

## What is an Angel Investor?

An angel investor is a high net worth individual who invests his or her own money directly into an early stage company, in return for equity (ownership) in the company.

In addition to providing financial capital, angel investors mentor and coach their portfolio companies, and help fill in functional or skill gaps in the company. They introduce the companies to other investors, and to colleagues who may be able to increase the company's value.

Most angel investors are entrepreneurs who have exited one or more businesses. They often invest in companies for reasons that go beyond monetary return. This may include staying in touch with new business developments, mentoring another generation of entrepreneurs, helping to run a company without the usual stress of day-to-day operational issues, and giving back to their communities by leveraging their skills.

Typically, angel investors invest in new, innovative companies that are highly scalable, that can quickly grow revenue and value. They primarily invest locally, so that they can stay in personal contact with their companies.

The term "angel" originally comes from Broadway, where it was used to describe wealthy individuals who provided money for theatrical productions. In one notable early angel investment, Harry Frazee, owner of the Boston Red Sox, used the proceeds from selling Babe Ruth to the Yankees (resulting in the curse of the Bambino) to finance a Broadway musical.

The Center for Venture Research estimates that angel investors invested \$19B in more than 55,000 startup businesses in 2008. Many successful large companies were started with angel backing, including Google, Yahoo, Amazon, Starbucks, and Facebook.

## What's the Difference Between Angel Investors and Venture Capitalists?

Angel investors generally are investing their own money, unlike venture capitalists (VCs) who manage the pooled money of others in a professionally managed fund. Angel investments generally take place after the initial "friends and family" investors who provide the seed funding, but before venture capital investors. VC investments tend to start at \$2M, while angel investments are typically smaller.

## What are Angel Groups?

In an angel group, individual investors join together to evaluate and invest in entrepreneurial ventures, and, in some cases, pool their funds together to leverage their investments. Angel

organizations come in many forms, but in general, they meet regularly, select entrepreneurs to make presentations to the group, and work together to conduct due diligence and define deal terms. For an angel investor, two main benefits of group membership are access to potential deals (deal flow) and the opportunity to discuss pros and cons of deals with other like-minded investors.

Because angel investors usually invest locally, there are many angel groups throughout the US, and in other countries. The [Angel Capital Association](#), (ACA) has 165 angel groups, which represent 7,000 accredited angel investors in North America.

According to the ACA, the average ACA member angel group had 42 members and invested a total of \$1.94 million in 7.3 deals per year in 2007. In the Philadelphia region, angel groups usually invest between \$250K and \$500k in a company as part of a \$1 to \$2M investment round.

#### What is Angel Group Syndication?

Angel groups often syndicate deals, which means the groups join together to invest in a given company on the same terms. Since companies often require a greater investment than any one angel group will provide, and since angel investing requires significant research and preparation, syndication benefits both the investor and the entrepreneur.

There is usually a lead investor who defines the deal terms, but in some cases the angel groups will work together to define the deal terms. In some cases the startup company will bring the different groups together, but in many cases, a lead angel investor will “syndicate” the deal to other angel groups. In the Philadelphia region, angel groups syndicate deals on a regular basis, sharing due diligence as well as terms.

#### What Makes a Company a Good Candidate for Angel Investment?

1. *The company has a must-have product or service with a unique competitive advantage.*

The company’s product must identify a significant need among a large and clearly-defined target market. Investors use the term “pain point” to describe the problem that the product will solve – and the company needs to relieve the customer’s “pain” in a unique and compelling way. It needs to be a “must-have” rather than a “nice-to-have” product for its target market.

- 2. The company has a working prototype of its product or service, and at least one paying client.*

Essentially, the product needs to be ready to go. If the product is just an idea, it is too soon for angel investors to get involved. Likewise, if the company is already a successful business looking to expand its market, it may be ready for the larger resources that venture capitalists can provide. In the case of life science companies, the product should be either in clinical trials, or ready to begin this process.

- 3. The company has a detailed and well-thought-out business plan.*

Entrepreneurs should be prepared for detailed, rigorous questioning about their business plan. Remember that most angel investors have already built and sold their own businesses, and are well aware of the challenges and pitfalls that startup companies face.

- 4. The company has talented managers in place.*

Typically a company will have at least two key managers in place: a technical leader who understands the product's development, and a business manager who has a track record of success in running startup companies. Other key people that are good to have, but could be added after the angel investment round, include a production manager and a marketing/sales leader. Investors also look for high-quality outside board members and advisors, who have extensive experience in the market sector and can help the growing company with advice, perspective, and contacts.

- 5. The company has a way to protect its market share from competitors.*

When a business is successful, competitors notice – and often try to take market share by offering a similar product. In the case of a small startup company, there is often a very small window of opportunity before larger, better-established competitors try to move in. To be successful beyond the initial product launch, a company must establish barriers to entry, either through a patent or other intellectual property (IP) protection, or by quickly gaining a large enough share (critical mass) of the market to prevent competitors from taking over.

- 6. The company will grow very quickly.*

Angel investments bear extremely high risk, and are usually subject to dilution in future investment rounds. It is an angel maxim that in a portfolio of 10 well-chosen

companies, there will usually be one home run, a few singles and doubles, and the rest will eventually strike out. The problem is that even though investors can weed out many companies which lack the potential for success, it is not possible for even the best angel investors to predict in advance which of their many promising companies will actually succeed.

Therefore, in order to get a desired return on their investment, most angel investors look only for companies that can be a home run. A good rule of thumb is that a target company should have the potential to increase in value 20 times (20X) from the initial investment to a liquidity event (buyout or IPO) five to seven years later.

Since companies are typically valued based on a multiple of their revenue or profits, an angel-funded company will be expected to increase market share, revenue, and profits very quickly.

*7. The company has already used self-funding and investments from family and friends.*

In order for the angel investor to make 20X on their investment, they will need to own a commensurate percentage of the company. For example, if the company anticipates being acquired for \$100M, and the angel group has invested \$1M, they would need to get \$20M, or 20% of the company, at exit.

Angel capital investment thus can be expensive, and the entrepreneur should try and grow the company organically until they really need the capital infusion.

*8. The managers of the company are willing to give up some control to outside investors.*

Entrepreneurs are often used to being the sole owners of their companies, and making the big decisions on their own. When they finance their companies' growth with angel investments, they are also taking on new part-owners who are very focused on growth, expense control, profitability, and an eventual sale. As mentioned earlier, the primary goal of an outside investor is for the company to grow quickly and profitably so that it can be sold in 5-7 years. This will require the entrepreneur to report to a professional board, and possibly even step down as CEO at some point if a more effective leader is identified. While outside investors are often able to provide substantial guidance and assistance to help companies succeed, entrepreneurs should remember that taking on outside investors means that they will no longer be making all the decisions on their own.

*9. The company will be put up for sale in the next few years.*

Angel investors only receive a return on investment when there is a liquidity event (sale of company, IPO), so they are looking for a clear exit strategy from the entrepreneur. Entrepreneurs who wish to build a business without selling it at some point should not consider angel or VC money, as the motivations will be at odds from the very beginning.

According to [the Center for Venture Research at the University of New Hampshire](#), mergers and acquisitions represented 70% of the angel exits, and IPOs 4%, in 2008. Bankruptcies accounted for 26% of the exits.

### How is Angel Investing Affected by a Recession?

Like most everyone, angel investors typically have less investable funds during a recession than in boom times. However, most are still actively looking for investment opportunities. Despite the reduction in available cash, early-stage investing remains attractive because valuations tend to be lower and investors typically have more leverage in negotiating deal terms. Investing in high-quality startup companies during a recession is the classic “buy low, sell high” strategy.

Because investable funds are more limited in a recession, angel investors tend to be more selective about the companies they choose for investment, and due diligence reviews tend to be more detailed and rigorous.

### What Do Angel investors Want?

There are almost as many answers to this question as there are angel investors, but in general, most angel investors want a board position and good communication. Good communication can mean anything from weekly updates to quarterly reports, depending on individual angel and stage of the company. Most are looking for a high rate of return (20X over five years), with a significant stake in the business. Many want preferred stock with rights and liquidation preferences over common stock, while some want convertible debt. In addition, some angel investors ask for the right of first refusal in the next round of financing, and specify approval rights to protect their investment, such as approving sale of stock, issuing additional stock, creating new classes of stock, and changing liquidation preferences. Many angel investors also ask for anti-dilution protection that will result in their receiving more stock should the company issue stock at a lower price than paid by the angel investors.

### Deal Terms

The two most basic numbers are how much money an investor is putting in, and the valuation of the company. The valuation determines how much stock the investor gets. If an investor

puts \$50,000 into a company at a pre-money valuation of \$1M, then the post-money valuation is \$1.05M. The investor receives  $.05/1.05$ , or 4.76% of the company's stock.

If the company raises more money later, the new investor will also get equity in the company from the existing shareholders. The angel investor's stake in the company would therefore be reduced. This is called dilution, and it is a normal part of the process. However, it is important that the dilution be commensurate with the added value of the company at this stage. As the old adage goes, it is better to own a small piece of something worth a lot, than a large piece of something worth a little.

### How Can an Entrepreneur Meet Angel Investors?

The best way to meet angel investors is through a referral. Private investors, attorneys, accountants, etc. are usually well-connected in their regional entrepreneurial community and can make referrals. In addition, angel investors attend venture fairs and entrepreneurial events. Before meeting with angel investors, it is important to understand their investment profiles, their portfolios, and their current appetite for investments.

### What are the Steps of the Angel Investment Process?

Most angel groups go through the following steps:

1. *Application*: The entrepreneur submits a business plan and/or an executive summary to the angel group. Many angel groups have online applications on their websites.
2. *Screening*: A screening committee reviews the applications to see if the idea would be of interest to the members. If a company meets the angel group's criteria, they invite the company to present to the membership at their regularly scheduled meeting. (Most groups meet monthly.) In some cases, the screening committee will ask the company to provide more information or to come back when they have reached a particular milestone. In other cases, the screening committee will inform the company that the group is passing on their opportunity, and will provide some feedback about their reasons.
3. *Presentation to Members*: The management team presents to the full membership. Generally, this involves a short presentation (generally 15-30 minutes) followed by Q&A.
4. *Due Diligence*: If the group is interested, they will form a due diligence team to verify the entrepreneur's business plan, presentation and financial projections. A background check will generally be done, and in some cases, the team will talk to current and prospective customers, and other investors in the deal. In most cases, the team will work closely with the company throughout this process.

5. *Term Sheet Negotiation:* After successfully completing the due diligence process, the angel group will create a term sheet that defines the structure of the investment deal.
6. *Funding:* When everyone is satisfied with the terms and the due diligence, the angel group will fund the deal. At this point, board membership is defined, financial reporting requirements are established, and updates on the company's business milestones begins. In many ways, this is really only the starting point of the relationship.

**INFORMATION RESOURCES:**

- Angel Capital Association
- Center for Venture Research – University of New Hampshire
- National Association of Seed and Venture Funds