Angel Group Financing

A Venture Capital Guide For Entrepreneurs

By
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VentureDeal is a venture capital database that provides the latest information about venture-backed technology companies, venture capital investors and transactions in the United States.

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I. Introduction

The idea for this eBook came out of a series of blog posts at VentureDeal and it aims to shed light on the world of angel groups. In doing so, perhaps more entrepreneurs will be encouraged to seriously consider angel groups as a viable funding source and stepping stone to business success.

This work represents my own views on standard practices among the more established angel groups. For any particular group, there may be significant variation from what I describe. That is to be expected, as this relatively new form of organized investing grows and adapts to the business environment around it.

To entrepreneurs seeking funding for their startup company, angel investment groups are shrouded in mystery. It needn't be so. While angel groups tend to be private organizations operating in many cases by word of mouth, they actively seek high quality investment opportunities and strive to work effectively with both experienced and promising entrepreneurs.

An angel group is a loose organization of SEC accredited investors who come together to invest individually or as a group in promising business opportunities. This eBook will focus on the modern version of the angel group, more specifically groups that invest principally in technology-oriented startup companies. In addition, I hope to provide entrepreneurs with insight in dealing with angel groups and the process by which they source, evaluate and interact with investment opportunities.

The earliest technology-focused angel groups were initially formed in the mid 1980's. One objective of these groups was to invest venture capital in promising technologies and entrepreneurs that were coming out of existing, large technology companies, notably the semiconductor and software companies among others. These large entities were the backbone of the nascent technology industry at the time.

Early angel groups formed from a small core of successful technology entrepreneurs, adding members based on word of mouth. Over time, a simple framework emerged: The members would share duties of sourcing and evaluating new companies. They would meet once per month, usually over dinner, to have the potential investee companies formally present their opportunity for funding. Members who decided to invest would do so from their own account. Later, some groups would develop a separate fund, financed by institutions to co-invest alongside members when additional funds were needed.

Not long after, other successful business people located in various technology-oriented regions of the country began to adopt various forms of the same idea, so that today there are numerous variations on the original theme.

Today, angel groups operate with numerous structures: some groups have created a fund for individual members to invest in and have decision-making authority over. Others form a separate corporate entity for each investment. Other groups invest on an individual member basis. Some angel groups have separate funds, while other groups do not see the need to raise and operate a fund.

There are also angel group networks, which are umbrella organizations that help underserved regions easily create and develop angel groups using a template. The umbrella organization assists the local angel groups to perform the necessary administrative work, thus freeing them to focus on sourcing and evaluation of potential investees.

On a national level, the Angel Capital Association (ACA) was formed in 2004. The stated purpose of the ACA is to "increase the success of member angel groups," by sharing best practices, educating members via its affiliate Angel Capital Education Foundation (ACEF), promoting regional collaboration among member groups and encouraging individual angel investors to join angel groups. As of publication date, the ACA listed 126 angel groups as member organizations. The ACA is led by a Board of Directors composed of prominent angel group leaders and has several sub-committees responsible for recommendations on various aspects of its operations.

II. Are Angel Groups Right For You?

The first question to ask yourself as an entrepreneur is whether angel groups are right for you and your company. To gain insight into that question, you should understand where angel groups fit into the "funding chain."

The funding chain can be roughly summarized as follows, with exceptions based on differing circumstances:

1. Self funding - an entrepreneur provides his or her own funds to begin development of the company's technology. Common funding amounts range up to $100,000.

2. Friends and family - usually tapped for larger funding amounts to further develop the product or service to demonstration or alpha stage. Common funding amounts range up to $250,000.

3. Angel groups - a higher funding threshold for creating a beta version of the company technology for pilot test purposes or initial marketing. Common funding amounts

range from $250,000 to $1 million.

4. Institutional venture capital firms - commonly used for final product/service development as well as sales and marketing expansion once the technology has been validated on a smaller scale. Provides follow-on financing through exit via M&A transaction or IPO. Common funding amounts exceed $1 million.

Another metric for determining whether an angel group is right for you and your company are the types of investments the group typically makes. Most angel groups invest via preferred company stock, which places an agreed-upon valuation on your company as of the transaction date and in which you trade an ownership stake in your company in return for the investment. Other groups prefer to invest via promissory notes, often called convertible bridge notes, which typically convert at some discount to the next equity round. Additionally, promissory note transactions tend to be simpler and faster, with less documentation and lower legal fees.

The central question for the entrepreneur on this issue is whether you wish to give up equity in your company, or sign on a promissory note in return for the investment. On the angel group side, many groups prefer not to use the bridge note vehicle, due to a lack of alignment of interests that may occur.

This lack of alignment can happen because the investor in a bridge note is helped if the note converts to equity at a lower valuation in the subsequent equity round, whereas the entrepreneur wants the highest possible valuation. Also, with a bridge note, the investor has no shareholder voting rights in the company, which typically come with an equity stake.

A third element for reviewing potential angel groups is qualitative. Does the group have members that are knowledgeable and familiar with your industry? If so, the group may be able to enhance your future prospects by introducing you to resources and other investors, providing valuable guidance and adding value in other, non-financial ways. By learning about the industries and other companies that an angel group has invested in, you may be able to determine if that group is potentially a good fit for your business.

Another aspect in dealing with angel groups is their particular process for reviewing investment opportunities. The group should be open about their process - what it entails and how long it typically lasts. If they aren't forthcoming, you would be well advised to proceed with caution.

Most angel groups do not require a fee for evaluating your opportunity. However, some do in order to defray their administrative expenses. Many groups do have significant administrative costs and are not money-making concerns at the administrative level, so in some cases a nominal fee may be justified. This is for you to judge whether you find it acceptable to pay a fee.

Many groups provide online forms for submitting your company information. Follow these procedures as closely as possible. Angel groups typically review large quantities of business opportunities and "following the rules" will only help your chances. Groups want to be able to easily compare opportunities, so it is important to provide your company information in their format. Standing out from the crowd at this stage would not be helpful to you, as it would likely be perceived by the angel group as "can't follow simple instructions." If you want to create the impression that you are easy to work with and establish a relationship with, this is your first test. As you proceed further down the funding process, some groups even provide consulting to help improve presentation skills and materials.

As for the amount of time it should take to obtain funding, a good estimate for the situation of a motivated angel group, an investee company that has clean due diligence and both parties share reasonable deal term expectations, is about 90 days from initial process to the check in the bank. It can be shorter in duration in some situations, such as a convertible bridge note with an experienced entrepreneur, or longer if due diligence is difficult, lengthy or deal negotiation (and re-negotiation) causes delays.

III. Approaching Angel Groups

There are a few ways to approach an angel group to present your company's investment opportunity. In order of preference, the following methods are most commonly used:

1. The best way to be introduced to an angel group is by being "sponsored" by a member of the group. This usually means that you've developed a relationship with a member and shared the business opportunity with him or her and they bring you into the angel group evaluation process by stating "I'm going to invest in this company and I think it is a great opportunity to invest." This is the best introduction you can get.

2. The next warmest introduction is through an attorney, accountant, consultant or other person who puts you in touch with someone at the angel group who then helps you through the process. Angel group members are usually well-connected in the business community and have relationships with other business people whose

judgment they value. Having a personal introduction via one of their business colleagues is extremely valuable.

3. The last way is "over the transom," where you contact the group yourself directly by phone, email an executive summary or go through the angel group's online registration system. Even though this approach is not via an introduction, you shouldn't downplay this opportunity. Angel groups are very active and are looking for quality opportunities wherever they may be.

While none of these ways to approach an angel group will guarantee you success, generally you should attempt to be introduced by a existing member, since this effectively operates as an initial "vetting process" in your favor. You can also obtain good feedback on the status of the evaluation process from an angel group member whom you have befriended. Even if the angel group decides not to invest, your relationship with the angel group member may assist your efforts in developing your technology or finding other potential investors.

Should you approach more than one group? Certainly. Most sophisticated investors will assume you are contacting several sources.

Obtaining funding is sometimes a function of contacting a number of potential investors with the understanding that many of them may not invest in your company for different reasons. Also, some individual angels are members of more than one group. Venture investing communities tend to be small and word travels fast. So if you are asked, simply disclose that you are contacting other investors as well. There's no need to be coy or not to disclose your actions. When in doubt, disclose, and you'll stay on the good side of potential investors.

IV. Executive Summary And Business Plan

Executive Summaries can take virtually limitless forms, from one page introductions to 20 page documents. There is much variation among angel groups on format. Some groups use an online submission program that requires submissions be provided in a certain format. Others have no set format but a page limitation. Still other groups have no set criteria and leave it completely up to the entrepreneur to decide how to submit their information.

In any event, most summaries are no more than 3 - 4 pages in length. They provide just enough information in a variety of categories about company management and history, the technology, market dynamics and size, and the amount and expected use of the funding proceeds.

The tone of the summary should be factual, not "salesy." It should be brief and to-the-point. Readers of the summary will appreciate your clarity of thought, not a long rambling explanation of a small point. This is your first impression on the group, and as with all first impressions, it counts heavily. I suggest having others read your summary for content as well as any typos, mistakes or awkward grammar. When in doubt, keep your writing simple, clear and direct.

One question entrepreneurs often have is how much information to divulge, considering their technology may have significant intellectual property. A general answer is to explain as much as you feel comfortable doing so. A common misconception among entrepreneurs is that since angel groups have a large number of entrepreneurs, there is a strong chance of someone "stealing" an idea. While anything is possible, most angel group members are members because they want to give back to the entrepreneurial community from their own successes. The furthest thing from their mind is to take someone's idea.

Furthermore, regarding Non-Disclosure Agreements (NDAs), most groups or venture capitalists won't sign them. An exception can be made in certain circumstances where an individual member of the group will sign an NDA, and the presenting company will then divulge the "secret sauce" for that one person to review and provide a comfort level to the rest of the interested angel members. So, if you have technology, you will have to show it to someone at some point in order to get them to invest. Saying "trust us, we have great technology" won't win an investor, at least not the kind of sophisticated investors that you want to ally yourself with.

There are a variety of excellent business plan software packages that can assist you in creating a high quality plan. Also, some groups and venture capital firm websites will include a sample summary or business plan in their "Resources" section. There are also consultants who specialize in providing business plan services.

V. How Angel Groups Evaluate Deals

Once you've created your summary or plan and submitted it to the angel group, the ball is in their court to make an initial evaluation.

One of the benefits of dealing with angel groups is that they usually have a process of evaluating the merits of an investment in your company. A typical initial evaluation process might be with a deal screening committee. Some angel groups have specialized deal screening committees for different sectors of the technology industry, such as general technology and life sciences.

Your summary or plan may be distributed to several group members for each of them to review and rate according to the angel group's system. Some angel groups have a formal, point-based rating system that includes comments. Others have a less formal system - something like a "thumbs up or down." Still other groups may have individual members who have expertise in your particular industry or application to review your information. Each group is different and may operate differently according to the particular situation.

The rating system usually includes things like: quality of management, status of product or service development, market size, scalability, technology, funding amount required and valuation expectations, if any.

Generally speaking, angel groups invest in technology companies in order to achieve certain meaningful milestones, so that the company can then obtain additional funding at a higher valuation to further propel them down the road to success. While every company is different, some common milestones are:

- Development completion of a beta test version of the company's product or service
- Successful pilot test with a marquee reference customer
- For life science companies, initial proof of concept feedback on a device or process
- Sourcing a well-regarded chief executive ready to join the effort upon further funding

The milestones must be both achievable and meaningful, so that the company is properly positioned to obtain funding from an institutional investor such as a venture capital firm. Funding amounts sought by startup companies should be enough to cover both the achievement of the milestones plus the time that it will take to obtain the next round of funding. Most often, entrepreneurs underestimate the amount of funding they need, given these two requirements. Also, an angel group may have a high opinion of your company, but decide that the parameters of your particular situation, such as higher funding amounts needed to achieve meaningful milestones, may not fit their criteria.

As for the various reasons why investors evaluate and invest in companies, entire books have been written about the subject. From a macro level, sophisticated investors want the answers to three main questions:

1. Why should I invest in this *Technology*?
2. Why is it important to invest *Now*?
3. Why should I invest in *You*?

There are many ways to answer these and the myriad other questions that investors may pose to you. For technology startup companies, answering these three questions in a compelling manner will take you far down the road to obtaining funding.

Lastly, since angel groups tend to review large numbers of deals, you should follow up with them according to their estimated turnaround time and not assume that they will contact you. If you pass the initial review, they will let you know what happens next. If you don't pass the review, ask for a reason why. Although some groups won't provide that information, some may do so, and you will be better off understanding why the group did not invest than just wondering why.

VI. The First Meeting

The next step on the way to a successful financing is when you've provided an initial summary or plan, you've passed the initial evaluation screen and the group invites you to a short, in-person meeting.

Usually this meeting is set up to have you provide a short summary of your offering and the remainder of the time is spent with various angels asking you questions about you and other company management, the product or service status, the market, your proposed milestones with the financing amount and other topics.

You should expect a very intense "grilling" at this meeting, since the group is looking for any signs that you aren't ready to present to the entire angel group at their next meeting. Since this is the first in-person impression that the angel group will have of you and your company, you should be extremely well-prepared for this opportunity. Bring your business partners along to add their comments to yours, so that each question is fully answered. You usually get only one chance to communicate your message.

A word about financial projections. Investors are used to seeing the typical "hockey stick" revenue curve. Smart investors are more concerned with understanding how you intend to make money and that you are knowledgeable about the financial issues that drive your industry or new technology. They are looking to see if you have a clear understanding of how you will make money, and what will provide "venture" level returns on their investment. Building a nice business is certainly valuable, but angel investors are looking for large, outsized gains to offset the greater risk from very early stage investing. It's your job to convince them that such gains are possible and likely, given the assumptions.

Based on this meeting, you may be asked to either formally present your company to the angel group or provide additional information before a final decision is made by the group. In rare cases, if it was a close call, you may be put in the "queue" for next month's process.

If you keep in touch with the angel group throughout that time and avoid letting the concept "stale out" in the group's mind, you may get the opportunity next time to move on the next step in the process.

VII. The Main Presentation

Once you've been invited to present your opportunity in front of the entire angel group, it is important for you to understand the format for that particular group.

Different angel groups have different formats, but one that is common is a 20-30 minute time slot allotted for your presentation, usually in a dinner setting in front of the entire angel group. At one veteran group I'm aware of, each presenter receives 30 minutes total time. They usually limit their formal presentation to 20 minutes and allow 10 minutes at the end for question and answer.

Some angel groups also provide presentation coaching, and I highly recommend that as a presenter you get the proper coaching you need, so that your "delivery" doesn't get in the way of communicating your opportunity. In the past, some company founders didn't have good presentation skills and their prospects for getting financing dropped accordingly, since their poor or disorganized method of delivering the message got in the way of the angel group members trying to understand the opportunity. Potential investors are also looking at you to have a high degree of maturity and ability to clearly get your message across. Even if you are a company founder who does not intend to be in charge of general management or other public-facing responsibilities, you should be able to demonstrate your ability to communicate to a group of people.

There are many books and resources on the subject of presentations. One interesting rule of thumb is the 10/20/30 rule: 10 slides in length, 20 point font minimum size, 30 minutes maximum. It may be difficult to adhere to exactly, but it is a concept that can be beneficial to keep in mind as you create your messaging.

You need to be succinct, clear, and obvious about the market pain, how your company alleviates that pain and how you intend to go to market and actually sell the technology. Whatever you do, never say that your business opportunity is "the next Google." That will likely end your chances of raising money from that angel group.

In the allotted Q&A period, expect to be hammered with tough questions. Make sure you repeat the question for everyone to hear, and don't dodge it or provide an evasive answer.

If you don't answer the question directly, you will leave the impression that you either don't know the answer or don't want to share it. Be clear and candid, and you'll have the best chance for success.

Lastly, if the angel group allows, stay after the presentation to answer any additional questions members may have. It is a great time to make additional contacts and get feedback about your presentation and whether angels are interested. Frequently, after a well-received presentation the presenter will be peppered with additional questions or expressions of interest, so make yourself easily approachable.

VIII. Following Up After The Presentation

Once you've presented to the full angel group, it is time to follow up to determine if there is initial interest by the group to invest in your company.

Assuming there is interest, many groups will schedule a in-depth follow-up meeting whose purpose is for those interested angel group members to more fully examine you and your company. This type of meeting can last several hours. In some cases, the meeting is structured so that the company presents a very brief summary of their opportunity and then the angels in attendance start peppering the presenters with specific questions. The purpose of the intense questioning is to find out where the holes in the company are.

Experienced angels know that very early stage companies are like Swiss cheese - they have lots of holes - and in assessing their interest in investing they have to understand where the weaknesses are and where the strengths are.

As a presenter, it is entirely acceptable to say, "Here's where we're weak and here's where we're strong." If the angels agree, then you've just banked some credibility. If you answer their question with a vague or evasive answer, you might get past the question, but your non-answer will stick in the minds of the angel group members after you've left meeting. Investors must have a clear and compelling desire to invest, otherwise they will pass. In truth, they only invest if they are extremely positive and enthusiastic about your opportunity.

If they still like your company after this meeting, it is on to some initial due diligence and discussions about deal terms.

Additional note

Entrepreneurs say that one of the things that annoys them the most is not getting a firm 'Yes' or 'No' from venture capital firms or angel groups they are presenting to. They feel like they get strung along without a definite ending or closure to the process. Unfortunately, in too many cases, that is an accurate statement.

The simple answer: if an angel group is interested in investing in your company, they will make it very clear to you. They will engage you in obvious ways like asking you back for additional meetings with final decision makers, asking detailed questions about you, your company and the opportunity and sending feelers about financial terms, etc. They might begin to bring in other investors who may be interested.

In other words, if they aren't enthusiastically engaging with you, then you should assume the answer is No. It's like that scene in the popular television serial 'Sex in the City', where the man on a date decides not to come up to the woman's apartment, and provides some vague excuse - the real answer is that he "just isn't into her." It's the same with investors -- if they don't respond enthusiastically with interest in taking the next steps, they're just not that into you.

In some rare cases, a group will tell a presenting company that upon achieving a few more milestones, the group will become interested in investing. In practice, it is difficult to retain the interest of a group in this situation, so you should be wary of this type of verdict.

IX. Due Diligence

Once an angel group has indicated an interest in investing in your company, they will start looking deeper into you and your company's background, the technology and development to date. This is called due diligence. Because there are usually several angels who become interested in a deal, they will need to decide who is going to perform the due diligence. Sometimes it will be one person, sometimes they will divide it among several angels, based on their individual expertise or desire to contribute.

It is critical to cooperate with them and show them everything. It looks bad if they get to the end of the diligence process and find the proverbial "skeleton in the closet," so it really behooves you to show them everything up front. Investors want to deal with honest, transparent entrepreneurs.

If you have extremely sensitive technology, it would be appropriate to only show it to one angel and ask them to sign an Non-Disclosure Agreement. Assuming all goes well, the angel would report back to the group that there are no problems with the technology.

Anything you can do to make the due diligence process run more smoothly is greatly appreciated by your potential investors and business partners. I've seen very organized startups that have non-proprietary documents converted to PDF files and make them available in a password-protected online location for easy access and review.

Keeping the due diligence part of the process organized and well-run also indicates that you understand the investment process and is a good overall indicator of your level of organization. Since investors are considering a potentially long term investment in you and your company, they will evaluate you on your ability to manage various constituencies and information requirements.

X. Negotiating Investment Terms

Angel groups will usually begin discussing investment terms while they are performing due diligence on you and your company. The reason is that they want to send out deal feelers to see if there is a basis for negotiating a deal before they spend too much time in due diligence.

When discussing deal terms, many entrepreneurs get stuck on trying to be a tough negotiator. It's understandable - you've worked hard to get your company to where it is, and you want to control the process as much as possible. In addition, you want to keep as much of your company as you can. Sophisticated angels understand this because they are usually entrepreneurs themselves.

Entrepreneurs should focus more on getting the right angels as their investors, and less on squeezing the last nit-pick deal term. Reasonable negotiation is fine and is a good indicator of both parties' definition of a company's value, but if you find yourself spending in inordinate amount of time wrangling over negotiating points, it may be worthwhile to step back and ask yourself if you are focused too much on the fine points to the detriment of moving forward and getting the financing done.

As for the various deal terms themselves, there are numerous books and blogs (see the Additional Resources page) that can help you get a clearer understanding of the details surrounding the terms that typically appear in equity or debt financings. In addition, there are other considerations such as legal incorporation entities, board seats, management and employee compensation plans and other issues that arise. In any event, you should have knowledgeable and competent legal counsel representing your interests.

Lastly, it is important to keep the angel round deal terms as straightforward as possible. In the past, some angel groups and entrepreneurs began to get a reputation among venture capital firms of creating structures and terms that were onerous, difficult to undo, or simply didn't make long term financial sense.

If you expect to obtain additional rounds of funding for your growing company, you would be wise to keep the early financing transactions such as friends & family and angel groups "plain vanilla." This strategy will make the transition to institutional financing much easier and smoother. It will also make keeping track of the terms and conditions easier for you.

XI. Closing Process & Post Closing Reporting

The transaction closing process is certainly exciting, but usually stressful. It usually involves stacks of paperwork, expensive attorneys charging by the hour, and potential last minute hiccups in terms. Based on the number of individual angel investors, you can expect to have many signatures required on many documents. It is important to provide full documentation to all parties, and to keep backup copies in convenient locations. In addition, you should keep a simple summary of important terms for your own review, since you may soon forget many of them while you put the new found investment dollars to work growing your business and achieving your milestones.

Once you have closed the transaction, it is usual for investee companies to provide a written summary of the company's operations and/or financial statements on a quarterly basis to all of the investors who are entitled to such reporting rights. In some cases, this information may be communicated verbally in order to retain privacy for competitive reasons.

You should make it a goal to proactively keep the lines of communications open with your investors, even the ones who may not be on your company board of directors. Since many angels are successful entrepreneurs or senior executives, one of the benefits of having them as investors is the assistance they can provide you and your company as you work to execute or adjust your business plan.

Angels can provide business advice or introductions to potential partners or customers. Further down the road, they can begin to introduce you to sources of institutional venture capital, thus minimizing your time locating the right interested parties. Fundraising can be an extremely time-consuming process, and can take away time and resources needed to propel your business forward while you search for funding. Angels who are connected to the venture capital community can be a tremendous resource to you when your company is getting ready for its next funding search cycle.

XII. Final Thoughts

The angel investment community is growing, both in size and in capabilities, and seeks to assist motivated and talented entrepreneurs in building sustainable, successful businesses. Angel investors can add tremendous value to a new business. Many successful entrepreneurs have become angels because they know how difficult it is to build a successful business from scratch. They want to give back to the community and perhaps make some money in the process. Most of all, they get excited about the prospect of new technologies that improve our quality of life, in whatever form they may take.

While there's an old saying, "Banks provide you money when you don't need it," angel groups aren't like banks - they provide you with investment funding and counsel when you need it most.

When you need capital, advice or connections, angel groups can be a great resource for startup entrepreneurs.

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XIII. About The Author

Don Jones is a member of a prominent angel group based in Silicon Valley, a veteran of three startups and the founder and CEO of his fourth startup: VentureDeal, a venture capital database serving the emerging technology industry. Previous to that, he was in senior management at Cogent Communications (Nasdaq:CCOI), a Cisco-backed international all-optical telecommunications carrier. His particular area of expertise is in early-stage business development and sales, with over 15 years of successful results in a variety of organizations.

His close relationships with a number of investors, technology companies and professional service firms allowed Don to create VentureDeal, which provides the highest quality emerging company information for funding search, business development and venture investing needs.

XIV. Additional Resources

Books

Term Sheets & Valuations - Alex Wilmerding
Venture Capital Due Diligence - Justin Camp

Blogs

Angels

AngelBlog
5280 Angel
Don Jones

Venture Capitalists

Fred Wilson
Brad Feld
Guy Kawasaki
Peter Rip
Jeff Clavier
Josh Kopelman
Matt McCall
Mike Hirshland
Ed Sims

Technology Entrepreneurs

Dick Costolo
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