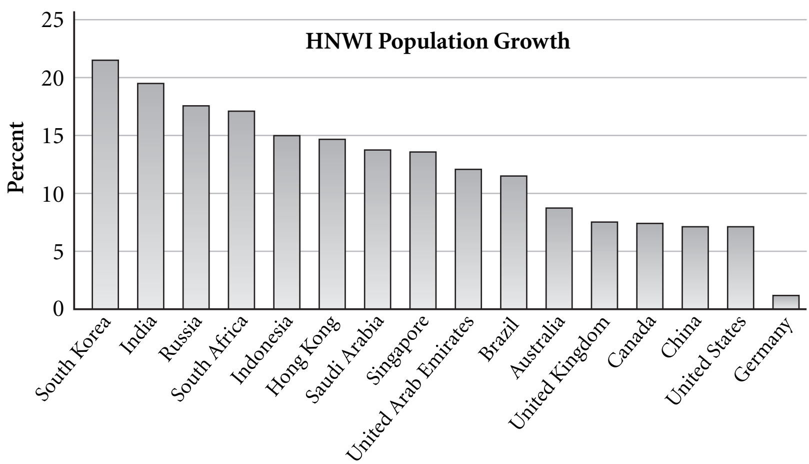


Figure 2.8 Percentage Growth in High Net-Worth Individuals Globally, Selected Countries

also understanding that wealth generation is driven by growth in GDP and robust public markets; in other words, when the public markets are positive and corporate earnings are up, HNWIs have greater earnings and therefore more disposable income with which to invest in risky ventures such as seed/start-up companies. The inverse also applies. In 2005 and early 2006 the U.S. Federal Reserve kept increasing the overnight lending rate in an attempt to keep inflation in check, ultimately slowing (though not entirely stopping) GDP growth. Interest rate increases, coupled with devastation caused by Hurricanes Katrina and Rita, and with soaring oil prices, all reduced investor and consumer confidence and undercut the willingness and interest of HNWIs, or angel investors, to take greater risk with their investment capital. Therefore, as an entrepreneur, you must understand that even though your company is just taking off, domestic and global factors will influence your access to capital, markets, and talent.

Angel Organizations

Over the last ten years, according to the Center for Venture Research at the University of New Hampshire, the number of angel organizations has grown exponentially. Several factors have been responsible, including the Internet bubble—as evidenced by the large jump in 1999 shown in Figure 2.9. A natural fall-off occurred with the 2001 bust, but the trend for establishing angel groups continued in following years.

Why this proliferation of organizations? One of the key reasons is quality deal flow. Entrepreneurs would much rather present to a room full of accredited investors than make individual presentations to each investor. The best deals want the most efficient course to financing.

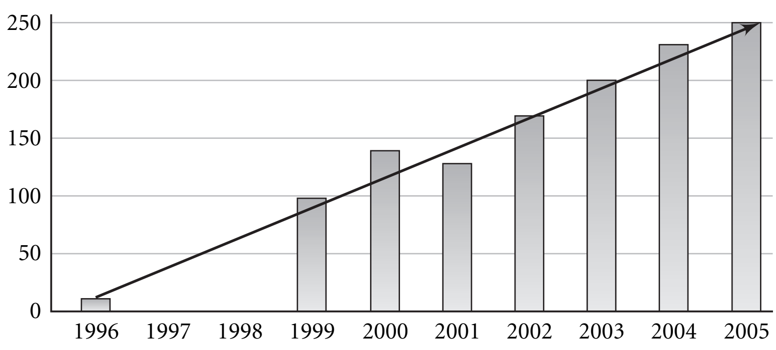


Figure 2.9 Growth of Angel Organizations in the United States