

CHAPTER

1

The Fascinating World of Angel Investors

It's really this simple: Angel investors are the start-up entrepreneur's best friend. Wealthy individuals, or angel investors as they have come to be known, are by far the most important source of capital for early-stage ventures, and as such are vital contributors to our economy's continued growth and prosperity.

Financial angels have earned their wings through prior business success, accumulating wealth and wisdom that they re-deploy in ventures founded by the next generation of entrepreneurs. They willingly, even cheerfully, assume financial risks that would frighten off even some of the most experienced venture capital firms.

Remarkably, they take these risks not only in search of great rewards, but also because of an unshakable belief in the viability—and necessity—of entrepreneurship. And they invest many times at the very earliest stage of a venture, when there is little more there than the dream of an entrepreneur. They come in at the most exciting and confounding era in a company's development, when the outcome is very much in doubt.

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They serve as coach, mentor, champion, white knight, and hero, helping the company along through good times and bad. Their guiding principle is that uniquely American vision that tomorrow is undoubtedly going to be better than today. Very often, theirs is an amazingly clear vision, based on the success angels have achieved with these investments.

Equally remarkably, these angels are often people who have just completed a lifetime journey of long hours, worry, never-ending problems, huge responsibilities, disappointment, and elation in order to build their own company. So what do they do? They sell their company, then turn around and seek to experience it all again from the start-up stage.

For the typical entrepreneur, angels represent the most attainable source of capital. Angels are not just the best friend; they sometimes are the only friend on the lonely entrepreneurial road.

Who Are Angels?

Angel investors are definitely a Nation of Individuals (and colorful characters). The most common type of angels are generally thought to be older businesspeople who may have sold the companies they started, and now put money in early-stage companies as a kind of hobby/investment opportunity. But this is certainly not the only type. With angel investors, generalizations are elusive and hazardous.

A relatively recent phenomenon is a younger group of high-tech millionaires who have decided to reinvest some of their winnings from taking their own companies public. The stock market correction of late 2000–2001 notwithstanding, the boom in the market over the last years of the 1990s sent the assets of many upper-middle-class individuals up to levels that allowed them to join the ranks of wealthy individuals. With the optimism born of dizzying stock market gains, many of these people decided to become angels as well.

We are even seeing a recent phenomenon of not-so-rich individuals who are trying to crack into venture investing indirectly, by buying public shares in entities that, in turn, put capital into early-stage deals.

ANGELS AND THE WORLD THEY OPERATE IN

Who would be best able to describe the world of angel investing, the financing of early-stage ventures?

Charles Darwin?

Horatio Alger?

Lewis Carroll?

Should we view this marketplace as survival of the fittest, in which all the ideas and management teams do battle against one another, until the best ones—the ones with the highest potential returns and likelihood for success—emerge the winners and get capital? A marketplace in which, at the end of the day, the companies who should get capital, usually do?

Or is the marketplace for start-up capital a place where pluck and perseverance—the ability to pick yourself up and dust yourself off—continue on despite repeated dead ends and disappointments, and are rewarded with the ultimate result of successfully finding investors? Are the stories of successful entrepreneurs heartwarming and uniquely American?

Or is it best viewed through the looking glass, a strangely alien, disorganized world where serendipity, chance meetings, and the secret password of “whom you know” determine who will get capital, where rational analysis gives way to gut instinct? Is this strange world a place where you want to get in, get your capital, and then get out and return home as soon as possible?

In this book, you will see examples of all three, and a key question is investigated: Is it possible to find rules or guidelines an entrepreneur can rely on when seeking angel capital, or is every situation completely different because every company is different, as is every angel investor?

We believe that to understand angels, it helps to look at them up against their more visible and well-publicized counterparts, the venture capital firms (VCs), because the behavior and investment interests of angels are shaped by an important difference with VCs:

Angels invest their own money they or their families and companies have earned.

VCs invest money they have raised from other financial institutions and wealthy individuals.

Thus, we can use this general definition of angel investors: A person, partnership, or corporation that uses his, her, or its own funds to invest in private companies, which are often early-stage companies but not exclusively. This is in contrast to venture capital firms that raise money

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from institutions (pension funds, insurance companies) and sometimes from wealthy individuals, and then invest the money on behalf of these limited partners in primarily later-stage companies (but, again, not exclusively). Venture capitalists, then, are really money managers. Angels put their own (usually hard-earned) money at risk. Angels have created wealth in the past in their own entrepreneurial ventures and now put a portion of the wealth to use in building another entrepreneur's company. They make the money, then they manage it. Venture capitalists invest private equity as a full-time job. Most angels only devote a portion of their time to making and watching over these investments.

Entrepreneurs who want to raise money successfully from angels have to keep these facts mind, because most of the advice that entrepreneurs read or hear about regarding raising capital is primarily applicable to working with venture capital firms. Venture capital firms are much more well known. They are interviewed more often, and their activity and methods are easier to observe.

Although some standardization is emerging as a result of the formation of angel groups that invest as a unit, the negotiation and due-diligence process with angels varies widely with the angels themselves. This implies that, from the entrepreneur's point of view, gaining an understanding of the angel as an individual, prior to taking money from the angel, is an important factor in determining whether the partnership with the angel will be successful.

Do They Have Cell Phones in the Clouds?

In our book, *Inside Secrets to Venture Capital*, one entrepreneur observed, "VCs are like UFOs, everyone talks about them but they are seldom seen."

If that's the case about VCs, then financial angels are very well named: The angels depicted in art and literature are spiritual beings that are immortal, not easy to find, may be all around us but are typically unseen. They serve as guardians or advisors to mere mortals, and exhibit virtues such as goodness and selflessness.

Financial angels know they are mortal, but they hope to build enterprises that will live on after they are gone. Financial angels are not easy to find, certainly, but we pass them on the street every day, even in small towns in rural areas. The most competent financial angels take their role as advisors very seriously. Are they good and selfless? That's a tough one.

If you set about to help someone and in the process greatly enhance your own wealth, are you selfless?

Medieval angelology tells us there are nine levels or orders of these beings. If we were to create an order or ranking of financial angels, how would we do it? Would we base it on:

How old they are?

How much money they have?

How easy they are to work with?

How frequently they make investments?

How skilled they are at advising companies?

How fast they act in making investment decisions?

How successful they have been in their own business?

How knowledgeable they are about your industry, or market?

How well connected they are with other investors, including venture capitalists?

The highest angel from the entrepreneur's standpoint would be one who can comfortably write a check for the full amount of capital the company needs, provides positive support but does not try to get too involved in running the company, can zip through the due-diligence process in 30 days, has a great deal of practical wisdom to provide based on his or her own considerable success, understands the company's market enough to share the entrepreneur's enthusiasm about the venture, and is already thinking about the perfect venture capital firm to bring in for the second stage of the company's financing.

Does this highest, perfect angel exist? Sure. You will meet several of them in this book. They are just referred to as angels, though. They were far too modest to let us designate them as perfect. That's part of the reason they deserve the designation. If someone in the financial world has to tell you how great they are, they probably aren't.

THERE IS A DARK SIDE TO WATCH OUT FOR

If you have read the preceding paragraphs, right about now you may be hearing in your head the theme music from the old TV series, *The Saint*, and expecting the halo to appear over Simon Templar's head.

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Before we conclude that he is representative of angel investors, we might want to switch channels and go over to the contemporary TV series, *Angel*. The hero on that program is a vampire who tries to do the right thing and help little, suffering people, but sometimes he lets his unnatural affinity for blood get the better of him. At his worst, though, he is still generally a far cry better than his archrivals, a consortium of guys in dark suits who work out of a high-rise and try to take over the world.

Substitute the words *investor*, *start-up entrepreneurs*, *greed*, and *venture capitalists* and you pretty much get the idea that whenever you are out there looking for capital, it pays to watch your back.

Just as *Angel* works in a shadowy world where seemingly attractive people with absolutely perfect hair can turn into horrible demons right before your eyes, the true motives of angels are many times unseen until much later in the transaction. Fortunately, bad angels do some things that tend to give themselves away before it's too late for the entrepreneur to escape. Their unwillingness to meet with you before dusk is one example. Nobody's that busy.

Risk Capital and Ultrarisk Capital: Not Investments for the Faint of Heart

Funding of early-stage companies involves a high degree of risk, as we all know. The capital that VC firms raise for their funds is sometimes called risk capital to reflect this reality. But venture funds also employ a number of strategies to mitigate the risk. The investments they make are often a blend of early-stage—even seed-stage—companies, and later stage, the Series B or Series C round of financing, as it is sometimes called. These investments would be made to help already successful companies expand and hopefully dominate their markets, and they are, therefore, significantly lower in risk.

Venture funds also spend time and money to get their names known, to, in effect, create a brand image for the fund that allows them to receive a large number of deals, and hopefully the best quality deals. Venture funds also have experienced staff members who know how to evaluate the growth potential of a given company thoroughly prior to funding it. Venture funds rely on complex legal agreements and compli-

cated deal structures to protect their investment and allow them a certain degree of control over the direction of the enterprise.

Angel investments, then, should be called ultrarisk capital. Angels often provide the very first funding a company gets—when few milestones have been reached, and the company has not in any way demonstrated that its business model will be successful. Sometimes, they put money into a deal that is not even a company yet; it is just one or more individuals with the vision of a company in their minds.

When we asked the question, “Why do you want to be an angel?” we got nearly the same answer every time, whether we talked to angels, managers of angel networks, attorneys who represent angels, and even, sometimes reluctantly, venture capitalists. Angels get involved because many of them are highly successful with these investments. They frequently make tremendous returns on their investments and get the added psychic satisfaction of contributing to the growth of a company, and even of helping their community and nation. And they have fun doing it.

Angels succeed. That is the lesson you learn when you study this field of investing. But why do they succeed, how do they do it, and how can an entrepreneur tap into this large and growing source of funding? We hope to provide the answers to these questions in this book.

EARLY-STAGE INVESTING IS WHERE THE RETURNS ARE

Why do angels concentrate their activity on early/seed-stage investments? They know that’s where you make the highest rate of return.

We tend to think of the last five years as the red-hot period for private-equity investing, and the 28.3 percent return that all private equity earned, as shown on Table 1.1, certainly bears that out. But look at how early/seed-stage investors did over the last five years—a return of more than 65 percent, and more than double that earned by later-stage private-equity investors.

For those wealthy enough to play in this arena, those who won’t be that adversely affected even if the company they invest in turns out to be a bust, it can certainly be an exhilarating experience when you succeed. If you held an investment for five years and it earned 65 percent annually, your \$100,000 investment would be worth \$1.2 million.

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Table 1.1 Venture Economics
U.S. Private Equity Performance Index (PEPI) as of 12/31/2000

	1 Year	3 Year	5 Year	10 Year	20 Year
Early/seed	51.20%	93.70%	65.50%	35.80%	23.80%
Later stage	19.90%	31.70%	31.10%	25.20%	18.30%
All private equity	20.00%	30.30%	28.30%	22.10%	19.30%

Angels love start-ups just as much as start-ups love angels. It's easy to see why!

WHERE ENTREPRENEURS GO WRONG IN THEIR SEARCH FOR ANGELS

Despite the fact that angel capital is relatively plentiful and, as we will see, in some cases easier to obtain than capital from venture capital firms, entrepreneurs make some of the same mistakes when seeking capital from angels that they make when approaching VCs.

First and foremost, they do not realize that getting angel capital requires an investment of significant time and effort on the entrepreneur's part. Let's look at the day's schedule for a typical harried founder of an early-stage company:

The Entrepreneur's To-Do List

- 8:15 A.M. Meet with attorney to finalize patent application
- 11:00 A.M. Look at office space with realtor
- 12:15 P.M. Go to OfficeMax and buy supplies
- 1:25 P.M. Finish installing new printer on computer
- 2:00 P.M. Interview CFO candidate
- 3:30 P.M. Raise \$1.5 million from angels

Unfortunately, many entrepreneurs assign the same degree of difficulty to each of these tasks. And notice how this entrepreneur left raising capital until the end, when all the other chores were done. The fact is that many founders of start-up companies end up feeling as though their full-time job is raising money, and as a result, a lot of other important tasks get pushed aside while they are out chasing dollars. Part of this is due to the entrepre-

neurs' lack of planning in their capital search, and going about it incorrectly. Part is due to the nature of the process and the barriers that are erected between the entrepreneurs and their prize: the elusive angel dollars.

AN ANGEL IS MUCH MORE THAN A PERSON WITH A CHECKBOOK

Innovation and job creation come mainly from small enterprises; these small enterprises are early-stage companies that have taken off. It is critical that we create a more efficient equity-capital formation marketplace to enable these companies to flourish. Many entrepreneurs are still limited to family-and-friends capital. Although it is great that some entrepreneurs have these sources ready to be tapped, they do not really fill the needs of most early-stage ventures, which need:

- Capital
- Experience
- Contacts

The true angel can provide all these, and all are critical to the success of an early-stage venture. Many angels make the case that the experience and contacts they provide actually add more value than the capital they provide.

WHY ANGELS ARE INCREASINGLY VITAL

The published numbers for capital invested and number of investments done by VC firms is somewhat misleading because a number of the investments is skewed by follow-on investments in companies, expansion capital rather than start-up capital.

One reason angels have prospered is a simple supply/demand equation: The number of quality start-up ideas has risen much faster than the number of professional venture funds (and the number of venture-fund partners available to analyze deal flow). Angels fill this void very eagerly. The average size of investment done by VC firms has risen dramatically over the last five years, to reach nearly \$16 million in 2002, by some estimates, meaning that companies with smaller needs for capital are, for all intents and purposes, shut off from obtaining capital from VC firms.

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The very earliest-stage companies often have incomplete management teams and need a great deal of mentoring assistance. The partners of VC firms, whose time is spread over many tasks, cannot usually provide the intensive assistance these companies need. Angels may be better able to do this, but it depends on their interest level, other commitments angels may have including their own companies, and the simple fact of whether they get a kick out of mentoring.

Chapter Summary

- Angel investors are the most important source of capital for early-stage ventures.
- Angels are individuals who invest their own money, which they have earned.
- Angels have diverse backgrounds and motivations for investing.
- Angels know and are willing to accept the fact that they are taking great risks.
- Historically, early-stage investments achieve the highest rates of return.
- Angels provide companies with experience and business contacts as well as capital.
- Angels help make the market for private equity more efficient around the United States.
- Angels provide vision.