Venture Support Systems Project:

Angel Investors

Release 1.1

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The Venture Support Systems (VSS) Project is managed by a team at MIT and HBS. It was funded by a generous donation from Ronald A. Kurtz (MIT 1954) and David Kurtz (HBS 1992). Other reports from the VSS Project include cases, teaching notes and monographs.

This report was prepared by Lucinda Linde (Marlin Capital) and Alok Prasad (Pittiglio, Rabin, Todd & McGrath) under the direction of Kenneth P. Morse and Matthew Utterback of the MIT Sloan School and Howard Stevenson and Michael Roberts, of the Harvard Business School.

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Alok Prasad and Lucinda Linde prepared this note as the basis for discussion rather than to illustrate either effective or ineffective handling of an administrative situation

Executive Summary

Angel investors are an important and growing source of financing for the start-up and initial growth phases of technology ventures. This study focused on high net worth angel investors with entrepreneurial backgrounds. Many of these angels invest in first time entrepreneurs before the entrepreneurs secure venture capital financing. Besides earning a strong return on their investment, these experienced angels are motivated to "give back" to the community which helped make them successful. Very little published data is available on angel investing and little research has been done on the experienced angel investor. It may be valuable for first time entrepreneurs, venture capitalists, regulators and other members of the venture community to understand, leverage and support this growing class of experienced angel investors.

This study introduces and defines the experienced angel investor, outlines the angel investing process, discusses the rise of organized angel groups, and provides advice for high net worth individuals aspiring to become angel investors. The intended audiences are business school students, aspiring entrepreneurs, aspiring angel investors, and other members of the venture support system.

Some of the key findings of this study are:

- *Angels vs. Early Stage Venture Capitalists:* The motivations and operations of experienced angel investors are typically different than those of early stage venture capitalists. First time entrepreneurs can benefit from approaching experienced angel investors, prior to meeting early stage venture capitalists, when seeking early stage funding. This study outlines the differences.

- *The "Network of Trust":* An angel's personal network of contacts is a key element in screening deals, conducting due diligence, negotiating terms, adding value after the investment, securing additional rounds of funding and executing the exit strategy.

- *"Not All Angels are Alike":* It pays for entrepreneurs to understand the type of angels they need and the role that the angels will play in building their company. We have categorized angels into four groups: Guardian Angels, Operational Angels, Entrepreneur Angels and Financial Angels. We describe how these various angel types operate and how they provide different value to emerging ventures.

- *Systemization is on the Rise:* Experienced angel investors are becoming increasingly systematic in their operation. Systematic evaluation and analysis help reduce risk, improve returns, and increase the number of deals considered.

- *The Need to Clarify the Angel Investing Process and Terms & Conditions:* We found wide variation in the way angel investors conducted the investing process, in particular, regarding the specific terms and conditions (T&C's) of the term sheet. We devote a chapter to understanding the angel investing process and explain some common terms and conditions.

- *The Rise of Angel Groups:* We identify and describe the recent rise in angel groups. Angel groups are an important new development in venture creation. These groups provide the fastest way for entrepreneurs to find angels and provide a way for angels to leverage their combined skills, time, expertise and networks. We outline four types of angel groups and define a framework for growing and managing angel groups.

- *Becoming an Angel:* Finally, we explored how wealthy individuals become successful angel investors. In our survey, we sought advice from experienced angels on this topic and summarized their thoughts.

In conclusion, the six chapters of this study are designed to enable the reader to develop a good understanding of angel investing. We outline the chapters below:

Chapter 1 outlines the funding options available to entrepreneurs and describes how angel investors fit within those options. We also highlight data on angel investing in the United States and compare that with bootstrapping and venture capital investment data.

Chapter 2 introduces the experienced angel investor and the survey we used to collect data for our analysis. We explain the factors driving the recent growth in angel investing and outline the rich diversity of angel investing behaviors. Chapter 2 also describes a model we constructed to understand the involvement and value of different types of angel investors. Finally, we compare and contrast experienced angel investors with early stage venture capitalists.

Chapter 3 describes the angel investing process from deal sourcing to deal exit. We discuss the screening criteria, due diligence performed, terms and conditions, post-investment involvement, and exit strategies of angel investors.

Chapter 4 outlines the different types of organized angel groups, angel businesses, angel clubs and match making services. As we interviewed individual angels, we found many of them belonged to 1 or 2 organized angel groups. We outline a framework to characterize and compare the various angel groups. This framework can be used to build and grow angel groups.

Chapter 5 is based on the advice experienced angel investors would offer aspiring angels. We outline how to become proficient, and how experienced angel investors are willing to help newcomer angels. We also describe some investment strategies commonly used by experienced angel investors.

Chapter 6 concludes with some perspectives developed while conducting this study.

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Chapter 1. Context for Angel Investing-Overview of Funding Options

Chapter 1 outlines the funding options available to entrepreneurs and describes how angel investors fit within those options. We also highlight data on angel investing in the United States and compare that with bootstrapping and venture capital investment data. This chapter serves as the foundation for characterizing angel investing.

1.1 How Do Entrepreneurs Fund Start-ups?

Entrepreneurs today have access to a wide variety of funding alternatives. Inc. Magazine lists 20 ways to finance start-up businesses[1]. Fundamentally, the entrepreneur must decide if the business will require outside equity capital for growth, or if the company can be bootstrapped. When entrepreneurs bootstrap, they do not access external equity capital, but rather fund growth by using founders' capital, sales revenue, lines of credit and other non-equity sources of capital. Table 1.1 shows the options available for entrepreneurs to fund start-up companies. Usually if there is a need to establish market share rapidly, entrepreneurs will seek outside capital to fund faster growth. Other reasons may also drive their need for outside capital.

There is little definitive data on bootstrapping and capital raising in early stage companies because there are minimal or no reporting requirements on the hundreds of thousands of investors that inject private capital into small, private companies. Studies based on surveys or interviews of entrepreneurs and angel investors have no scientific means of verifying responses. Reliable data on venture capital financing is available because venture capital companies are required to report on their investments.

Table 1.1: Funding Options for Start-Up Companies

Bootstrapping	**Equity Financing**
Early Sources Founders' Capital Savings Credit Cards Second Mortgage Venture Leasing Sales Revenue	Early Sources All Bootstrapping Early Sources Capital also from: Friends and Family Angels Angel Groups Early Stage Venture Capital Firms
Later Sources Lines of Credit SBA Loans Asset Backed Lending Accounts Receivable Factoring, etc. Corporate Strategic Partnerships Banks That Lend To Start-Ups Government Grants (SBIR, DARPA, etc.) Company Earnings	Later Sources All Bootstrapping Sources Venture Capital Firms Corporate Venture Funds Private Equity Firms Private Placement Firms Mezzanine Financing Firms Investment Banks Public Markets

Source: Inc. Magazine and Genesis Technology Partners analysis

[1] Fraser, Jill Andresky, March 1999, "How to Finance Anything", *Inc. Magazine*, p. 32

1.2 Bootstrapping, Angel, and Venture Capital Investment Data

1.2.1 Highlights from Limited Bootstrapping Data

There are only a few studies that shed light on bootstrapping and angel investing. Amar Bhide reported that 80% of the 1989 Inc. 500 grew to be on the Inc. 500 list through bootstrapping only.[2] The Inc. 500 is a list of the 500 fastest growing private companies over the previous 5 years. The companies represent a mix of high-tech, service and retail businesses. He interviewed 100 founders and discovered they used personal savings, credit cards, second mortgages, etc. to fund a median start-up capital requirement of $10,000. Less than 20% of bootstrapping founders raised follow-on equity capital within 5 years of founding their company. They relied on debt or earnings to finance growth. Ross Perot's initial investment of $1000 to launch EDS is perhaps one of the most famous examples of venture bootstrapping.

Freear and Wetzel and the Center for Venture Research at the University of New Hampshire conducted a study in 1987 on the financing of 284 New Technology –Based Firms (NTBF's) that had been founded in New England between 1975 and 1986.[3] They found that 38% (107) received no outside equity funding, preferring to bootstrap the operations of their companies. For other companies, individual angel investors were the most common source of funds providing 177 rounds of equity financing for 124 firms. Ninety firms raised equity from venture capital funds in 173 rounds. Table 1.2 shows how many individual angel investors and venture capitalists invested in the rounds of financing tracked by the study. While the data is fairly old, this study is the most extensive and systematic view into the early funding of high-tech ventures. The study does not seek to describe which form of financing leads to the fastest growth or the greatest long-term shareholder value.

Table 1.2: Angels and Venture Capitalists Complement Each Other in Funding Technology Ventures

Financing Round ($k)	Number of Individual Angels Investing	Distribution of Angels Investing (%)	Number of Venture Capitalists Investing	Distribution of Venture Capitalists Investing (%)
<250	102	58	8	5
250–500	43	24	14	8
500–1,000	15	8	31	18
>1,000	17	10	120	69
Total	**177**	**100**	**173**	**100**

Source: Freear and Wetzel (1987)

[2] Bhide, Amar, November/December 1992, "Bootstrap Finance: The Art of Start-ups", *Harvard Business Review*, p. 109

[3] Freear, J., and Wetzel, W. E. 1990 "Who Bankrolls High-Tech Entrepreneurs?" *Journal of Business Venturing*, 5 (2) p. 77–89.

1.2.2 Highlights from Limited Angel Investing Data

Limited and fragmented data is available on angel investing. Gompers (1998) references and summarizes the research studies conducted on angel investing.[4] Two studies, outlined below, estimate the number of angels investing and the amount invested per year by angels. The two studies provide widely differing estimates of the capital committed by angel investors each year to emerging companies.

Freear and Wetzel (1996) estimate that approximately 250,000 angels invest between $10–20 billion in roughly 30,000 firms each year.[5]

Gaston and Bell (1988) studied the annual rate of informal venture investing based on a sample of 435 individual investors drawn from Dun's Market Identifier File.[6] They estimated that 720,000 investors annually made 489,000 informal venture investment with a mean dollar value per investment of $66,700, implying annual equity capital investments of $32.7 billion from individual investors.

1.2.3 Highlights from Venture Capital Investing Data

Table 1.3 (based on Venture Economics data presented in the Venture Capital Journal) shows the explosive growth in funds raised and invested by the venture capital industry. Even as the number of rounds invested has steadily risen since 1993, so has the amount invested per round.

The buoyant stock and initial public offering markets of 1995-1997 has driven recent high rates of return (IRR). This fact that has not been lost on the capital markets investing in private equity. Limited partners committed a record $24.3 billion to venture capital funds in 1998, up from $13.1 billion in 1997 and $3.0 billion, a cyclical low, in 1991 (Table 1.3). Record levels of funds have been committed by institutional investors such as pension funds (60%), corporate funds (11%) and family/individual (11%). Remaining VC funding sources include financial (6%), foundations (6%), funds of funds (3%), other (2%), and foreign (1%).[7]

[4] Gompers, P.A. 1998 "A Note on Angel Financing" Harvard Business School Case Study, Ref: 9-298-083.
[5] Freear, J., Sohl, J.E. and Wetzel, W. E. 1996 "Creating New Capital Markets for Emerging Ventures" Prepared for the Office of Small Business Administration under contract SBAHQ-95-M-1062.
[6] Gaston, R. J., and S.E. Bell 1988 "The Informal Supply of Capital" A report prepared for the office of Economic Research, Small Business Administration.
[7] *Venture Capital Journal*, March 1999, p. 45.

Our interviews with venture capitalists, angel investors, start-up lawyers, accountants, and other members of the venture support system revealed a widespread feeling that angel investing has grown in a manner similar to the venture capital funds. A large portion of our interviewees felt that the growing class of cashed-out entrepreneurs and successful high-tech executives helped drive the growth in angel investing. Many angels also commented that today's angel investing is more organized and systematized than ever before. Chapter 3 describes the range of organizations involved in angel investing processes. Chapter 4 characterizes the organized angel groups that have contributed to increased systemization.

Table 1.3: Recent Growth in Venture Capital

Year	**Capital Committed to VC Funds ($B)** [8]	**Capital Invested by VC Firms ($B)**[9]	**# Rounds**	**$M/Round**	**Annual Net IRR (%)**[10]
1998	24.3	16.0	3470	4.62	17
1997	13.1	10.0	3279	4.00	29
1996	9.9	7.5	2675	3.70	42
1995	6.0	4.4	1900	3.16	49
1994	5.6	3.8	1800	3.11	13
1993	5.7	2.5	1700	3.35	18
1992	5.6	2.5	2000	2.80	11
1991	3.0	1.3	1600	1.88	21
1990	4.0	1.8	1900	2.11	2
1989	5.9	2.4	2200	2.68	5
1988	5.9	2.9	2000	2.95	2

Source: *Venture Capital Journal* (based on data from Venture Economics Information Services) and Genesis Technology Partners analysis

1.3 Overview of Financing Over the Early Life of a Company

Table 1.4 identifies different equity financing rounds, the typical amount invested in each round, and the investors who typically invest in such rounds. The typical investment ranges are based on anecdotal information received from investors and are not based on any systematic analysis. Generally speaking, the amount invested in each round depends on the type of start-up, the industry of the start-up and other valuation determining factors (such as recent stock market performance). Note: Investors in early rounds often participate (usually on a *pro-rata* basis) in later rounds, though they may not be the primary suppliers of capital.

[8] *Venture Capital Journal*, July 1998, p.37 and *Venture Capital Journal*, March 1999, p.41.
[9] *Venture Capital Journal*, August 1998, p. 38; *Venture Capital Journal*, March 1999 p. 44 *and Venture Capital Yearbook* 1996 p. 31.
[10] *Venture Capital Journal*, July 1998, p. 44 and *Venture Capital Journal*, July 1999, p. 44

Table 1.4: Equity Financing Rounds over the Early Life of a Company

Financing Round	Definition	Typical Amounts	Who Typically Plays
Seed	Prove a concept/qualify for start-up capital	$25,000–500,000	Individual Angels Angel Groups Early-stage Venture Capitalists
Start-up	Complete product development and initial marketing	$500,000–3,000,000	Select Individual Angels Angel Groups Early-stage Venture Capitalists
First	Initiate full-scale manufacturing and sales	$1,500,000–5,000,000	Venture Capitalists
Second	Working capital for initial business expansion	$3,000,000–10,000,000	Venture Capitalists Private Placement Firms
Third	Expansion capital to achieve break-even	$5,000,000–30,000,000	Venture Capitalists Private Placement Firms
Bridge	Financing to allow company to go public in 6–12 months	3,000,000–20,000,000	Mezzanine Financing Firms Private Placement Firms Investment Bankers

Source: Interviews; definitions taken from *Pratt's Guide to Venture Capital Sources* p. 14, Securities Data Publishing ©1999

1.4 Summary and Conclusions

Entrepreneurs starting ventures may have access to a variety of funding sources. The late 1990's have witnessed explosive growth in venture capital fund raising and investing, driven by the buoyant stock and initial public offering markets. Based on comments in our interviews, angel investing has probably experienced similar growth over that time period.

Angel investing is a major source of funding for the seed ($25,000–$500,000) and start-up ($500,000–$3,000,000) rounds. Estimates of total annual angel investments in the United States range from $10–30 billion invested by 250,000–700,000 individual angel investors.

It is an important dimension of the American high-tech culture that successful entrepreneurs choose to invest part of their gains and provide active assistance to follow-on new ventures. Public policy initiatives, including tax policy, should continue to support such pro-active reinvestment of money and skills.

Chapter 2. Profile of the Typical Angel Investor

In this chapter, we characterize the angel investor based on interviews with angel investors, venture capitalists, accountants, venture attorneys, entrepreneurs, and others; and on data from the literature. The sections in this chapter:

1. Define and outline angel investing

2. Explain the factors driving the recent growth in angel investing
   - Economic and environmental factors
   - Non-economic factors motivating high net worth individuals

3. Characterize the rich diversity of angel investors
   - Outline the attributes along which angel investors differ
   - Understand their diversity of involvement and the value which angels provide to emerging companies

4. Describe the similarities and differences between experienced angel investors and early-stage venture capitalists

2.1 Angel Investors: Definition and Survey Background

The term "angel" originated in the early 1900's and referred to investors on Broadway who made risky investments to support theatrical productions. Today, the term "angel" or "business angel" refers to high net worth individuals, usually "accredited" investors as defined by SEC Rule 501, who invest in and support start-up companies in their early stages of growth.[11]

For the purposes of this study, we defined an angel investor as a high net worth individual (with investable funds >$1 million) who invests a portion of his/her assets in high-risk, high-return entrepreneurial ventures, typically in the pre-seed, seed, or start-up stage. In addition to providing financing, angels typically support the company by actively providing advice and assistance with other activities, such as recruiting management. The "3Fs" (friends, fools and family) sources of funding were not considered in this study.

We focused on the experienced angel investor who repeatedly invests in start-up ventures. We interviewed 26 experienced angel investors, of which 24 have more than 2 years' experience as angels. The angels in our sample averaged 12 years of angel

[11] According to SEC Rule 501, an individual must have net worth of at least $1 million or earn more than $200,000 per year to qualify as an "accredited" investor. For a more complete description of unregistered security offerings, refer to article by Jack Levin, 1994 "Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions, (CCH, Inc. Chicago). Further, see http://www.law.uc.edu/CCL/33ActRls/regD.html, provided by Center for Corporate Law describing SEC Rule 501.

investing experience. All the angels interviewed were located in the Boston/Route 128 or San Francisco/Silicon Valley areas. Twenty-five of the 26 angels interviewed invested primarily in technology-based companies. Most of the angels in our survey invested in the seed and start-up stages. Together, these angels have invested in more than 407 companies over their angel-investing career, averaging 15 companies per angel. Angels in our survey invested over $8 million in 1998 alone, averaging more than $335,000 per angel. The average investment was greater than $80,000 per company per angel in 1998.

Besides interviewing angel investors, we also interviewed angel groups, lawyers, accountants, start-up company founders, venture capitalists, and investment brokers to better understand how angel investors operate. Some key statistics from our interview sample are displayed in Table 2.1.

Table 2.1 An Overview of Angels and Other Interviewees in the Interview Sample

Category	Interview Facts	Comments
1. Number of Interviews Conducted:	Total Interviews: 53 • 26 Angel Investors • 12 Angel Groups • 15 Complementary Interviews: Lawyers, Accountants, Start-up Companies, Venture Capitalists, and Investment Bankers	
2. Average Number of Years as an Angel Investor:	12 Years	
1. The Number of Angels Focusing on the Different Stages of Investment:	a. Seed Stage Investing: 22 b. Start-up Stage Investing: 17 c. First Stage Investing: 7 d. Second Stage Investing: 2 e. Beyond Second Stage: 1 f. *Number of Angels Responding to Question:* 26	• Angel investors can and do invest in more than just the seed stage
2. Estimated Average Number of Companies Invested in (over angel's career):	a. Total Number of Companies Invested by Angels: >407 b. Number of Angels Responding to Questions: 26 c. Average Number of Investments: >15	• 4a and 4c were calculated from the lower limits of ranges in interview questions.
3. Estimated Average $ Invested per Angel Investor (1998):	a. Total $ Invested in 1998 by Angels: >$8+ million b. Number of Angels Responding to Question: 24 c. Estimated Avg. $ Invested in 1998: >$335,000	• 5a and 5c were calculated from the lower limits of ranges in interview questions.
4. Estimated Average No. of Companies and Average $ invested by Angels per company per Angel Investor (1998):	a. Total No. of Companies Invested in 1998: >94 b. Number of Angels Responding to Question: 24 c. Average No. of Companies Invested per Angel: >4 d. Average $ Invested by Angels per Company per Angel in 1998: >$80,000	• 6a, 6c, and 6d were calculated from the lower limits of ranges in interview questions

2.2 Recent Growth in Angel Investing

In recent years, angel investing has seen rapid growth and increased systemization. Though statistics are hard to find, evidence of increased activity and systemization can be found by looking at the increase in angel group enrollment and activity. From 1995 to 1998, the number of members in the Band of Angels organization, a Silicon Valley angel group, grew from 12 to 110.[12] The Band of Angels invested in 19 deals in 1995 and 23 deals in 1997. The average investment per company increased from $290,000 to $535,000. The growth in activity and systemization is occurring not only in Silicon Valley, but also across the U.S., in Europe and in other countries. For example, in the last five years, the Boston/Route 128 area has seen the emergence and growth of at least a dozen new and different angel groups.

2.2.1 Economic and Environmental Trends Driving Increased Angel Activity

We identified four economic and environmental trends driving angel activity:

a. Secular Trends in New Technologies[13]

Secular trends in the Internet, communications technologies, life sciences, and other technologies are providing start-up opportunities for entrepreneurs. These opportunities, when combined with the availability of capital and the strong IPO and acquisition markets, are allowing founders and executives of start-ups to amass wealth rapidly. A number of these entrepreneurs have become angel investors.

b. Continued Strength in Financial Markets and Increased Capital Availability for Private Equity

The strong stock market of the mid-1990s has provided lucrative exits for VC portfolio companies through IPOs or by being acquired, both at high valuations, driving high rates of return. Table 2.2 shows that although the aggregate capital raised by venture-backed companies in IPOs each year is highly variable, the pre-IPO valuations and median dollars raised have increased to record levels over the past 5 years.

Table 2.2 IPO Data for Venture-Backed Companies[14]

Year	Aggregate $M Raised	# Venture-Backed IPOs	Median $M Raised	Median Pre-IPO Valuation ($M)
1993	5,577	162	24.5	51.2
1994	2,944	121	21.0	45.5
1995	5,681	160	31.5	68.9
1996	9,676	232	33.3	79.5
1997	5,365	135	33.0	103.6
1998	4,231	77	45.0	169.6

[12] Based on presentation by McLaughlin, G., 1998, "Angel Investing: Silicon Valley", in Chicago.
[13] "Secular trends" is a commonly used term in venture capital and fund management referring to extended period trends in an industry.
[14] "Liquidity Report: Initial Public Offerings", *1998 Venture Capital Industry Report*, p. 108.

Large corporations have expanded liquidity opportunities for venture capitalists by acquiring rapidly growing venture-backed companies. Corporations facing a fast and competitive environment have found it is more financially compelling to buy a company with a complete solution than to develop it in-house. M&A of venture-backed companies remained steady as 190 venture-backed companies were acquired for $12.6 billion in 1998 and 198 venture-backed companies were acquired for $12.8 billion in 1997.[15]

Early stage venture capital funds have grown in size without similar expansion in the number of experienced partners. To adapt, early stage venture capital companies are funding larger but later stage deals, investing at higher valuations in high growth well-rounded ventures, establishing feeder angel and angel groups, or setting up angel advisory teams to support their early stage investments. Venture capital firms have not had the time to focus on "raw" early stage deals (deals with first time entrepreneurs). This has provided angel investors and angel groups with an expanded investment range to establish themselves in the early stage private equity market.

c. Returns of Angel Investors and Success Stories Profiled in the Media

The media has profiled the strong returns on investment experience by a large number of angel investors. As a result, more high net worth individuals are interested in angel investing.

d. Emergence of Angel Groups

Angel groups such as angel clubs and matchmaking services are systemizing the angel investing process, providing support and information to their members, and raising awareness about the angel investing process. High net worth individuals are finding it easier to understand and invest in start-ups.

2.2.2 The Non-Economic Factors Driving High Net Worth Entrepreneurs to Become Angels

Cashed out entrepreneurs regard angel investing as a way to stay involved in start-ups without actually doing it again full-time. Though economic returns are important objectives for these entrepreneur/investors, they indicate that the non-economic reasons also drive them to become angels. The non-economic reasons are:

- *Desire to Give Back:* Angels enjoy the chance to mentor entrepreneurs. Having founded and grown companies themselves, many angels they have empathy for the extent entrepreneurs personally have to grow to lead their companies and to accomplish their visions. Angels feel that if they had had similar coaching when they were building their companies they would have reached greater heights or not committed some of their mistakes.
- *Involvement without Immersion in Start-ups:* Angels enjoy the adrenaline rush of emerging company volatility, but without the 80-hour workweeks and the burden of ultimate responsibility for the company.

[15] "Liquidity Report: Mergers and Acquisitions", *1998 Venture Capital Industry Report,* p. 124.

- *Fun, Passion, Commitment:* Since most angels no longer have to work to support themselves, they angel invest because they enjoy investing in start-ups.
- *Networking Benefits:* Angels enjoy maintaining or building their personal networks with similarly interested people while helping the companies.
- *Technology & Markets*: They keep abreast of rapidly evolving technologies or markets.
- *Intellectual Challenge:* Angels keep their minds sharp through dealing with the business issues faced by the companies.
- *Creation of Societal Benefits*: Some angels, especially those in the medical device and biotechnology areas, take great pride in the fact that the products developed by these companies save lives or make people's lives better.
- *Control of Time:* Angels do not want to be full-time venture capitalists They want the flexibility of investing without the pressures of raising funds, managing limited partners' expectations and optimizing IRR.

2.3 The Rich Diversity of Angel Investors

2.3.1 Attributes along which Angel Investors Differ

Angels are high net worth investors with varying styles, investment behavior, experiences, judgement, networks and focus. Table 2.3 shows some of the richness.

Table 2.3: Select Attributes and Ranges of Behaviors within Our Angel Investor Sample
Note: The different attributes listed below represent the range for that attribute. Each attribute should be considered as independent. The extremes of each spectrum do not represent any single type of angel.

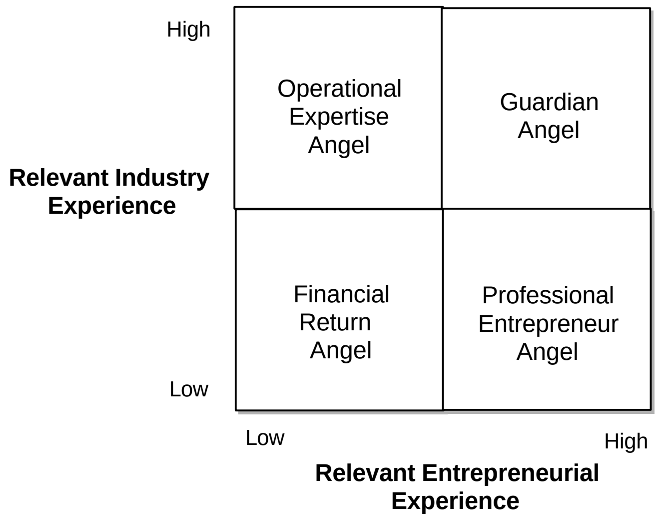
For example, some angels invest $25,000–$50,000 per round; others invest as much as $750,000 per round. In another example, some angels invest only in seed rounds; others invest in seed, start-up and first rounds. Both attributes are *independent*.

Independent Angel Attributes	➢ ➢➢ ➢➢ ➢ Variance Among Angels	➢ ➢➢ ➢➢ ➢	
1. Investment Amount	$25,000–50,000 Per Round	To	$250,000–750,000 Per Round
2. Stages Invested In	Seed only	To	Seed, Start-up, First Round
3. Number of Investments/Year	1	To	20
4. Industry Focus	Single industry (for example, investing only in data networking hardware)	To	Multiple industries and socially responsible investments
5. Geographic Focus	Within 50 miles of their location	To	Day round trip by airplane
6. Experience	Engineers from Cisco or Oracle	To	Founders of multiple successful companies
7. Network	Limited; a few industry contacts	To	Gold Plated: Top venture capitalists, attorneys, executives in strategic industry players, other great angel investors etc.
8. Growth Prospects of Investments	Can be a moderate growth, niche business that supplies profit sharing	To	High-growth companies that will require substantial venture capital funding and result in a large liquidity event
1. Willingness to Work	Rolodex access (<1 day/month)	To	Interim member of top management (10+ days/month)
2. Involvement Style	Hands-off, laid back	To	Hands-on and very demanding
3. Personality	Like an entrepreneur	To	Like a banker

2.3.2 Understanding the Diversity of Angel Investors: Categorizing Angel Investors

Diversity among angel investors is wide. We have attempted to categorize angel investors to help understand the involvement and value provided to start-up companies. Our categorization is based on relevant industry experience and entrepreneurial experience. Depending on the individual investment opportunity, an angel may operate in more than one category.

"The Different Types of Angel Investors"



a. Guardian Angels: *(Primary target of this study)*

General Description:	These angels are active investors who guide and coach the management team to help them grow the company. They usually work with a limited set of start-ups. Guardian angels can invest significant amounts of time in the company, especially after they have developed confidence in the entrepreneur.
Objectives:	They have strong non-economic reasons to work with entrepreneurs, besides achieving high economic returns.
Geographic Focus:	They invest within a 1 to 2 hour driving radius.
Investment Amount:	These angels invest substantial amounts in a limited number of start-ups. They often average $100,000–150,000 per company.
Number of Investments per Year:	Guardian angels invest in a limited number of companies, (typically 2–4 per year), primarily in the seed stage.
Due Diligence:	Guardian angels rely on their network to source and screen opportunities. They conduct their own due diligence and consult experts to supplement their expertise.

Post-Investment Involvement:	They usually take Board seats and provide guidance and coaching to the management team. They help recruit other Board members, members of the management team and, next round investors such as venture capitalists. They provide assistance in other areas based on their expertise.
Performance:	These angels usually experience high rates of return. Many said they have recently achieved greater than 40% ROI.
Potential Issues With Later Stage Investors:	Later stage investors often want guardian angels with strong business credentials to remain on the board.

b. Professional Entrepreneur Angels:

General Description:	These angels have entrepreneurial experience but are investing outside their area of expertise. They may have limited angel-investing experience. They are usually followers and invest based on recommendations of other angels they trust and whose expertise they respect. Angels in this category may be Guardian Angels for other ventures.
Objectives:	These angels primarily seek high rates of return by investing in start-up companies outside their area of expertise, (e.g., investing in an unfamiliar industry). They may also wish to build their expertise in angel investing
Geographic Focus:	No particular focus
Investment Amount:	Varies
Number of Investments Per Year:	Varies.
Due Diligence:	They rely on the lead angel to conduct the bulk of the due diligence, structure the terms and conditions, provide support to the start-up after investing, and monitor the progress of the start-up. They conduct some limited due diligence on their own, especially if they are trying to build their angel experience.
Post-Investment Involvement:	Their involvement with the start-up is usually limited though they may provide market research and other

	information. They may periodically review the progress of the company.
Performance:	Moderate. Returns not as high as Guardian Angels but potentially not as low as some Financial Angels. (Based on responses from Guardian Angels investing outside their industry of expertise).
Potential Issues With Later Stage Investors:	In most cases, these angel investors are patient investors with a good understanding of start-up milestones and growth stages.

c. Operational Expertise Angels: (Our characterization of this group is based on complementary interviews with lawyers, accountants, start-up companies, venture capitalists and investment bankers).

General Description:	These angels, are or have been, senior executives in major companies in the start-up's target industry. Usually, other angels approach Operational Expertise Angels for due diligence insights and confirmation of the deal quality.
Objectives:	These angels invest for non-economic reasons as well as for economic returns.
Geographic Focus:	Not determined in this study.
Investment Amount:	Not determined in this study.
Number of Investments Per Year:	Not determined in this study.
Due Diligence:	These angels do their own detailed due diligence. They will also involve other trusted and known resources to understand unfamiliar markets or technologies.
Post-Investment Involvement:	These angels usually provide active support to the company (e.g.: take Board seats if offered, provide customer and other strategic partner introductions, and provide other operational structuring and guidance to the company).
Performance:	Not determined in this study.
Potential Issues With Later Stage Investors:	Having these angels on the Board is usually perceived to be positive by later stage investors.

d. Financial Return Angels: (Note: We collected limited data on these angels. Characterization is based on responses from lawyers, accountants, and other members of the venture support system).

General Description:	Financial return angels are high net worth investors who have little relevant entrepreneurial experience and who invest in companies in which they have little industry experience. Usually these angels are high net worth individuals who have made money through the stock market, real estate, inheritance, and through professional occupations not related to starting up companies (such as doctors, dentists, lawyers, accountants, engineers, consultants, brokers, etc.).
Objectives:	These angels are investors looking for high rates of return by investing in start-up companies and do not desire to be actively involved with the start-up.
Geographic Focus:	No particular focus.
Investment Amount:	Often <$50,000 per investment.
Number of Investments per Year:	The number of investments varies, depending on risk profile, deals available etc. Quality deal flow can be uneven because brokers, accountants or lawyers supply deals to these angels on an *ad hoc* basis.
Due Diligence:	Usually these angels use attorneys and personal accountants to review paper work and perform limited due diligence. Their networks usually do not include venture capitalists or industry experts that could greatly aid due diligence.
Post-Investment Involvement:	The value-add to the start-up company is usually limited to financial support. Some Financial Return Angels will provide general business and guidance support depending on their background. They may also provide access to friends and associates. Their interactions with the company are varied and dependent on the individual's temperament.
Performance:	Not determined in this study.
Potential Issues With Later Stage Investors:	Later stage, professional investors are less likely to invest in deals that have too many financial return angels in the previous rounds. These investors are less aware about the ups and downs of start-up company investing and they can become impatient or "spooked" when the venture experiences a downturn. Usually these angels do not protect themselves adequately when structuring terms and conditions.

Though the above framework is helpful in characterizing most angels, other segments of individual angel investors exist that do not align with this segmentation scheme (e.g., socially responsible angels do not map to the above characterization). Further, an angel investor within a segment may not align with all the characteristics mentioned.

2.4 Summarizing Similarities & Differences between Experienced Angel Investors and Early Stage Venture Capitalists

	Experienced Angel Investor	Early Stage Venture Capitalist (VC)
Variation Among Investors	• As mentioned, wide variations exist among even experienced angel investors. Anyone with a checkbook can try to become an angel investor.	• Venture capitalists have less variation. It takes a good track record to raise a large fund. This weeding out process improves the odd that VCs who invest for a living have some proficiency.[16]
Industry Focus:	• Active experienced angel investors tend to have targeted industry focus when they are the lead. Passive angel investors may not have an industry focus.	• Most early stage venture capitalists focus on one or a few industries. VC's do not fund passive investments.
Investment Amount:	• $25,000 to $750,000 per round. • Many angels only invest in the seed and start-up stages. Though some angels, especially lead angels, set aside funds to participate in subsequent rounds. • In lower growth, lower capital industries, the angel may be the only investor and expect the company to self-fund growth.	• Though VCs may invest $150,000 to $350,000 in seed stage, they are more interested in the subsequent rounds of financing in a winner. • VCs have the resources to support a company through a downturn.
Number of Investments per year:	• 1–20 It depends on whether the angels are active or passive, and on the total funds they invest in new ventures.	• 5–50 depending on the available fund size and number of partners. An average VC partner can support 6–10 ventures.
Stages Invested	• Angels invest in seed, start-up and sometimes in the first round. Later stage funding requirements become too large for angels to finance. • Often the large, professional investors want to finance the entire round and discourage angels from participating in follow-on rounds.	• Invest from seed to exit. They usually increase their investments in winners and starve losers. • Later stage VC's expect that earlier stage VC's will invest in subsequent rounds, if the deal is good.

Continued on next page

[16] ONSET Ventures HBS Case Study and interviews with early stage venture capitalists forms the basis for Section 2.4. See Tempest, N. and M.J. Roberts, 1998 "ONSET Ventures" Harvard Business School Case Study, Ref: 9-898-154.

	Experienced Angel Investor	Early Stage Venture Capitalist (VC)
Type of Investment:	• Angels are more willing to invest in a first time entrepreneur and provide coaching to the entrepreneur so that he/she can grow with the business. • Some angels will invest in “lifestyle” companies while VCs will not.	• Venture capitalists will provide guidance and support to an experienced team. Some early stage venture capitalists allocate up to 70% of their portfolio for seed and subsequent round funding of entrepreneurs they have previously funded.
Accessibility:	• Angels do not promote themselves and are not listed in any directory. The number of deals an angel gets depends on the angel’s network and the number of entrepreneurs that the angel comes across. They can be easy to meet in the right places.	• Venture capitalists promote more heavily than angels do. They are easy to find but it can be harder for first time entrepreneurs to receive funding from venture capitalists.
The Need to Invest:	• Angel investors do not need to invest. Angels typically allocate less than 30% of their total net worth to financing early stage companies. • For a number of active angels, the chemistry with the entrepreneur is more important than the specific deal • The angel investor is accountable to himself/herself for the investment.	• VCs are paid to manage other people’s money. They are required to invest in a manner consistent with the strategy they marketed to their limited partners.[17] • VCs are measured on the IRR they return to their limited partners. They target IRR’s of at least 30-35%. Consequently they focus their investments in very high growth industries.
Due Diligence:	• Angels rely on a more subjective evaluation. Their due diligence may be less rigorous than venture capitalists. Angels often base their decision to invest on their personal (gut) assessment of the entrepreneur, the technology and the market. • Most angels look to one or two lead angels to do most of the due diligence and will invest if the lead angel invests.	• Venture capitalists are usually more rigorous in their due diligence. A venture capitalist must justify the investment to his other general and limited partners.

Continued on next page

[17] Darwall, C. and M.J. Roberts, 1998, The Band of Angels, HBS Case Study: 9-898-188.

	Experienced Angel Investor	Early Stage Venture Capitalist
Valuations:	• As a group, angels invest in a higher range of valuations than do venture capitalists. (Based on anecdotal information).	• Venture capitalists are tougher on valuations. They are more aware and strict about adhering to venture capital industry “norms” for valuations.
Terms and Conditions:	• Higher variances in terms and conditions. Terms and conditions vary from little or no protection to VC-like terms and conditions. Increasingly in technology deals, angel investors terms and conditions are getting to be similar to VCs.	• Standard terms and conditions. • Usually they posses negotiating power to achieve favorable terms and conditions such as liquidity and vesting schedules. These are often missing from angel term sheets.
Round Closure:	• A pure angel round can close faster than a venture capital round. Closing angel rounds in 6–8 weeks is not unheard of.	• VCs wait until the business model is clear and sometimes until the market for the product or service is clear. • Closing a VC round can take from 3 months to a year.
Post-Investment Involvement:	• Active angels typically provide guidance and support that will impact the company growth for 1–18 months. • Active angels normally have more operating experience than many venture capitalists. These angels have good contact with operating personnel and can help recruit management team members and early customers.	• Venture capitalists usually target to provide guidance and support to build the 18–36 month infrastructure for the company. • It is often useful for early stage venture capitalists to have a successful track record building and operating new ventures. However, some entrepreneurs and angels complain that there are many partners in VC firms that do not have company operating experience. • VCs usually bring strong expertise to define and implement financial strategies.
Patience with Investment	• Experienced angel investors can be more patient investors. Because angels cannot easily change management, they are more willing to work with existing management and help recruit people to round out the team • If the company performs poorly, angels are more likely than VCs to walk away from the venture and accept the business as a write-off.	• VCs are required to deliver on IRR expectations to their limited partners. They may be less patient with inexperienced entrepreneurs and more likely to replace the management team if it performs poorly. They have the network and resources to replace management team members.

2.5 Summary and Conclusions

Angel investors are an important and growing source of financing for the initial start-up and early growth phases of technology ventures. Secular growth in new technologies, continued strength in financial markets, media coverage, emergence of angel groups, and non-economic factors are driving the continued growth of angel investing.

Angels are a diverse group of individuals. We categorized angels into four groups that supply different levels of involvement and value to start-up companies. We also outlined the similarities and differences between experienced angels and early stage venture capitalists.

This chapter introduced angel investors and their role in early stage financing. The next chapter outlines the angel investing process and how angel investors operate.

Chapter 3. The Angel Investing Process

In this chapter, we describe the angel investing process from deal sourcing to the time of exit. Our description of the process is based on literature, information and interviews with angels, angel groups, venture capitalists, lawyers, accountants, and start-up companies. Table 3.1 shows the 5 steps we observed in the angel investing process and the topics we addressed within each step:

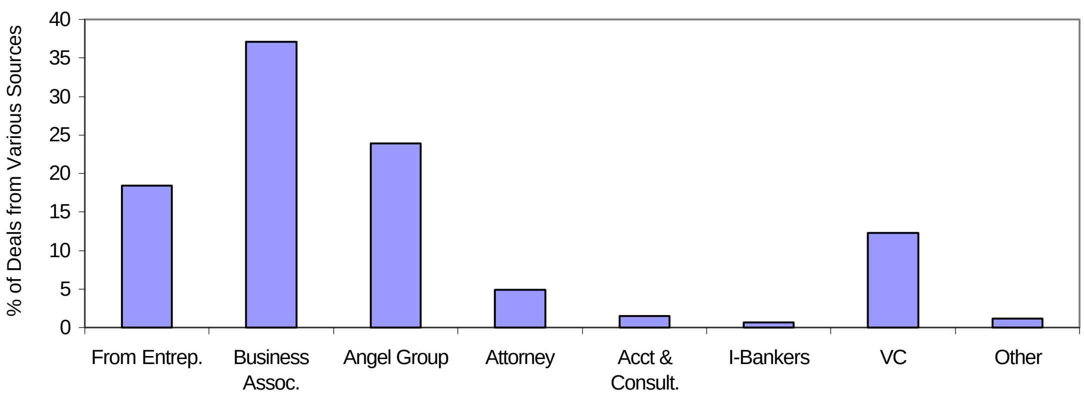
Table 3.1 Angel Investing Process Steps and Topics Addressed in this Chapter

Process Step	**Topics Addressed in this Chapter:**
1. Deal Sourcing:	• Define the sources through which angels obtain deals • Identify why angels use networks to pre-screen deals • Describe how angels prefer to receive opportunities
2. Deal Screening and Due Diligence:	• Discuss the ease with which angels invest • Outline the characteristics of a typical angel-financed company • Identify the criteria angels use to screen and conduct due diligence and how these criteria vary by different angel type • Show one angel's due diligence checklist
3. Term Negotiations:	• Discuss the main components of a term sheet and describe some term sheet variations (in angel financed rounds) • Discuss the terms and conditions typically used by angels in term sheets • Identify typical angel investment timeframes and other statistics • Outline some insights related to the valuation process. We did not explore valuation techniques
4. Post-Investment Involvement and Follow-on Financing:	• Post-investment involvement of active and passive angels • How angels help start-up companies, post-investment • How the roles of actives angel change as professional investors participate in subsequent rounds
5. Exit:	• How angel investors have exited, the returns they expected, and the returns they experienced • The most common exit • Why angel investors feel "stuck" in some investments, and what they do to ensure a timely and profitable exit

3.1 Deal Sourcing

With the explosion of the Internet, new medical technologies, IPOs and entrepreneurism, there is no shortage of deals. Yet, it is hard for some angels to find the deals that fit their background, ROI requirements and personal motivations. Most angel investors establish a venture support network of trusted and known contacts to optimize the time spent looking for deals. Passive angels without a strong network, often use matching services to identify and screen deals.

Figure 3.1 Deal Sources for Established Angels



Number of Angels Responding to the Question: 23

Note: Multiple category mentions allowed

3.1.1 Deal Sources

Figure 3.1 shows how the established angels we interviewed find investment opportunities. Below we discuss the volume and quality of deals angels receive from different sources:

a. Deals Directly from Entrepreneurs

Experienced angels are more open to taking on deals directly from entrepreneurs if they have a well-defined deal screening process with established criteria.

Angels agreed that deals received directly from entrepreneurs were typically of poorer quality because they were unscreened by the angel network system. Consequently, most angels do not want to publicize their names. Some angels will not even consider deals sent directly by the entrepreneur without a reference or a recommendation from an associate they trust.[18]

[18] Some angels differentiate between a reference and a recommendation. A reference is a simple introduction while a recommendation is an affirmation of the deal quality.

b. *Deals from Business Associates and Angel Groups*

Trusted business associates and angel groups are the primary sources of high quality deals for established angel investors. Other researchers report similar findings.[19,20]

c. *Deals from Attorneys, Accountants and Consultants*

Most experienced angels do not rely on attorneys, accountants and consultants as primary deal sources. Angels feel that the quality of deals from these professionals was not as high as the deals from trusted business associates and angel groups. We did find exceptions to this rule, especially if the attorney sought to invest his/her money in a recommended deal and had a track record of successful investing.

Attorneys may be an important source of deals for new angels who are starting to build their network and who want to develop an understanding of the deals in the marketplace. These angels tend to use and value attorneys more than established angels.

d. *Deals from Investment Bankers*

None of the angels we interviewed used investment bankers as a source of deals. The major issue was quality. Major investment banks do not have expertise in early stage investments and do not get involved. Most experienced angels we interviewed questioned the quality of the deals they receive from smaller bankers and brokers. Further, experienced angels with established deal flow do not want to pay for investment opportunities.

Some angels do use brokers, but none were in the sample we interviewed. One venture broker commented that he shows deals only to a well-defined set of angel investors. Again, the "network of trust" was the key element in using brokers as a source for deals.

e. *Deals from Venture Capitalists*

Based on anecdotal evidence, venture capitalists have recently started sharing more early stage deals with select angels. According to one venture capitalist, the angels they work with must have:

- An outstanding and relevant business background so they can add value
- A strong track-record as an angel so they are efficient to work with
- A "gold-plated" rolodex
- A willingness to work hard with the company after the investment is made

As fund sizes have grown, venture capitalists have not had the time to nurture "raw" early stage deals. They also value the industry-specific expertise angels can

[19] Known and trusted business associates are defined as "associates", who are familiar with start-ups, have invested in deals themselves, and in whom the angel has faith. Associates are usually other angels. Angel groups include angel clubs, third party matchmaking and investment services, and angel businesses.

[20] Freer, J., J.E. Sohl, and W.E. Wetzel, 1994. The Private Investor Market for Venture Capital, *The Financier*, 1(2):7–14.

bring to early stage companies. Angels feel that deals from venture capitalists are usually of high quality even though they require incubation.

f. All Other Sources of Deals

All the other sources of deals were less frequently mentioned and were angel dependent. For these sources, there was not enough data to extract meaningful conclusions. The "Others" category included sources such as *alma maters* and associations.

g. Deal Quality

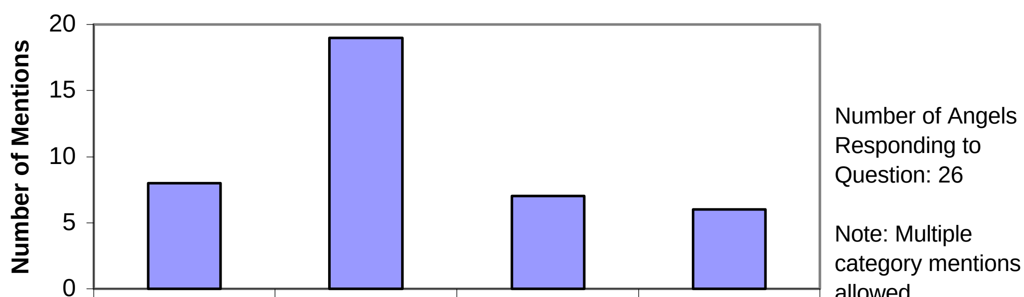
The angels we interviewed said they received the highest quality deals from their network of trusted business associates. After business associates they ranked angel groups, venture capitalists, attorneys and finally entrepreneurs as sources of high quality opportunities. Other sources such as accountants, consultants, and investment bankers were too infrequently cited to establish a consistent rating.

3.1.2 Building the "Network of Trust"

The "Network of Trust" is used to identify and screen venture opportunities. Relationships and trust are built on shared experiences and working with the players within the venture support network system over an extended period of time. Angels seek to work and develop relationships with people who have similar or shared experiences. For example angels who have started successful companies enjoy working with each other. Thereafter, the relationship develops based on the experience working together.

If an angel receives a few *poor quality* deals from a source, that source is downgraded in value. The angel will be less likely to further investigate opportunities from that source. Poor deals weaken the bond; high quality deals strengthen the relationship. This mechanism sets checks and balances in the network and helps optimize the time angels spend screening deals. Time and resources are scarce commodities for angels. Few angels will consider business plans faxed or emailed without a reference. As Figure 3.2 shows, most angels rely on their networks to source and pre-qualify deals.

Figure 3.2 How Do Entrepreneurs Find Angels?



Angel Network	Personal Network	Assoc./Org.	Other
8	19	7	6

Angels prefer to look at a 1–2 page executive summary of the opportunity before they consider the full business plan. Angels typically will not sign a non-compete agreement or a non-disclosure agreement before they read a summary or a business plan and only some will sign one afterwards. The summary or business plan should allow the angel to screen the deal. It should outline the market need, define the business model, highlight the competition and other market issues, describe the product or the technology, outline the financials, justify the financing need, and define the path to liquidity. Entrepreneurs can help justify the desired valuation by citing the valuations of comparable start-ups.

3.2 Deal Screening and Due Diligence

In this section we characterize the opportunities that angels will most likely finance, define the criteria they use to screen opportunities and to conduct due diligence, and discuss a few approaches to due diligence.

3.2.1 The Types of Companies in which Angels Invest

a. Companies in which Angels will Most Likely Invest

Angels will easily invest in a start-up that employs a unique competitive advantage (such as proprietary technology or well-protected intellectual property) to capture a large new primary market, lead by a successful, experienced management team and priced at a reasonable valuation.[21] Usually, such strong companies seek professional venture capital financing. However, some start-ups may approach angels to build out their Board of Directors or to accomplish a milestone that will greatly increase their valuation in subsequent rounds. Most angels will readily invest in such strong ventures, given the opportunity.

b. Companies in which Angels will Least Likely Invest

Angels cited a few characteristics of start-ups that greatly decreased their likelihood to invest: poor assessment of entrepreneur, lack of sustainable competitive advantage, and limited markets.

A poor assessment of the entrepreneur and the management team will cause most angels to balk at investing, even if the start-up is targeting a great market with a strong technology. Reasons for a poor assessment can include inexperience in the marketplace, poor previous track record, lack of drive, personal dislike and questionable integrity,

[21] Other criteria may be used to define good start-ups. In section 3.2.2 we discuss different criteria used by angels. Note: Strong start-ups are different from “hot” start-ups. “Hot” start-ups refer to deals that have other investors such as VCs interested in them.

among others. Recently graduated MBA students typically do not have the business track record that angels would easily finance.

Start-ups with no defendable and sustainable competitive advantage, such as a protectable breakthrough technology or a compelling value proposition, are less likely to be financed. Strong technology students, with a break-through technology that provides a compelling competitive advantage, can provide the core of a successful start-up. They can greatly benefit from the complementary business experience (and funding) that angel investors can bring to the venture. Without a compelling competitive advantage, a newcomer start-up will not be able to grow in an entrenched or crowded marketplace.

Companies that target small markets are not typically funded by most of the angels we interviewed. Angels would rather direct their company-building skills and efforts to companies that target large markets with a defendable value proposition.

c. Companies in which Angels Typically Invest

Hi-Tech Angels Investing in Technology Deals

Most of the angels we interviewed invest in technology-based opportunities. Typically, hi-tech angels invest in seed-stage companies that have 2–3 people, a business plan, a working prototype or, for medical technologies, some unique defendable technology, and potentially a first customer or strong interest from initial customers.

Usually at least one person on the start-up team has technical expertise and another person has business or market expertise. Strong consideration is given to the quality of the team. Angels feel that the market opportunity may shift but a good entrepreneur can evolve the offering and the technology with the market to make the company a success.

Most angels expect the major technical issues for the working prototype to be resolved prior to their consideration. Angels expect that their investment will be used to generate sales, build out the product, and recruit and build out the team.

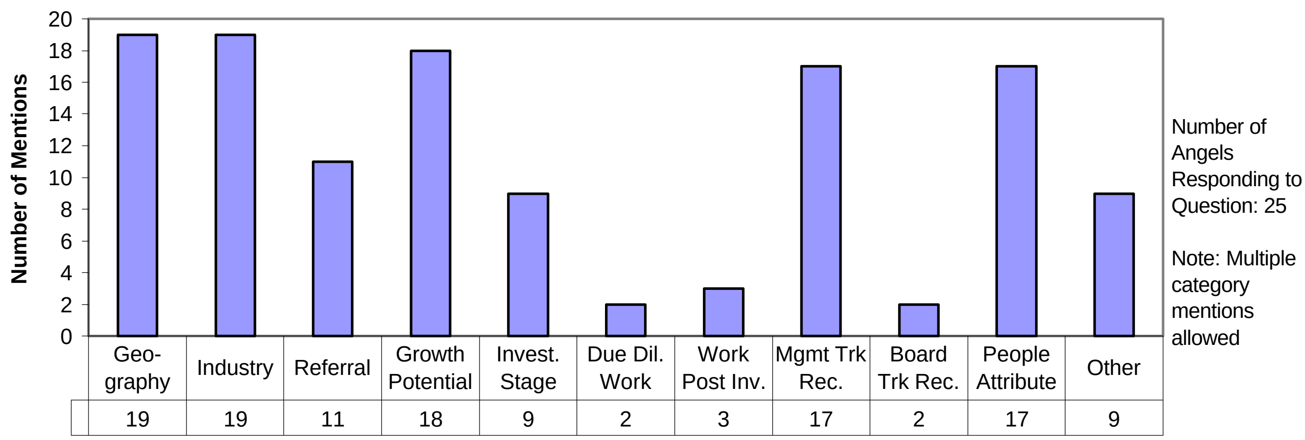
Non-Technology Angels Investing in Deals

We interviewed only a few non-technology angels. One non-technology angel, with a clear investment strategy, was most comfortable investing in consumer product companies that could generate positive cash flow within a year. Typically he was the only investor since he did not invest in deals requiring multiple rounds of financing. He conducted little due diligence. His personal assessment of the entrepreneur and of the business plan drove his decision to invest. We have no information on his track record to verify the success of his strategy.

3.2.2 Criteria Used by Angels for Screening and Conducting Due Diligence

a. Criteria Typically Used by Most Angels for Screening and Conducting Due Diligence

Figure 3.3 Screening and Due Diligence Criteria Used by Angel Investors



Note: Some angels mentioned that pre-money valuation was a key criterion for screening a deal, but we did not get consistent data.

Figure 3.3 illustrates the criteria used by angel investors in conducting screening and due diligence. The majority of our sample felt the five criteria listed below were the most important:

- Geography: location of the venture; near the angel
- Industry: high growth industry usually within the angel's expertise
- Growth potential of the venture: high growth market targeted
- Personal attributes of the entrepreneur and the management team
- Track record of the entrepreneur and the management team

Table 3.2 provides specific insights on the screening and due diligence criteria mentioned most often.

Table 3.2: Common Criteria for Screening and Due Diligence

Criteria	Context
1. Industry	Most angels will only consider deals within a targeted industry based either on their personal expertise or on a desire to invest in a high growth industry.
2. Geography	Many angels, especially those playing an active role in start-ups, are particular about the geography. Most active angels will not invest in opportunities outside a 1-2 hour driving range.
3. Market and Growth Potential	Market and growth potential are important criteria in selecting an opportunity. Some angels define rate-of-return and sales-growth-rate criteria. Entrepreneurs need to articulate how the market will develop and why they will command the premier position.
4. Personal Integrity and Attributes	Integrity and other personal attributes of the management team are extremely important considerations in the decision to invest. Some important elements are: • *Integrity:* Angels look for trustworthy entrepreneurs who keep the investors' interests in mind as they grow the company. • *Passion:* Angels look for entrepreneurs who are passionate about their idea and the market. They look for passion tempered by adaptability and coachability. • *Coachability:* Angels prefer entrepreneurs that can take advice from others and are coachable. • *Commitment to the Company:* The entrepreneur has to be committed to the success of the company more than to his personal control of the company. If need be, the entrepreneur should be willing to step aside and let a more experienced management team/leader drive the company. (The entrepreneur does not leave the company; he/she takes on other key roles). • *Confidence and Leadership:* Angels rely on the entrepreneur to inspire the team to achieve the vision they have articulated. Angels also look for confidence and ability of the entrepreneur to grow with the venture.
5. Track Record of the Management Team	Most angels consider a strong track record as a "nice to have" criterion but not a requirement for investment. Most angels feel that companies with a complete, experienced management team would approach venture capitalists rather than angels. Experienced angels will not invest in people with poor track records; however, they may invest in people that have not yet built a strong track record.
6. Referral Source	Angels place varying importance on the source of the deal. Some angels consider this criterion as a factor in catching their attention. Others, however, use this criterion as a means of screening in/out deals, especially if they rely on their network to provide part or all of the due diligence.
7. Track Record of the Board	Many entrepreneurs do not have a Board at the seed stage, so this is not usually an important consideration. Entrepreneurs often want angels to build the Board.
8. Other Criteria	Effort required from the angel: Some angels want to create winning companies; others feel they should *pick* winning companies and it is up to the entrepreneur to create the winning company.

b. Different Angel Types Use Different Screening and Investment Criteria

Active Angels Use More Specific Screening and Investment Criteria

Active angels take an active role in the company, often occupying a Board seat or serving as an interim member of the management team. Active angels typically have stringent screening and investment criteria. For example, most active angels invest only in their immediate geographic zone and are focused on one or two related industries. Usually active angel investors invest larger amounts of money and time in fewer deals compared to passive angel investors.

Passive angel investors have less stringent screening criteria. Passive angels, tend to invest in local companies, so they can monitor progress. However, some will, on occasion, invest in deals outside their immediate geographic zone and industry expertise. Passive angels usually rely on the due diligence and the terms negotiated by active lead investors. Angels that normally take the lead/active role can sometimes make passive investments.

Different Industries Rely on Different Investment Criteria

Differences in criteria exist by industry. For example, some medical technology angels will not consider a deal if the venture does not own intellectual property rights. Many software and Internet-focused angels do not consider patents an important factor, yet only consider deals with a working prototype. This area could provide a rich opportunity for further research.

3.2.3 Variation in the Depth of Due Diligence Performed by Angel Investors

Due diligence conducted by angels varies widely. At one end of the spectrum, angels primarily invest on "gut feel". They will talk with the entrepreneur, ask targeted questions, build impressions based on entrepreneur's responses, and, in some cases, discuss the opportunity with few trusted friends and business associates to make their decision. Some of these angels rely on the network to screen the deals before they conduct their minimal due diligence; others may piggyback on due diligence of other angels or venture capitalists.

At the other end of the spectrum, some angels conduct detailed due diligence. They:

- Read through the business plan
- Speak extensively with the entrepreneur and the management team
- Check the references and background of the team
- Phone current and prospective customers
- Discuss and introduce the company to prospective customers and strategic partners to gain a better understanding of market interest
- Ask technology experts to evaluate the technology
- Discuss the deal with targeted industry business associates

- Understand product specific market issues by talking with industry consultants and investment bankers
- Ask other angel investors or venture capitalists familiar with the industry to look at the deal

3.2.4 One Angel's Detailed Due Diligence Checklist

The table below illustrates the information collected by a well-respected active angel investor who performs detailed due diligence. The angel uses the checklist to capture and summarize information collected from meetings and company interviews, reference checks (e.g., previous employers of founders and management personnel), customer calls, industry analysts, company lawyers and other sources.

Table 3.3: One Angel's Detailed Due Diligence Checklist

<table>
<tr><th colspan="2">Due Diligence Checklist</th></tr>
<tr><td>
Background Information
• Date Submitted
• Company
• Address
• Entrepreneur Information: Name, Title, Email, Phone, Fax, Prior Employment

Summary Information
• Web Site URL:
• Referred by:
• Seeking $:
• Valuation, By Whom
• Already Invested $:
• Break Even $:
• Burn Rate $:
• Have talked to
    • Angels/ VCs (list each with comments)

Product Description
• Stage:_Alpha:_Beta:_Ship_
• When did you begin working on this?
• Product
• Elevator Pitch

Marketing
• Marketing Strategy:
• Target Market:
• Competition:
• Competitive Advantage:
• Business Model:
• Make $ By:
• Underlying Technology:
• Intellectual Properties:
• Manufacturing Process:

Sales
• Unique Selling Proposition:
• Distribution Plans:
• Sales Force:
• Number of Customers:
• Pricing Strategy:
• Cost of Manufacturing:
• Sales by Product: Name, Description, Average Price, Unit Sales per Year
</td><td>
Financial Data
• 5-year Table: Revenues, Operating Expenses, Net Income, # of Employees

Business Structure
• Type:
• Inc. Date:
• Inc. State:
• What are you offering? (Equity, Convertible Debt, Debt, Don't Know/Not Sure, Warrants)

Service Provider
• General Counsel:
• Legal Disputes:
• Bank:
• Accountants:
• Audited Financials:
• For how long?

Management & Staffing
• Full-time Permanent Employees:
• Full-time Contracted Employees:
• Critical Positions Filled

Capitalization
• Total funding to date $:
• Capitalization Table:
• Shares & $ Invested by Founders:
• Other Senior Managers:
• Other Employees
• Outside Directors
• Other Investors
• Total
• Debt Financing?
• How have you used funds to date?
</td></tr>
</table>

Source: High Tech Angel Investor

3.2.5 Angel Investment Statistics

We asked angels how many deals they screened and how many they conducted due diligence on. Based on the numbers provided, angels typically invest in 3–4% of all deals that come to them versus venture capitalists that invest in 1% of all deals they receive[22]. They invest in 25–30% of all deals on which they perform due diligence.

Based on the interview responses, angels will invest, on average, three months after they receive a deal. The minimum stated timeframe to invest was one month and the maximum was seven months.

Angels exited their investments in a median timeframe of four years. Recent exits have taken place as fast as six months. Angels commented that the strong stock market and the rapidly consolidating Internet market place have shortened exit timeframes in the late 1990's. The longest exit timeframe was six years. These exit timeframes would be longer if we conducted the surveys in a weaker economic period.

3.3 Negotiating Terms and the Term Sheet

3.3.1 Agreeing on the Term Sheet[23]

Once the angel has performed sufficient due diligence, the angel will present a term sheet to the start-up. The term sheet outlines the key terms of the proposed financing. The term sheet usually signals that the investor expects to work in good faith with the start-up company as they negotiate the detailed terms and conditions of the business deal.

The term sheet should be agreed upon before substantial legal or other costs are incurred in closing the deal. Venture lawyers can help explain implications of the terms and conditions. One entrepreneur we interviewed recommended seeking outside advisors to help the entrepreneur incorporate his best interests in the deal. He commented that most company resources (e.g., company attorneys) are focused on the best interests of the company and not necessarily the best interests of the entrepreneur. Usually the company is responsible for all legal incurred once the term sheet has been signed.

Some term sheets have a "No-Shop" clause that restrains start-ups from showing the deal to other investors while the terms and conditions are being negotiated. "No-Shop" clauses are more prevalent with venture capitalists than with angel investors.

[22] Fenn, G.W., N. Liang, and S. Prowse, 1995, The Economics Of The Private Equity Market (Washington, Board of Governors of the Federal Reserve System).
[23] Morreale, J.P., 1995, Raising Growth Capital—A Businessman's Outline. MIT Enterprise Forum Fall Workshop, October 14, 1995. Bingham Dana, 150 Federal Street, Boston, MA 02110.

3.3.2 An Illustrative Term Sheet

A generic, yet illustrative, term-sheet used by a high tech angel investor is outlined below. Additional example term sheets used by angel investors are included in Appendices A, B, and C.

Table 3.4: Illustrative Term Sheet Used by an Experienced Angel

Type of Security:	Convertible Series A Preferred Stock (Series A).
Dividend:	8% non-cumulative.
Liquidation Preference:	Non-participating Preferred (Return capital to Series A, then remaining proceeds to Common); provided that if the Company grants participating rights to next round of investors, then Series A will be revised to include similar rights.
Conversion:	Autoconversion on IPO at 5x purchase price with offering size of at least $10,000,000; permissive conversion at any time.
Anti-dilution:	Stock splits and price based anti-dilution on a weighted average basis.
Voting Rights:	Preferred vote with Common, except as required by law. Other protective provisions may be included
Directors:	Series A elects one director, Common elects one director, all others elected by Common and Preferred voting together.
Information Rights:	Major investors get annual audited and monthly unaudited financial statements (Major investor is anyone investing at least $100,000 with affiliated entities being aggregated).
Registration Rights:	Two demand, unlimited piggyback, one S-3 per year. All rights terminate 5 years after IPO.
Right of First Refusal:	Major investors get right to maintain ownership percentage on future financing.

Source: High Tech Angel Investor

3.3.3 Discussion of Term Sheet Variations among Angel Investors

a. Informal Terms and Conditions

Some angels use informal or simple term sheets, or in some cases, there is no term sheet. As a result these investments have limited, if any, protection. Usually these investors:

- Invest primarily for non-economic reasons,
- Invest in limited number of deals, or
- Are new to angel investing.

Venture capitalists feel that these investors do not get compensated for the risks they take. Because these investors are not protected, they can suffer dilution, poor step-up valuation, and other negative impacts in later stage financings.

b. ***Venture Capital Terms and Conditions***

Experienced and financially sophisticated angels negotiate terms verging on those negotiated by venture capitalists. Because they have outstanding business or investing track records, entrepreneurs are willing to agree to the terms and conditions outlined by these angels. However, even experienced angels do not achieve all the stringent venture capitalist terms. They do not have the negotiating power of venture capitalists and they would much rather invest in a good deal with less stringent terms and conditions than in a poor deal with stronger terms and conditions. Most of these angels develop a standard term sheet over time.

Venture capitalists view experienced angels as early stage venture capitalists with smaller funds. Organized angel groups (see chapter 4) use their negotiating power to achieve terms similar to those negotiated by venture capital firms.

3.3.4 Comments on Valuations and Terms Used by Angels

Our data on valuations, terms and conditions is limited. Many angels felt uncomfortable discussing terms and conditions. Also, due to the wide scope of our interviews, we were only able to collect partial data on venture valuations.

The below comments on valuations and terms used by angels are based on what angels desire rather than what they actually agree to in negotiations.

a. Valuations

The experienced angel investors we interviewed used a variety of methods to set valuations. Anecdotally, the pre-money valuation of technology ventures at the seed stage typically ranged from $500,000 to $3 million. Valuations greater than $5 million required an extraordinarily compelling story. [24]

Valuations are calculated on a fully diluted equity basis. This includes all equity, loans (if convertible), options, share commitments to founders and lead employees, and other financial instruments that affect the value of the company. Usually the fully diluted equity basis also includes the option pools set aside for key employees. The fully diluted basis becomes the basis for calculating the pre-money valuation.

[24] Pre- and post-money valuation: If a start-up is looking for $200,000 for 20% of the company, the total valuation of the start-up after the investment is made is $1,000,000 ($200,000/0.2). This total valuation after the investment is made is called post-money valuation. The pre-money valuation is the value of the company without the investment and in this case it is $800,000. For further information read: Johnson, R.M., 1997. Valuing Start-ups & Early-Stage Companies: The Venture Capital Method, London Business School Case Study, LBS-CS97-012.

Our study did not analyze valuation approaches. Harrison and Mason found valuation methods to be characterized by entrepreneurs and angels as "arbitrary", "informal" and "by negotiation".[25] We found angels determine valuations using a variety of methods:

- Some angels adjust the entrepreneur's financial projections by injecting their own market and cost assumptions.
- Both entrepreneurs and angel investors benchmark recent, similar deals to help set the valuation of the company. This assessment is based on deals in similar industries, at comparable development stages and lead by comparable management teams. Angels and early stage venture capitalists develop rules of thumb to assign valuation ranges for deals with these characteristics.
- Some high tech angels try to anticipate the valuation of the next financing round, potentially through discussions with venture capitalists, and assume a 30–50% step up to back-calculate the valuation of the current round.
- Some high tech angels use convertible debt to avoid the battle over valuation with the entrepreneur. These securities allow the venture capitalist or other second round investors to set the value of the company in the next round (*e.g.* Series A) and provide the angel seed investors a discount to that round.

b. Two Types of Security Offerings

In this section we discuss two types of securities used in angel seed or start-up rounds:

- Convertible Debt
- Preferred Stock with Various Rights Impacting the Company Valuation

Convertible Debt: Recently companies that anticipate pursuing venture capital in later rounds have structured their seed round as convertible debt. The convertible debt is a bridge loan that converts to equity in the next equity round. These convertible debt securities enable the next round investors *(e.g.* venture capitalists) to set the value of the company in the later (Series A) round and provide the angel seed investors a discount to that round.

We observed that angels target a 30% discount, though actual discounts ranged from 10% to 30% based on discussions with venture lawyers and entrepreneurs. The convertible debt mechanism allows venture capitalists to set the valuation and eliminates the battle between the angel and the entrepreneur in setting the valuation. Further, it allows the company to raise financing rapidly without complex term sheet discussions. For example, it took only 6–8 weeks for one company to close a convertible debt round.

Angels who used this structure expect that the company will successfully secure professional venture capital financing within 6 months. Some angels attach terms that specify the size of the next financing and the conversion valuation if the next

[25] Harrison, R.T., and C.M. Mason, 1996, Informal Venture Capital: A Study of the Investment Process, the Post-Investment Experience and Investment Performance. *Entrepreneurship and Regional Development*, 8, 105-125.

round is below that level. Further, these angels limit the amount of the convertible debt to $500,000 to $1,000,000 because the debt increases the pre-money valuation of the company. High pre-money valuations can deter venture capitalists from participating in later rounds.

Some angels and entrepreneurs feel that convertible debt, while pragmatic, is a risky financing mechanism since it assumes the next round of funding will definitely happen rapidly.

<u>Preferred Stock with Various Rights Impacting the Valuation of the Company</u>: Most angel investors seek Preferred Stock over Common Stock. Preferred Stock provides priority rights to current investors over previous investors' and founders' interest. Usually these priority rights relate to Liquidation Rights and Voting Rights. Liquidation Rights allow Preferred Stock holders preferential treatment to dividends and payouts over Common Stock holders if any dividends or payouts are declared upon merger, sale, or liquidation of the company. Voting Rights give Preferred Stock holders higher voting privileges based on agreed terms that may be different than that based on straight percentage equity.

Liquidation Rights commonly used by angels, which impact the valuation of the deal, include:

i. Convertibility Rights (as in Convertible Preferred Stock).
ii. Participating Rights (as in Participating Preferred Stock).
iii. Redeemable Rights.

These features can be combined in a security offering. For example, some angels negotiate Participating Convertible Preferred Stock. We discuss each liquidation right below:

i. Convertibility Rights allow Preferred Stock holders to convert to Common Stock at some predefined conversion rate. This right is normally invoked at the time of an IPO or sale of the company. Convertibility rights can have significant impact on the value of the company if the Common Stock is priced nominally.

ii. Participating Rights allow angels to "double dip" if the stock is liquidated. Upon liquidation, Participating Preferred Stockholders will be "repaid" their original purchase price (plus unpaid dividends, if any) and then share in the remaining assets as if they held common stock. At low exit valuations, the Participating Preferred Stockholder still earns a return, while common stockholders realize little or no return. Participating Rights allow angels to take lower equity at the time of financing.

The example below illustrates the impact of Participating Rights. Consider the following cases:

Case A. Founders sell 40% of the company for $5 million of Preferred Stock with Liquidation Rights for investors to preferentially receive $5 million but no Participating Rights.

Case B. Founders sell 30% of the company for $5 million of Participating Preferred Stock.

In Case B the company is valued at $15 million post-money $10 million pre-money. In Case A, the company is valued at $12.5 million post-money and $7.5 million pre-money. Depending on the exit valuation, Case A may be the better deal for the founders who own common stock.

Payout schedule for Case A

In Case A, the investors have preferential Liquidation Rights. As a result they have the option of taking $5 million from the payout or getting 40% of the payout. The payout schedule would look as follows for different exit valuations:

Exit Valuation ($M):	5	10	12.5	20	35	100
Investors Payout ($M):	5	5	5	8	14	40
Founders Payout ($M):	0	5	7.5	12	21	60

$12.5 million is the breakeven exit valuation. Below the $12.5 million sale price, the investors get back only their principal back. Below the $5 million sale price, the investors lose part or all of their principal. Above $12.5 million, investors share in the payout at a 40% rate. This liquidation preference helps limit the angel's downside risk.

<u>Payout schedule for Case B</u>

In Case B, the investors first take out their $5 million initial investment, and then share 30% in all remaining equity.

Exit Valuation ($M):	5	10	15	20	35	100
Investors Payout ($M):	5	6.5	8	9.5	14	33.5
Founders Payout ($M):	0	4.5	7	10.5	21	66.5

Below $35 million exit valuation, the investors make more money in Case B than in Case A. Above $35 million exit valuation, the founders make more money in Case B than in Case A. The best deal for founders at the time of investment depends on the founders expectation of what may happen at the time of exit.

iii. Redemption Rights allow preferred stock investors to redeem their investments after a certain amount of time has elapsed, or in specific situations. For example, Appendix B shows a redemption example where a mandatory redemption will take place on the sixth anniversary of closing the investment round and the investor gets 10% annual cumulative compounded dividends.

c. Anti-dilution Clauses and Protective Provisions

Anti-dilution clauses are usually standard in term sheets and protect the angel investment from stock splits, unplanned stock dividends, recapitalizations, and other events that dilute ownership. Full-ratchet protection makes the angel investor indifferent to any changes. For example, if the angel investor bought the stock at $1.00 and then in the next round that share was priced at $0.50, full-ratchet protection changes the angel ownership structure so that the original angel investment gets priced at $0.50. However, few new (subsequent round) investors will allow this to happen. The more common form is weighted-average ratchet.

Right of First Refusal is usually standard and it allows Preferred Stock holders the rights of first refusal on future issuance of stock.

Protective provisions usually relate to the sale of the company, certain issuance of shares (senior/*pari passu* shares), change in business, and incurrence of debt.

d. Percentage Ownership and Control[26]

Angel investors, based on anecdotal data, look to own between 5% to 25% of the company, and typically own 10% of the company in the start-up stage round. High percentage ownership by angels can deter later stage investors from investing.

As low percentage owners, angel investors cannot exert formal control, though they often do have contractual controls through:

- Board participation and predefining the number of Board seats: It is not uncommon after the start-up round to have 3 directors on the Board[27]—the CEO, an angel, and one unaffiliated member chosen by mutual agreement during negotiations.

[26] Morreale, J.P., 1995. Raising Growth Capital—A Businessman's Outline. MIT Enterprise Forum Fall Workshop, October 14, 1995. Bingham Dana & Gould, 150 Federal Street, Boston, MA 02110.

[27] Based on term sheets provided by angel investors.

- Restrictive and affirmative covenants
    - On operational matters (e.g., capital investments, compensation, and even approval of management personnel under certain circumstances).
    - On corporate structural issues (mergers, sales of assets, purchases of businesses, etc.).
    - On equity matters (rights of participation in future financing; “ratchet-down” protection on future financing if valuation declines).

Founders anticipating raising several rounds of financing should be reconciled to losing control of the Board and the company after completing the second or third round. No one investor will control the company but outside investors as a whole will own more equity than the founders. Strong founders, however, control the company not by equity control but by consistently exceeding milestones set by the company and the Board

e. Exit Mechanism or Liquidity Contracts

Increasingly, angel investors are specifying liquidity terms such as redemption rights.

f. Key Employee Compensation and Incentives

Investors want to keep key management personnel “locked up” through employment contracts, with appropriate non-compete, ownership of intellectual property and confidentiality covenants. Some of the venture capitalists we interviewed felt that angel investors were weakest in this area of terms and conditions. Some angels feel that it is difficult for them as individuals to negotiate terms and conditions similar to that negotiated by venture capitalists, as they do not have the same negotiating power.

Nevertheless, angels are increasingly introducing vesting schedules for key employees and even founders who are key employees. These employees are asked to place a predefined portion of their stock at risk for a predetermined period of time. Founders are sometimes surprised that they are asked to vest their ownership when a venture investor comes into the company. The vesting schedule is typically 4–5 years with a 20–50% acceleration clause if the start-up is acquired prior to vesting completion.

Issues negotiated during vesting schedule negotiations include the amount of stock to be vested initially, the time period or other milestones for vesting and what happens in case of death, disability, or termination without cause. Besides vesting schedules, angel investors set aside options, stock appreciation rights and profit interests to provide adequate incentives for key personnel. The key employee option pool is created at the expense of the current equity holder, not the new investor.

The financing deal may also include "ratchet" incentive. The ratchet incentive is a mechanism by which the management team's percentage equity ownership can be increased when certain company milestones are achieved.[28]

3.4 Post-Investment Involvement and Follow-on Financing

Angel investors can choose to play active or passive roles in the company. We discuss each role for the angel investor.

3.4.1 Post-Investment Involvement of the Passive Angel

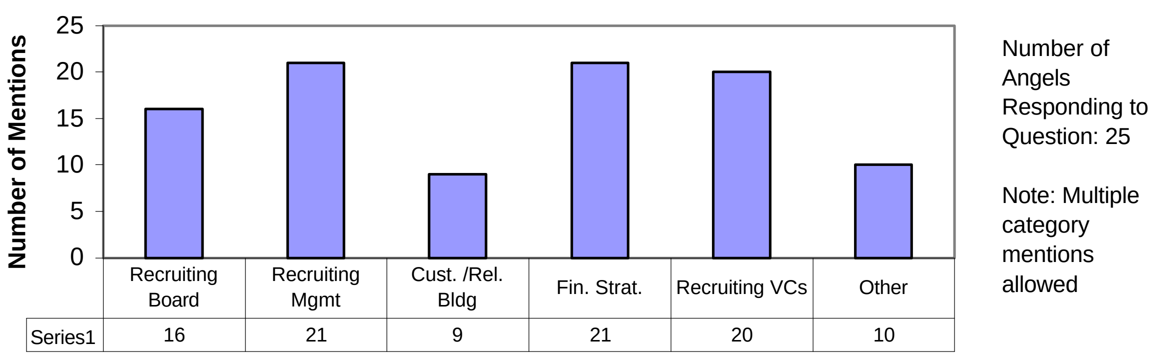
Passive angels do not take a Board seat and play a minimal role in the day-to-day operations of the company. They stay in touch with the start-up company on a periodic basis (monthly to quarterly) to keep track of their investment and the performance of the company.

Wyatt Starnes, CEO, Tripwire Security, a start-up with passive angel investors, sums up their activity, "Passive angel investors touch base with us infrequently. They send articles from the *Wall Street Journal*, market research information, and other data they come across that they feel will be helpful for the company."

They want to stay enough involved with the company so that they can decide whether to invest in subsequent rounds or whether to give up their option to invest. (Most angels have the Rights of First Refusal clause in their terms and conditions).

3.4.2 Post-Investment Involvement of Active Angels

Figure 3.4 Post-Investment Involvement: Perceived Strong Contribution by Active Angel Investors



[28] Based on discussions with angels and case study description. See Pesenti, S., 1994. Finance for Entrepreneurial Companies: Financing Instruments, London Business School Case Study, LBS Reference: LBS-CS94-007.

Active angels take a Board seat or take other advisory roles such as consulting to the company. Figure 3.4 shows where active angels perceive that their contributions are strong.

Note, angel involvement and contributions are strongly dependent on the angel's background, skill set and willingness to work with the company. Active angel investors with strong business backgrounds bring relevant industry experience and high value to the venture through his/her advice, network of contacts, and hands-on support. Their presence on the Board gives credibility to the company.

Based on our interviews, we outline the post-investment support which active angels typically provide to start-up companies:

Recruiting and Coaching Management: Helping in recruiting management is the most widely performed role by active angel investors. Although they do help identify management candidates, they are invaluable in assessing candidates and checking on their track records. They also enjoy coaching the management team, helping them overcome obstacles to their growth.

Recruiting the Board: Active angel investors help identify, recruit and select Board members. Strong industry and venture contacts and prior start-up experience help angel investors identify effective Board members.

Recruiting Venture Capitalists: Some of the angels we interviewed in the information technology industry, particularly on the West Coast, feel that their primary post-investment role is to incubate the company and help prepare it for subsequent venture capital funding. Experienced angel investors have strong venture capital contacts and help start-ups find the right venture capital partners to support their growth.

Assistance with Financial Structuring: Angels can help with structuring the option and incentive plans. They can also help craft the company's financial strategy, including in raising capital. Many angels have deep experience in financial structuring for mergers, acquisitions, and strategic partner investing.

Customer and Alliance Building: We were surprised to see how few angels helped build customers and alliances, even though most of the angels interviewed had deep industry experience and relationships. Only a few angels offered to attend customer sales calls.

Other Support Areas: Angels also provide support in organizational structuring; defining and establishing the marketing, sales and distribution strategies and providing general coaching and guidance. Some angels were willing to act as interim CEO or interim member of the senior management team.

Our post-investment involvement findings are similar to findings in the literature. Feear and Wetzel reported that Board representation was the most common form of participation for angel investors, followed by consulting relationships.[29] They found that Board seats were held in 71% percent of angel investments and angels participated as consultants in 65% of the ventures after investment. We did not scientifically validate the percentage involvement data.

Freear, Grinde, and Sohl also researched the extent to which angels benefit emerging ventures. Thirty-five start-ups responded to their research survey.[30] Twenty-three (68%) of the entrepreneurs believed that the angels had played a “productive” role in the venture. Five (14%) believed their role was neutral while seven (20%) of the entrepreneurs believed that the angels had played a substantially unproductive role.

3.4.3 Time Spent by Active Angels with the Start-up Company

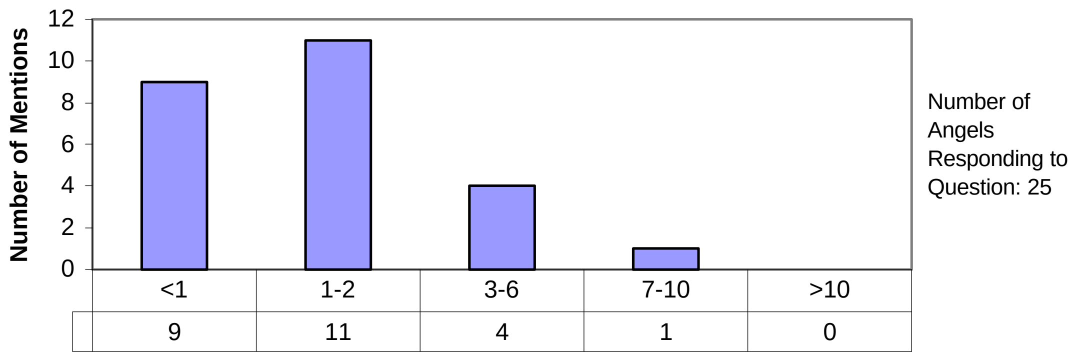


Figure 3.5 Number of Days of Angel Support Provided Per Start-up Company Per Month

We were surprised to find that most angel investors spent only 1–2 days per company per month, similar to venture capital support levels. We expected to find that angel investors spend more time with their portfolio companies than venture capitalists do.

[29] Freear, J. and W.E. Wetzel. 1992. The Informal Venture Capital Markets in the 1990s. In D.L Sexton and J.D. Kasarda (eds): State of the Art of Entrepreneurship. Boston: PWS-Kent, 462–486.
[30] Freear, J., R.B. Grinde, and J.E. Sohl. 1996. The Early Stage Financing of High Tech Entrepreneurs

3.4.4 Change in the Role of Active Angels as Professional Money Gets Involved

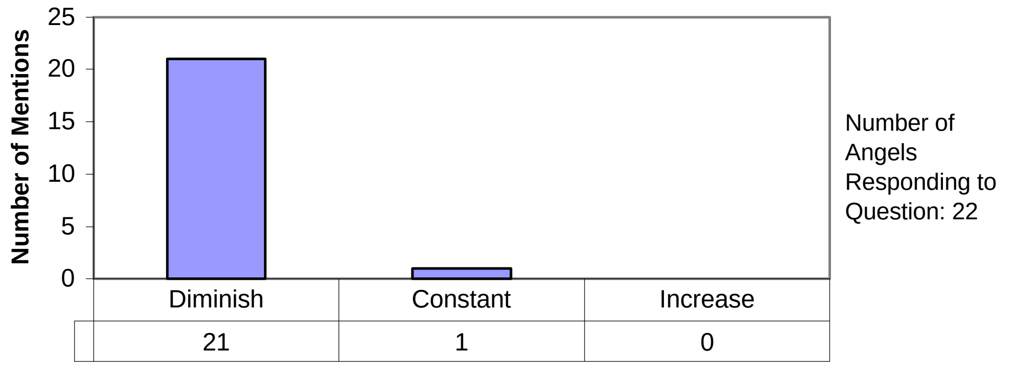


Figure 3.6 How Do Angel Roles Change as Professional Money Gets Involved?

Almost unanimously, we found that the role of angel investors decreases as professional money enters the venture. Active angels are often requested to leave the Board once professional investors participate in subsequent financing rounds. Angels with exceptional business backgrounds, however, may be asked to remain on the Board.

As George Neble, Partner at Arthur Andersen, describes, “Experienced angels understand that as the company grows and institutional money comes in, they take a more behind-the-scenes role. Experienced angels are like parents as their kids grow up. Later stage investors may put a more professional Board in place to support the company’s growth. Inexperienced angels, regardless of the level of ownership, can feel that they own and control the company. They sometimes resent being removed from the Board.”

3.5 Exit Strategy

3.5.1 Exit Strategy Preferred by Angel Investors

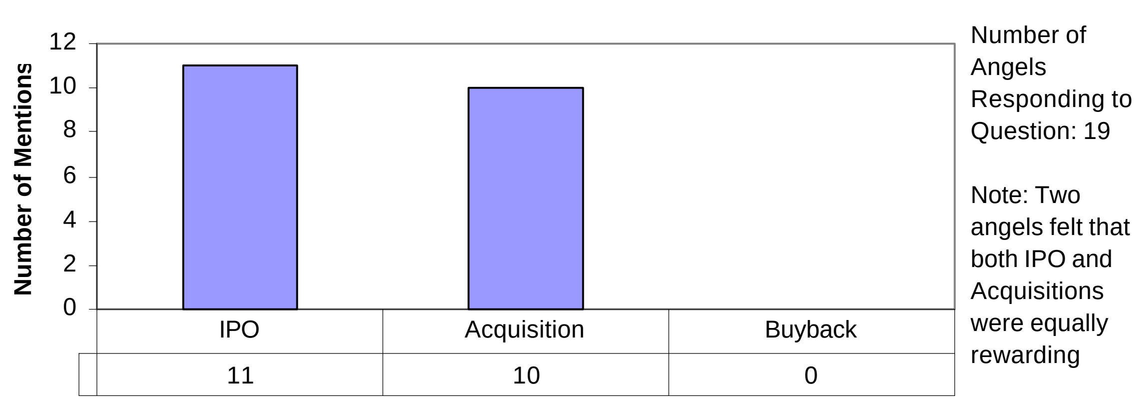


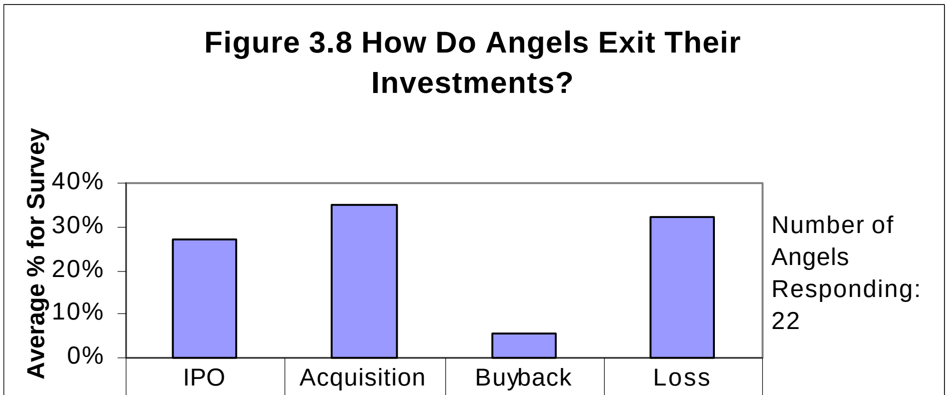
Figure 3.7 Exit Strategy Preferred by Angel Investors

Angel investors like both IPOs and acquisitions as exit strategies. Based on anecdotal evidence, both IPOs and acquisitions delivered strong financial returns. They cited some differences between IPOs and acquisitions:

a. ***Non-ROI Reasons for Preferring IPOs:***
   - IPOs are more satisfying and provide more visibility. There is further upside potential due to stock appreciation.

b. ***Non-ROI Reasons for Preferring Acquisitions:***
   - Acquisitions transactions are cleaner allowing the investor easier access to cash. IPOs can require longer "lock-out" periods and have more restrictions.
   - IPOs are too dependent on the stock market.
   - For Internet companies, some angel investors found that they received the highest and fastest returns when their company was acquired.

3.5.2 Exit Paths, Returns Expected and Returns Experienced



	IPO	Acquisition	Buyback	Loss
Series1	27%	35%	5%	32%

In our sample, most angel investors exited when the company was acquired. This potentially reflects the high percentage of angel investors in our sample who invested in the Internet and other related technologies. In our sample, we found that approximately 30% of angel investments turned into losses. Figure 3.8 shows how angels have exited.

In our sample, we found that most angel investors targeted and experienced a 5x to 10x return on their investment over five years. These returns were based on angel responses to our questions and not based on evaluating their angel portfolios.

West Coast angels targeted higher returns and experienced higher rates of returns. West Coast angels predominantly targeted 10:1 returns in 5 years while East Coast angels predominantly targeted 5:1 returns in 5 years. West Coast angels stated that they achieved 10:1 returns in 5 years and sometimes 10:1 in 3 years while East Coast angels mentioned that their returns were in the range of 4:1 to 10:1 over 5 years.

We asked some West Coast angels why they had higher ROI expectations than their East Coast counterparts. They attributed this difference to their investments in the Internet industry. They also commented that perhaps angels on the West Coast are more willing to take on risk than East Coast angels are. West Coast angels felt they had more and better access to market and technology to qualify risks, than did their counter parts on the East Coast. West Coast angels could therefore conduct more stringent and sophisticated due diligence.

Figure 3.9 Five-Year IRR Targeted by Angel Investors in Our Survey

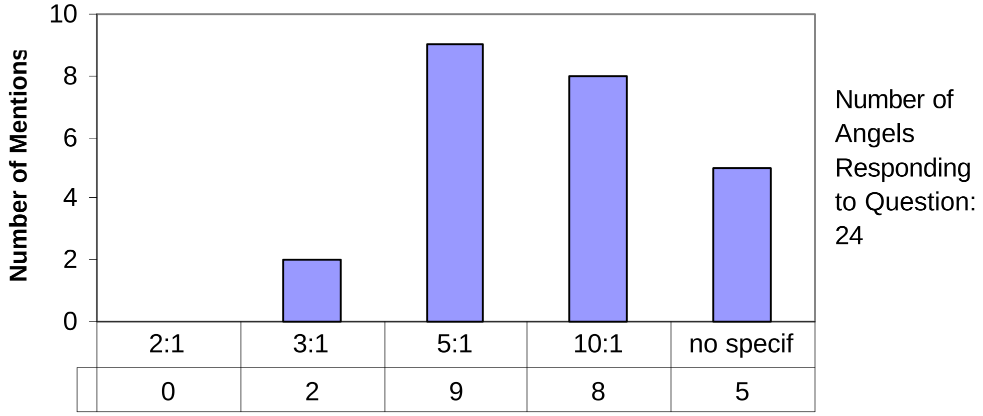
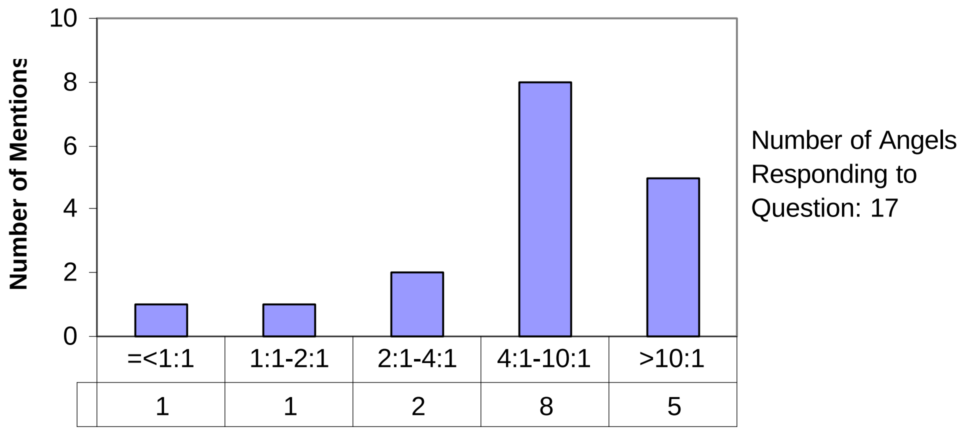
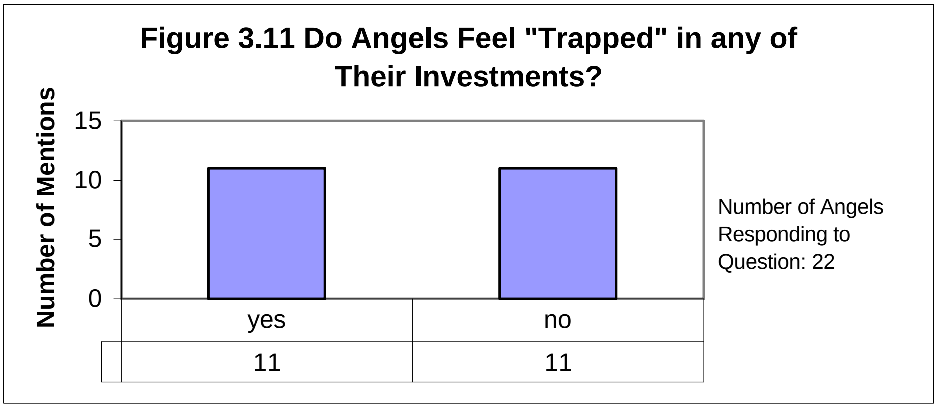


Figure 3.10 Actual IRR Experienced by Angel Investors



3.5.3 Do Angels feel "Trapped" in Any Investments? Why?



A number of angels felt "trapped" in some of their investments as shown in Figure 3.11. Angel investors felt trapped when:

- Founders became emotionally attached to the company and did not want to sell or commit to an IPO. As minority owners, the angels could not negotiate alternate exit mechanisms, especially without redemption provisions in the agreed-upon financing terms.
- These companies did not grow as expected. The companies continued to exist, "going sideways" or "in the land of the living dead".
- The management and angels lacked synergy.

3.5.4 How do Angels Ensure a Timely and Profitable Exit?

Angel investors employ a variety of methods to help ensure their company proceeds to a timely and profitable exit:

- Before investing, determine:
  - The founder's need for control and ability to be coached.
  - The founder's vision of the path to liquidity.

- Negotiate liquidity and exit clauses in the terms and conditions.

- After investing:
  - If the entrepreneur does not have the skills to grow a company, bring in a professional CEO to lead the company.
  - Find products that are attractive to the market and to acquirers.
  - Determine milestones for the exit path. For example, if the company plans an initial public offering, they may need to broaden their product line or their customer base and they may need to recruit new key management. If the company seeks to be acquired, it should define the potential acquirers and build relationships with them.

- It is important to “get out” when the losses are small. Experienced angels recommend that angels should take the opportunity to get out of deals that have lost their upside. “Return on invested time” should drive the angels’ decision to “let go” and move on to other deals.

3.6 Summary and Conclusions

Experienced angels use their networks to source and screen deals. Networks help angels optimize the number and quality of deals. Business associates and angel groups are the best sources of deals and provide the best quality. Unscreened deals sourced directly from entrepreneurs are usually the poorest quality deals. We also outlined how angels prefer to be approached with opportunities.

We described the types of company angels easily invest in. We discussed the wide variance in deal screening and due diligence approaches. Some angels are systematic and detailed in their due diligence while others rely primarily on their “gut feeling”. Experienced angels use industry, geography, growth potential, and their assessment of the entrepreneur’s attributes and track record as criteria to screen deals and conduct due diligence. We also attached an illustrative checklist used by an angel that conducts a systematic and detailed due diligence.

We discussed the key terms and conditions used by angel investors. We quantified the timeframe it takes for angels to invest and we outlined the support provided by angel investors after they invest. We outlined the measures angel investors take to ensure timely and profitable exit. Finally, we described the rates of return angel investors target and experience. Our interview results show that currently West Coast angels target and experience higher rate of returns than East Coast angels primarily due to investment in Internet-related technologies and better systemization of the angel investing process.

Chapter 4. The Rise of Organized Angel Groups

Angel groups are an important new development in venture creation. These groups are transforming the venture creation process by their support of very early stage deals, the value they add, and the volume of deals they handle.

This chapter describes the characteristics of organized angel groups, outlines why they are becoming more prevalent, and provides a framework for comparing and contrasting different types of organized angel groups. This framework has five elements:

- Strategies and Goals.
- Operating Structure.
- Venture Selection and Support.
- Membership Selection and Support.
- Investment Returns.

The focus of this chapter is on operating, venture selection, and support elements. Further work could profitably explore the strategies and goals; member selection and support; and on the investment returns of organized angel groups.

4.1 What Are Organized Angel Groups?

In the late 1990's, both the Route 128 and Silicon Valley areas have witnessed the creation and growth of organized angel groups. These groups leverage the combined expertise, negotiating power and contact networks of their members in executing the steps of the angel investing process.

To define the terminology, we defined *angel groups* to refer to all four types of angel groups. We defined *angel clubs* to refer to member organized angel clubs. We describe four types of angel groups below.

4.1.1 Seed Financing Businesses

Seed Financing Businesses (such as Furneaux & Co. and BRM.) are full-time businesses that provide seed, and routinely, follow-on financing. The firms' principals supply the capital and also provide emerging companies with "company growing" expertise on a full-time basis. These businesses help recruit executives. Sometimes the principals and employees of venture-launching businesses will assume interim operating roles to jumpstart the initial operations of a new venture. They typically make a few investments per year.

4.1.2 Member Organized Angel Clubs

Member Organized Angel Clubs (such as Band of Angels, Walnut Venture Associates, CommonAngels) are groups of active angels that use their combined networks to source, screen, investigate, negotiate, invest in, and manage emerging company investments. Angel clubs build a club of peers; admission is by invitation only. Members bring different skills to the group and value to the entrepreneurs. Each member decides whether or not to invest on a deal-by-deal basis.

Some angel clubs make more than 20 investments per year. However, because most angel clubs came into existence in the mid-1990's, they are still ramping up and evolving their investment processes. Members value the social and fun aspects of investing alongside angels that they like and respect.

4.1.3 For-Profit Matching and Investment Organizations

For-Profit Matching and Investment Organizations (such as Garage.com and VIMAC) are profit making third party organizations that provide screening, due diligence and investment services for member angels. There is a wide variance in the models used by organizations in this category. We will outline Garage.com and VIMAC to illustrate some of the variances in this category.

4.1.4 Third-Party Matching Services

Third-Party Matching Services are non-profit matching service organizations that match angels to ventures (such as the Technology Capital Network or the Investors' Circle). Entrepreneurs list their venture opportunities with the matching services. Little or no screening is conducted by the matching service organization. Angels are responsible for due diligence, negotiation and investing. ACEnet and Technology Capital Network (TCN) are in this group, though we did not interview them.

Note: Other organizations that actively and expertly match entrepreneurs to angel investors, such as the MIT Technology Licensing Office (TLO), were not considered as angel groups. The primary role of the TLO and other university licensing organizations is to license technology and to ensure that the technology gets into the marketplace, and hopefully earn a reasonable return for the university. Understanding TLO impact on angel investing is an area of further research.

Table 4.1: Investing Statistics of Organized Angel Groups (February 1999)

Angel Groups Interviewed	Age (years)	1998 $K invested	1998 #Initial Investments	Est. $K/ member/deal [31]	$K/ Deal	Members in the group
Seed financing businesses						
1. Furneaux & Co.	3	1,900	4	170	500	3
2. BRM	5	8,000	2	1000	4000	4
3. The Angels' Forum	<1	3,400	16	25	200	20
4. Seaflower Associates	6	4,000	4	N/A	750	N/A
Member Organized Angel Clubs						
5. CommonAngels	<1	1,000	2	25-100	500	25
6. Band of Angels	4	17,000	27	50-100	600	120
7. Walnut Venture Associates	3	1,500	2	50-100	750	16
8. Winnipesaukee Investors Group	3	3,400	2	50-200	1700	40
9. Boston Medical Investors	8	1,000	2	50-100	500	18
For Profit Matching and Investment Organizations						
10. VIMAC	17	7,000	6	50-200	N/A	175
11. Garage.com	<1	0	0	N/A	N/A	>100
Not For Profit Matching Services						
12. Investors' Circle	7	N/A	N/A	N/A	N/A	150
N/A = Not Available						

4.2 Why Are Organized Angel Groups Becoming More Prevalent?

The emergence of organized angel groups is a natural evolution of the growth and maturation of individual angel investing. Angel groups seek to mitigate the problems encountered in individual angel investing. Angel groups address some of these problems because they:

- Improve inefficient matching in the venture market: Identifying and matching the right venture with the right angel is time-consuming and imperfect. Organized angel groups leverage the networks of their memberships to access more high quality deals. Most promote themselves discreetly to be slightly more visible to entrepreneurs.

- Leverage time and resources for due diligence and venture support: Angel investors have little or no support staff. They have limited time and resources. Their operational expertise is often in focused markets. Each step of the angel investing process benefits from the combined efforts and skills of several or all of the group members:

  Deal Sourcing: The combined networks of the members can provide a large, high potential deal flow.

  Deal Screening and Due Diligence: Part- or full-time members/partners define and apply screening criteria to new venture opportunities. Their combined market expertise, technology knowledge, business perspectives

[31] Estimated $/member/deal is calculated from: $ invested in 1998/(# deals x estimated # members per deal).

and judgements of people can supply a powerful and efficient basis for due diligence.
Term Negotiation: Members familiar with emerging venture terms and conditions apply their expertise to standardize on terms and conditions.
Post Investment Involvement and Follow-on Financing: Angel groups can leverage the membership's expertise and judgement as their ventures encounter new business issues. The membership can also introduce the company to other angels and venture capitalists for follow-on financing.
Exit: Group members can leverage their contacts with the upper management of large industry players (potential acquirers) or investment bankers.

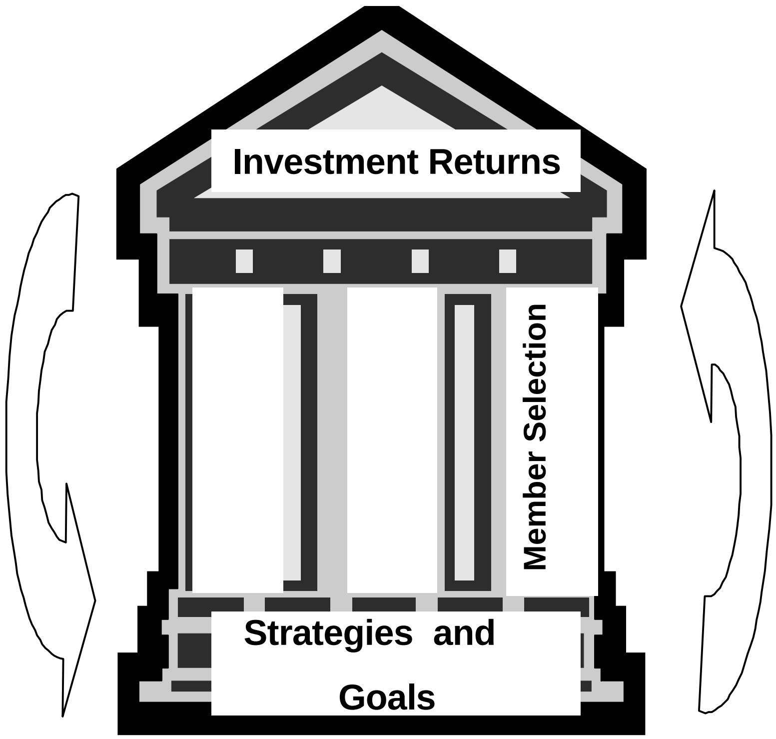
Other drivers of organized angel group investing include media promotion of angel investing and the need for some angels to invest with people they like and respect:

- Angel Group Success Stories are Celebrated By the Media: Just as individual angel investors have been profiled in the media, angel groups are also receiving extensive media coverage. Hans Severiens of the Band of Angels has been interviewed by *The New York Times*, the *Washington Post*, *Business 2.0 and Le Figaro* among others. Several of the angels interviewed said they greatly appreciated the positive exposure Hans has brought to angel investing.

- Networking, Fun and Other Social Reasons: Angels look to network with other angels for social reasons. Angel groups, especially angel clubs, provide this benefit. Many topics other than the deal at hand are discussed at angel meetings.

4.3 Understanding Organized Angel Groups

Some common elements emerged from our analysis of angel groups. Below we utilize an "Organized Angel Group Growth and Management Framework" to characterize the structure and operation of angel groups. Angel groups can use this framework to evaluate and build their organizations.



Organized Angel Group Growth and Management Framework

Key Elements of the Framework:

1. Strategies and Goals: describes the investment strategies and goals pursued by the angel group.

2. Operating Structure: describes the legal structure, staffing, promotion and organization processes/rules. Operating structure is a key pillar that drives investment returns for the angel group.

3. Venture Selection and Support: describes how the angel group executes the five angel investing steps defined in Chapter 3 (see Table 3.1). This element also deals with the involvement of members in the venture selection process.

4. Member Selection and Support: discusses how angel groups recruit and approve new members, how they set size and growth parameters, and how they collect and use membership fees.

5. Investment Returns: describes the economic and non-economic returns targeted and experienced by angel groups.

6. Feedback, Learning and Growth: Angel groups are evolving their organizations as they learn. Strategies and goals set the investment context and ultimately drive investment returns. Feedback from both successful and unsuccessful investments helps evolve the group's strategies and goals.

In the next four sections, we will use this framework to analyze the four different types of angel groups:

1. Seed Financing Businesses.
2. Member Organized Angel Clubs.
3. For-Profit Matching and Investment Organizations.
4. Non-Profit Third-Party Matching Services.

4.4 Seed Financing Businesses

4.4.1 Strategies and Goals

Full-time seed financing businesses not only fund emerging companies, but they also jump start the emerging company operations by temporarily engaging the resources of the seed financing business until the permanent management and employees are recruited. Examples of seed financing businesses include The Angels' Forum, BRM, Furneaux & Co. and Seaflower Associates.

Among the seed financing businesses, total deal size varies considerably, from $200,000 for seed investments to multiple millions invested in follow-on financings. With the exception of The Angels' Forum, these businesses tend to make larger investments in a small number of companies.

a. Angels' Forum Strategies and Goals

The amount invested per member varies widely depending on the business' investment strategy and how the business is organized. For example in 1998 The Angels' Forum's twenty members each invested, on average, was $25,000–50,000 per deal; in 1999, the average amount invested per member has risen. The Angels' Forum does not limit the amount any member can invest per deal. In 1998, Angel's Forum invested in 16 companies over a six-month period. The Angels' Forum typically invests in the seed and start-up stages, and positions its companies for subsequent venture capital investment.

b. BRM Strategies and Goals

Each of the four principals may average $1,000,000 per deal. BRM typically invests in one to three new companies each year, along with follow-on investments in portfolio companies. BRM also prepares its companies for subsequent professional investment. BRM makes it a point to invest $2–4 million in every financing to maintain, as much as possible, its equity position.

c. Furneaux & Company Strategies and Goals

Furneaux & Company has invested in 9 companies over three years. They invested $1.0 million in 1997 and $1.9 million in 1998. Furneaux & Company invests in the seed stage and routinely participates in the subsequent rounds. They work intensively with the company to define products and markets, create early customer relationships, and build the management teams so they achieve the milestones to qualify for venture capital financing in subsequent rounds.

d. Seaflower Associates Strategies and Goals

Seaflower Associates started as an angel-lead venture launching business and evolved into a venture capital firm. Jim Sherblom started by investing the capital of an informal angel group, then raised a $5 million angel fund and, based on the fund's performance, raised a $20 million venture fund with institutional participation. The investment strategy evolved from seed stage capital to larger investments including later stages.

4.4.2 Operating Structure

Seed financing businesses have fairly formal operating structures.

- <u>Legal Structures</u>: The businesses are incorporated as LLC's or S-corporations and the funds have legal structures such as limited or single purpose partnerships.
- <u>Staffing</u>: These businesses typically have full-time paid administrative assistance. The principals spend significant time engaged in operating roles in the new ventures. BRM also retains 30 programmers, 2 business development managers, and 2 human resource professionals to jumpstart new ventures.
- <u>Level of Promotion</u>: Promotion can include websites, speaking engagements, feature articles, etc. The level of promotion can vary widely depending on the character of the principals. BRM sponsored a seminar in Fort Lee, NJ in November 1998 entitled*: How to Build and Manage a Great, Successful High-Tech Company*. The Angels' Forum members speak at a wide variety of industry organizations such as the Silicon Valley Software Developers Association and The Indus Entrepreneur (TIE). Principals of Seaflower Associates belong to the Massachusetts Biotech Council and the National Venture Capital Association, among other organizations.
- <u>Club Processes and Rules</u>: Not explored in this study
- <u>Membership Outreach and Coordination</u>: The principals typically meet on a weekly basis to address the issues of the portfolio companies.

4.4.3 Venture Selection and Support

a. Venture Investing Process

<u>Sourcing</u>: Principals use their combined contact networks for deal flow.

Due Diligence: Due diligence starts with the principals' networks of contacts and then the business pays for expert opinions as needed; patent searches, market assessments, and background checks on the entrepreneur. The due diligence process performed by the Seed Financing Businesses is intensive. For example, Furneaux & Company's due diligence has several levels:

1. 5-Minute Screen: They screen for location, industry, market potential, management track record and valuation. They determine if it is in their area of interest, discuss the referral source, and scope the size of the opportunity.
2. 1-Hour Screen: They use most of the same criteria as the 5-minute screen, but develop more detail. They also read the business plan, assess competition, and evaluate how the opportunity stacks up.
3. 5-6 Hour Screen: Furneaux & Co meets with the management team. They probe to determine the technological advantage and market potential of the opportunity. They assess the personal attributes of the entrepreneur and the management team.
4. Extensive Due Diligence: They contact world class experts to assess the technology. Furneaux & Co. assesses the market place by meeting with several customers and researching the competitors in depth. They evaluate the soundness of market and financial projections and verify technology ownership. They extensively check the management by asking each member of the management team for three references. They ask each of these references for three more references and ask each of these references for three more, totaling 27 references in all.

   Furneaux & Co. spends time with the entrepreneur to determine that his/her team members have talent, believe in the vision, are coachable, and have an enormous desire to win. They must be willing to sacrifice and learn but they must also be strong enough to push back. They must recognize the leadership role they play, yet be willing to accept their sustainable position in the enterprise and be willing to make appropriate transitions, if needed, when the company requires more experienced management.

Term Negotiation: Each group stated they sought to negotiate terms similar to those achieved by venture capitalists. Future research could compare terms negotiated by the types of angel groups to those achieved by venture capitalists.

Post-Investment Involvement and Follow-on Financing: Seed financing businesses intensively work with entrepreneurs to bring products to market quickly and build out the management team.

For example, BRM supplies comprehensive assistance including programmers, human resources personnel, product managers, etc. to shorten the initial product's time to market. BRM principals accelerate the company operations by taking on interim management positions. It is expected that gradually the company will fill the management positions with its own independent personnel and that the dependency on BRM will decrease over time. They invest well over 30 people days per month after investing in a company.

BRM takes responsibility for leading the next financing rounds of the company and finding appropriate investors such as venture capitalists.

Furneaux and Company is also very active after investing. They take a Board seat, help recruit the management team and help define the products to target the early adopter market segments. They help write the business plan, secure the next round of financing, and may even temporarily take on the VP of Marketing role. They introduce the company to other angels and venture capitalists. They invest up to 15 days per month after investing in a company.

Seaflower Associates principals will on occasion become interim CEO or VP of Marketing until the company recruits the management team. Otherwise, it acts more like a traditional venture capitalist, taking an active Board seat, defining financial strategy, helping recruit management and securing follow-on financing. They typically invest 1–2 days per month per company after they invest.

<u>Exit</u>: Seed financing businesses are fairly young and do not have extensive experience with exit. Although these businesses may have only executed a few exits, most have principals with very deep experience guiding companies through IPOs or acquisitions.

b. Involvement of Members in Ventures:
Members work full time in the angel-lead business.

c. Size and Growth Parameters
Some companies will continue to invest at their current levels. Other businesses like Furneaux & Co. and BRM currently make one to four new investments per year; and are assessing the implications of investing in more companies per year.

4.4.4 Member Selection and Support

a. Recruiting and Approving Members
Founding members start the business together because they trust and respect each other and are committed to the same vision. Seed financing businesses recruit new employees in a manner similar to any emerging business.

b. Membership Fees
Not applicable to these businesses.

4.4.5 Investment Returns

a. Economic

Return on Investment is tracked by IRR. Because most of these organizations are under two years old, their investments are still in process and a meaningful IRR cannot be calculated. Most target 30–45% IRR. Because they are positioned as a seed investor, Furneaux & Co. targets an IRR that reflects a meaningful premium to venture firms, which invest post-seed.

b. Non-Economic

The non-economic motivations are fairly similar to those of individual angels. They have fun being a part of the start-up adventure and networking with others.

4.5 Member Organized Angel Clubs

4.5.1 Strategies and Goals

Angel Clubs are groups of individual angels that use their combined networks to source, screen, investigate, negotiate, invest in and manage emerging company investments. Typically, one member sponsors the deal and engages a team of the 5–7 most interested members to conduct due diligence. The angels are not paid for their work, although they often receive warrants in consideration for extra work. Some angel groups pay for part-time or full-time administrative assistance.

East Coast angel clubs include CommonAngels, Walnut Venture Associates, Winnipesaukee Investors Group (WIG), and Boston Medical Investors. West Coast examples include the Band of Angels.

a. Venture Investment Strategy

Members typically invest $25,000–100,000 in a given deal for total funding of $500,000–1,500,000. Often members can attract $500,000–$2,000,000 additional capital through their network with other, non-member angels. Not every member invests in every deal. Angel clubs can fund many early stage opportunities. In 1998, for example, the Band of Angels (120 members) invested $17,000,000 in about 30 companies at an average pre-money valuation of $4.8 million and an average equity stake of 15%. Through October 1999, CommonAngels invested $3.5M in 7 ventures.

b. Social Bonding

Social interaction and compatibility is crucial to the smooth operation of angel clubs because the members participate on a volunteer basis. Members say they want to work with people they respect and like. One angel assessed whether he would like to receive a call at home from a prospective member.

4.5.2 Operating Structure

- Legal Structures: Angel clubs may or may not be incorporated. The group does not necessarily invest as a whole. Each deal has different participation levels from different members; some may not participate. Funds are not syndicated.
- Staffing: Staffing may be entirely volunteer or supported by paid part-time or full-time administrative staff. CommonAngels uses an MIT Sloan MBA student.
- Level of Promotion: Some clubs are quite secretive and allow word-of-mouth to attract entrepreneurs. Other clubs promote themselves through articles in prominent business magazines, being profiled in business school cases, creating websites and/or giving talks at industry conferences.
- Club Processes and Rules: Not explored in this study.
- Membership Outreach and Coordination: Coordination is accomplished through weekly or monthly meetings, email and voicemail.

4.5.3 Venture Selection and Support

Angel club members usually meet monthly, at dinner or breakfast meetings. A few pre-screened companies present their business plans in 15 minutes and handle questions for 15 minutes. To present, a company has to be sponsored by a member.

After the company leaves, the angel club members discuss the venture opportunity. If there is enough interest, the sponsoring angel will lead a due diligence effort that involves the most interested members. Upon successful completion of the due diligence, the group negotiates the terms of the deal. Usually the sponsoring angel takes a seat on the Board and remains the most actively involved member. The other investing angels are typically passive investors. Here are details on the specific angel investing process steps:

Sourcing: Most clubs source deals through their members. In the Band of Angels, an angel can sponsor a company once the angel has already invested on the same terms that will be presented to the group.

Screening and Due Diligence: The group leverages the membership's combined industry expertise, contacts and time to determine if the group is interested in investing in a given venture.

Some groups perform screening and due diligence in a free form manner, often described as "herding cats". Other groups have rigorous and detailed screening criteria and due diligence processes. Table 4.2 shows the CommonAngel's Pre-Presentation Questionnaire and Table 4.3 shows the CommonAngel's Company Presentation Evaluation Criteria.

The Band of Angels differs in that it will present a company to its membership only after one of its members has already agreed to invest and is willing to sponsor the company to the Band. Other members can invest on the same terms as the sponsoring angel.

Table 4.2 CommonAngels Pre-Presentation Questionnaire

CommonAngels Pre-Presentation Questionnaire

Each company answers this short list of questions, before presenting to the CommonAngels. The purpose of this survey is to quickly provide an idea of which stage the company is in, and to provide enough background information so that member angels are able to focus fully on the company's business model.

1. Brief, focused description of company's business objectives:
2. Brief description of existing executive management team:
3. Date the company was founded:
4. Number of employees:
5. Revenue YTD:
6. Capital investment so far
   - Dates of investments:
   - Amounts:
   - Pre-money valuations:
7. Characteristics of the investment the company is seeking
   - Amount:
   - Pre-money valuation:
   - How long it will last:
8. Current burn rate ($$ spent/month):
9. Product status:
   - Concept, alpha, beta, shipping:
   - First customer ship date:
   - Average sales, service price:

Table 4.3 Company Presentation Evaluation Criteria

Company Presentation Evaluation Criteria

1. The company has made a compelling case for the overall attractiveness of the business opportunity it seeks to capitalize on.
2. The management team is reasonably complete, and each key individual appears to have relevant experience and an excellent track record.
3. The company's products or services address a clear need in a large market.
4. The company appears to have existing customers who are extremely satisfied with its products or services.
5. The company has presented a strong plan for marketing, selling and distributing its products or services.
6. The product or service to be offered by the company can readily be developed with the human and financial resources it already has or can reasonably obtain.
7. The company has clearly identified and analyzed its strengths and weaknesses relative to its likely competitors.
8. The company product or service has a strong intellectual property position or other significant barrier to entry that a competitor would have difficulty overcoming.
9. The capital being sought by the company should be sufficient to achieve the goals contained in its business plan.
10. The company's pre-money valuation appears reasonable.
11. I'm (member angels) very interested in learning more about the company.

    Other Information Collected
    - Name of Company
    - Date of Presentation
    - Number of Evaluators
    - Overall Score (Range: 0-3)

Source: CommonAngels

Term Negotiation: Each group has evolved to a fairly standard set of terms they apply to their deals. Some clubs regularly negotiate a participating, convertible, redeemable preferred stock. Other clubs use a wider variety of terms, depending on the specifics of the opportunity.

Most of the groups have modeled their terms and conditions after venture capital deals which include demand rights, voting rights/Board representation, registration rights, piggyback rights, anti-dilution provisions and information rights. Band of Angels[32] and Walnut Venture Associate[33] case studies provide examples of term sheets used by these angel clubs.

Angel clubs typically invest in companies with valuations less than $4 million. Several said that valuations above $4 million require a very compelling and extra-ordinary story. Nevertheless, a few clubs have invested in companies with $8–10 million pre-money valuations. It is too soon to judge what the returns on these investments will be.

In most clubs, the individual members decide to invest on a deal-by-deal basis. Some funds are considering a pooled side fund that the club would invest, but this has not happened yet. There are multiple legal issues to sort out.

Post-Investment Involvement and Follow-on Financing: Members' involvement after investment ranges from minimal to 3–4 days per month. Members that invested based on the due diligence team's recommendation are often passive investors. Members that are on the company's Board or that decide to take a temporary-operating role will spend more time. For example, Bob Carpenter (Boston Medical Investor's lead angel) sometimes becomes the CEO and Chairman of the new venture on a near full-time basis, until the CEO has been recruited. The Board member is often compensated in options or warrants, rather than in cash.

The group will help the company recruit other Board members, recruit and coach management, build customer alliances, define the financial strategy, recruit other investors and help with business, marketing and technology plans.

Some venture capitalists do not feel that angel groups support their companies well. They characterized angel clubs as dinner clubs in which members participated in due diligence, but did not sufficiently leverage their expertise and networks in building the company after the investment had been made.

Exit: If the angel club retains its Board seat to the time of exit or acquisition, the Board member will have some say in the terms of exit. Some of the clubs have been recently formed and have not experienced any exits to date.

[32] Darwall, C. and M.J. Roberts, 1998, The Band of Angels, HBS Case Study: 9-898-188.
[33] Roberts, M.J., 1998, Walnut Venture Associate, HBS Case Study: 9-899-097.

As of February 1999, the Band of Angels, Boston Medical Investors, and Winnepesaukee Investors Group had exited a total of 24 companies:

Acquisition	11
IPO	5
Share Buyback	0
Liquidation/Loss	8

4.5.4 Member Selection and Support

a. Recruiting and Approving Members

Not explored in this study.

b. Size and Growth Parameters

Band of Angels has grown to 120 members and has segmented its membership by industry. CommonAngels now has 50 members and is considering the benefits and costs of continued growth versus maintaining its current size. Boston Medical Investors is stable at 18 members. Walnut has had 16-18 members over the past year. Further investigation should be focused on optimal angel club size as the groups evolve and their track records mature.

c. Membership Fees

Not explored in this study. Some of the angel clubs charge about $1000 per year.

4.5.5 Investment Returns

a. Economic

Band of Angels states they have an average 32% IRR. Some clubs do not rigorously track IRR and the remainder have not been in operation long enough to have a meaningful IRR. Jim Nicholson (WIG), says he feels more secure making angel investments knowing that record levels of venture capital are available for follow-on financing

b. Non-Economic

Perhaps more than any other type of organized angel group, the "fun" factor is extremely important in a member's decision to join an angel club. Members of angel clubs commented that they enjoy investing alongside people they like and respect, coaching entrepreneurs and the intellectual challenge of tackling new-business and technology issues. The principals of angel clubs investing in medical technologies, such as Winnipesaukee Investors Group and Boston Medical Investors, state they enjoy building companies that provide societal benefits.

4.6 For-Profit Matching and Investment Organizations

4.6.1 Strategies and Goals

For-profit matching and investment organizations represent a wide variety of third party organizations that match angel investor funds with start-up companies seeking investments. These organizations provide a variety of services to angels and /or emerging companies for a fee. They usually have a side fund that invests in emerging companies.

Our characterization of this angel group is based on two companies: Garage.com and Venture Investment Management Company (VIMAC). The information presented on these companies is drawn from interviews and published material. We did not verify the information through other interviews. Garage.com and VIMAC have very different operating models; however, both companies are financial intermediaries that make money by:

i. Charging start-up companies and/or angel investors for matching and other services. Most of companies are not broker/dealers though the angels usually invest in a start-up company through a broker/dealer affiliated with the matching service. For example, Garage.com Securities, Inc is Garage.com's broker/dealer;
ii. Investing company funds and any side investment funds raised; and
iii. In some cases, earning returns through a carried interest.

a. Overview of Garage.com

Garage.com is an Internet "market-making matching service" officially launched on October 19, 1998. Their first deal closed in January 1999. Garage.com will identify, screen opportunities, groom start-up companies and post investment opportunities on its password protected Internet accessible on-line database called Heaven. These opportunities are seed stage investment opportunities in technology with investment needs of $500,000 to $2.5 million.

Interested and pre-screened accredited investors can select opportunities posted in "Heaven", contact individual start-ups, and initiate discussions for investment. Angels are responsible for their own final due diligence, though Garage.com will do significant up-front screening before they post the deal in Heaven. Subsequently, Garage.com may be involved as the angel investors execute their due diligence.

Garage.com invests money from its own investment fund; at the same time and on the same terms as when angels invest. Garage.com also has relationships with venture capitalists and corporate venture programs to help fund subsequent rounds for the start-ups. It provides several services to both start-ups and angel investors. We will outline some of these services later. Garage.com has an associated broker dealer group that helps place securities.

b. How Garage.com makes money

- Garage.com charges a placement fee (typically 5%) for all investments made through their service.
- Garage.com has the right to buy 5% of the company at the founder's price.
- The company has a right to invest $50,000 to $100,000 at the price set by angel investors. Garage.com has raised a $5 million side fund (called Garage.com Investments 1, LP) from a number of limited partners such as Advanced Technology Ventures, Silicon Valley Bank. Angel investors such as Compaq Computer Corporation's chairman, Ben Rosen, have participated as well.
- Membership fees of $5,000 per year are charged for institutional investors and $1,000 per year for individual investors. The fee for individual investors has been waived, as of November 1999.

c. Overview of VIMAC

VIMAC identifies opportunities, conducts due diligence and allows angel investors to invest in early stage deals through two approaches. In the first approach, member angel investors invest on a deal-by-deal basis. In the second approach, member angel investors invest in a side fund called "Vintage Trust" that invests targeted amounts in different VIMAC deals. In addition, VIMAC has raised its own funds that VIMAC invests at its discretion.

On a deal-by-deal basis, VIMAC puts together a term-sheet, creates a limited partnership memorandum and passes the memorandum to prospective angels who can then meet the entrepreneur and hear his/her presentation before they decide to invest.

The Vintage Trust side fund allows angel investors to contribute smaller amounts and enables angel investors to diversify their investments across multiple ventures.

d. How VIMAC makes money

- VIMAC charges a one-time 11% fee to angel investors for investing in the limited partnership. This includes a 10% management fee (based on 2% per annum for five years, the typical duration of the partnership), and a 1% placement fee paid to their affiliated broker/dealer. Should the partnership liquidate before the end of the fifth year, VIMAC refunds the unearned portion of the management fee to its investors. Limited Partners (angel investors) are also liable for extraordinary expenses such as interest on loans or extraordinary litigation to protect the interests of the limited partners.
- VIMAC also receives 20% of partnership capital gains after the principal has been repaid to the Limited Partners (angel investors).

Partners at VIMAC have operating and venture experience. They provide support to their start-up companies similar to that provided by a venture capitalist. In many instances, VIMAC may hire an independent investment manager to manage a transaction through the life of the investment. VIMAC will always seek to invest with other venture capital companies and to retain a Board seat. It invests in seed stage companies with investment needs as low as $100,000 and looks to support the company in subsequent rounds of financing. Typical investments range from $500,000 to $2.5 million. The targeted liquidation timeframe is three years for each seed stage investment, though limited partnerships are set up for five-year periods. VIMAC invests in information technology, telecommunications and medical device companies.

4.6.2 Operating Structure

Both VIMAC and Garage.com have raised lines of credit and sold equity to pay for operating expenses and investments by the company until they become cash flow positive. Garage.com promotes itself heavily through the media and as a result, a number of deals come over the transom (up to 50% according to Garage.com). However, angels, attorneys, business associates, accountants and consultants also supply leads.

4.6.3 Venture Selection and Support

Both Garage.com and VIMAC invest in seed stage deals. Typically they look for companies with working prototypes, proprietary technology, and lead customers or prospective customers. We describe Garage.com's investing process below:

Garage.com estimates that in1998, they looked at 1900 deals, conducted limited due diligence on 100–200 deals, conducted significant due diligence on 75 firms, and took on 12 firms as clients.

To screen a deal, Garage.com considers the quality of the deal, the source and the educational background of the entrepreneurs. To be considered, Garage.com asks the company to complete an online Q&A that provides the basic information about the company, market, and team. If Garage.com is still interested, they ask the company to complete a detailed application online.

Based on the detailed application, Garage.com decides whether or not to proceed with the due diligence. The due diligence process may be as simple as one phone call resulting in a decision not to work with the company. More extensive due diligence may involve several phone calls, meetings, and technical and market assessments. After the due diligence, Garage.com negotiates the terms and posts the opportunity in "Heaven". The opportunity is also sent to select investors, who are likely to be interested, based on preferences they have previously indicated.

A one-page summary, written by the entrepreneur, is posted in "Heaven" for prospective investors to scan. Prospective investors email and meet with the start-up company, do their own due diligence and invest in the opportunity. Typically, investors take a 20–30% stake in the company. Ideally Garage.com expects valuations to be less than $2 million and not more than $5 million.

Garage.com supports its start-up ventures by grooming them for angel investor scrutiny and due diligence (e.g., helping them with their business plan). It also runs “Boot-camps” for start-ups, provides access to literature through its web site, seeks to provide media coverage for start-ups through its media network, and provides other services which may be of help to start-ups.

4.6.4 Member Selection and Support

Both Garage.com and VIMAC seek accredited investors as defined by the SEC. Garage.com also looks for investors familiar with the high-tech industry and they expect lead angel(s) to take a Board seat on the company. Other angels involved in the deal can be passive. Garage.com has a total of 100 angels, venture capitalists and corporations with access to its on-line network.

VIMAC looks for high value add investors as part of its core group. VIMAC has 150 angel/high net worth individuals in its network. Of those, 50–55 angels and high net worth individuals are very active. Since VIMAC is committed to managing each investment at the Board level within its partner base, it can also work effectively with a higher percentage of passive investors.

4.6.5 Investment Returns

Garage.com recently started its operations and cannot yet calculate relevant returns. The first few deals have been very carefully managed and have received wide media coverage. Many investors and venture capitalists are waiting to see how effective, scaleable and sustainable the Garage.com model will become. In that regard, their expansion plans on Route 128 are being carefully watched.

According to the information provided by VIMAC, it has invested more than $25 million in fifteen venture-stage private companies from 1990 to 1997. VIMAC exited six companies in this period. Three went public, one was merged with another company, and two were written off. VIMAC’s $8.6 million investment in these six companies had a value of $38.5 million at the time of their IPO’s, merger or closure, $213 million at the time of their highest public price, and $62 million as of October 1, 1997. $14.8 million is invested in the remaining nine portfolio companies, which were valued at $19.9 million in October of 1997. Eight of the nine companies are likely to increase their stock price in the next round. It is curious, however, that VIMAC did not discuss data through 1998.

4.7 Non-Profit Third-Party Matching Services

4.7.1 Strategies and Goals

Third party matching services (such as the Investors’ Circle and ACE-Net) are non-profit organizations that bring angels and entrepreneurs together through conferences, workshops, informal meetings, and distribution lists. The matching efforts are often seen as a way to promote more capital for entrepreneurial firms in areas under-served by mainstream venture capital. These organizations make no investment recommendations, do little or no screening, do not undertake due diligence and take no commissions on investments made by investors.

a. Overview of ACE-Net

According to a recently published article[34] by Paul Gompers, the largest and most far-reaching non-profit third-party matching service effort to date is ACE-Net, the Angel Capital Electronic Network launched by the U.S. Small Business Administration's (SBA) Office of Advocacy.

Entrepreneurs who desire exposure on the ACE-Net network fill out an application, file financial statements with ACE-Net, and pay a $450 fee to appear on the network for six months. The company must also have a qualified offering with the SEC and state security agencies. Accredited investors (based on SEC Rule 501) receive a password by registering with a regional ACE-Net office. These accredited investors can view and target the types of investments they desire. To facilitate finding companies, ACE-Net company listings are organized by region, industry, and the investment sought. The typical investment range targeted through ACE-Net is $250,000 to $2 million.

b. Overview of Investors' Circle

Investors' Circle is not a government organized matching service like ACEnet, but rather, a privately formed non-profit matching service. Its primary focus is identifying socially responsible venture opportunities for its members. The organization was founded in 1991. Currently, it has approximately 150 members and in the last eight years members have invested over $40 million in 60 companies. Typically, start-up companies with investment needs of less than $5 million come to Investors' Circle.

Very little research has been done on non-profit matching services and it may be a good area for further research. Below, we use our "Organized Angel Group Growth and Management Framework" to characterize Not-for-Profit Matching Services.

4.7.2 Operating Structure

These organizations are non-profit organizations though they may have subsidiaries that are for-profit companies providing services to their members. In the Investors' Circle example, the organization has a Board of Directors responsible for the overall guidance, financial management and for selecting the companies that present at their conferences. They have two staff members for managing operations. Promotion is through word-of-mouth and through news media coverage. A for-profit subsidiary provides briefing summaries to the Investors' Circle members.

[34] This section is based on excerpts from "A Note on Angel Financing" and interview with Investor Circle. Ref: Gompers, P.A., 1998. A Note on Angel Financing, Harvard Business School Case: 9-298-083.

4.7.3 Venture Selection and Support

In most cases, the ventures seek out the matching services; matching services rarely seek out the venture. Members may refer opportunities to the matching service.

As mentioned earlier, Not-for-Profit Matching Services do very little screening or due diligence; it is the responsibility for the investors to do their own due diligence. Interested investors sometimes get together and undertake due diligence as a group. Investors' Circle will perform some preliminary screening to identify deals that meet its social responsibility charter. Increasingly, however, these organizations are looking to offer pooled investment vehicles and other services to members.

4.7.4 Member Selection and Support

Member angels usually have to be accredited investors. Little other selection or screening is done for members. Members usually pay fees to access investment opportunities and to attend events sponsored by the organization.

4.7.5 Investment Returns: Economic and Non-Economic Returns

Because the member angels do their own investing, the non-profit matching services do not maintain a record of economic returns achieved by their members. Angels we interviewed felt the quality of deals in the network was poor, because the deals were not screened. Many angels felt that these services do not easily leverage the "network of trust" that is at the heart of angel investing process, nor do they easily provide the human contact needed as the basis of the angels' judgements. Angels felt that the services are useful in providing a quick scan of technologies and markets targeted by new ventures.

Increasingly, matching services offer conferences and seminars to increase the interaction and learning among members. Investors' Circle, for example, has conferences twice a year to educate members on venturing. These events allow members to interact with each other and enable companies looking for funding to present to investors. Garage.com has started a showcase breakfast series, in which companies present to interested angels.

4.8 Summary and Conclusions

The rise of organized angel groups makes it easier for prospective angels to invest. A natural evolution is occurring as venture capitalists focus on larger and later rounds while angel groups focus on the seed and start-up stages.

We expect to see the growth of all types of angel groups, especially the popular angel club format. Angel clubs may find increased synergy by working together on opportunities.

Chapter 5. Becoming an Angel Investor

Experienced angels gave the following advice to aspiring angels:

Motivation: Understand the Reasons for Becoming an Angel
Temperament: Certain Key Personality Attributes Are Needed
Fundamentals: Learn the Basics of Angel Investing
Experience: Build the Angel Investing Experience Base
Network: Build the Angel Network
Capital: Understand How Much Capital to Put at Risk
Financing: Understand What the Next Round Investors Value the Most
Tools: Use Resources and Tools To Leverage Your Time

In this chapter, we also discuss how experienced angels are willing to help high net worth individuals aspiring to become angels, and we outline selected investment strategies used by experienced angels.

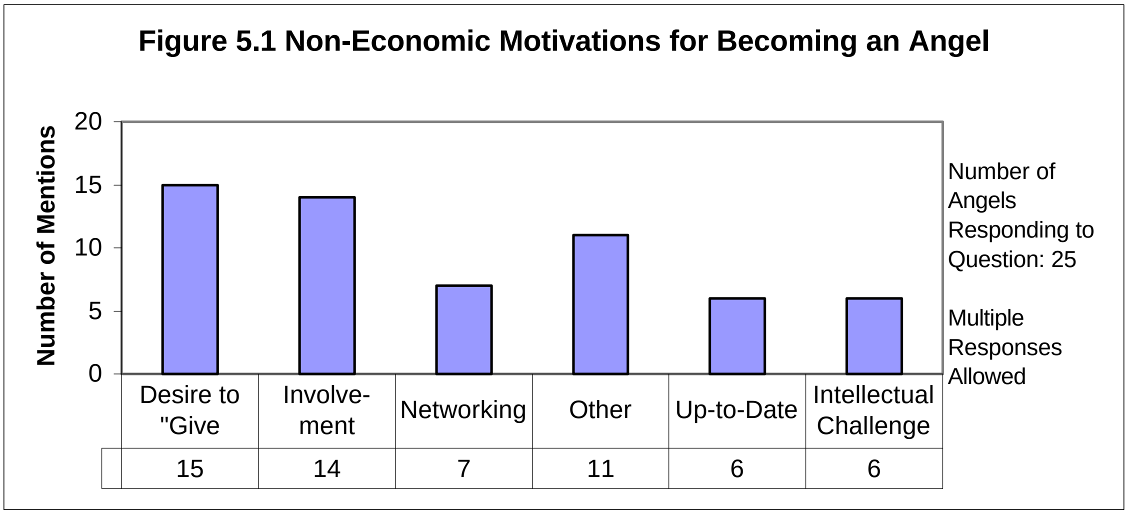
5.1 Advice from Experienced Angel Investors

5.1.1 Motivation: Understand the Reasons for Becoming an Angel

While most angels acknowledge that return on investment is an important part of their motivation, for many angels, it is not the most important motivating factor. As discussed in Chapter 2, angels invest in emerging companies not just for economic returns but also for personal benefits:

- *Giving Back to Aspiring Entrepreneurs:* Angels enjoy the chance to mentor entrepreneurs. Many angels have been through the process of founding and growing companies. They have empathy for the growing pains of the companies and the entrepreneurs. They feel they can help entrepreneurs avoid common mistakes and help their companies achieve grander goals.
- *Involvement with Entrepreneurs and Emerging Companies:* Angels enjoy the adrenaline rush of emerging company volatility but without the 80-hour workweeks and the burden of ultimate responsibility for the company.
- *Networking Benefits:* Angels enjoy maintaining or building their personal networks with similarly interested people, while helping new ventures.
- *Technology and Markets*: They enjoy keeping abreast of rapidly evolving technologies or markets.
- *Intellectual Challenge*: Angels keep their minds sharp by dealing with the business issues faced by the companies they invest in.
- *Societal Benefits*: Some angels take great pride in the fact that their companies improve people's lives through technology.
- *Control of Time:* Angels do not desire a full-time venture capital career. They want the flexibility of investing without the pressures of raising capital or managing IRR for their funds.

Figure 5.1 shows the non-economic reasons mentioned by angel investors in our survey:



Experienced angels felt that recent high returns from investing in emerging companies should not be the only driver to invest as an angel. They advised that if an angel's only objective is to earn a high rate of return, they should consider investing in venture funds. Venture funds do not require the time and effort of angel investing.

Several angels commented that the recent high returns achieved by angels and venture capitalists are probably not sustainable over the long term. Angels who have invested for longer than 10 years know that returns are cyclical with the stock, acquisition or IPO markets. As seen in Chapter 1, The IRR of the Venture Capital industry dipped below 10% for several years in the early 1990's. Angel investors probably did not achieve better returns during that period. Angels that have invested through good times and bad are driven primarily by the non-economic benefits of angel investing.

5.1.2 Temperament: Certain Key Personality Attributes Are Needed

Angel investing is not for everyone. Prospective angels should consider the following:

- *Willingness to lose entire investment in a start-up*: Many angels advise that if the investor cannot face losing the entire investment in a company, either emotionally or financially, he/she should not become an angel investor.

- *Ability to incorporate and adapt to new information*: An angel investor should be able to deal well with volatility and uncertainty and be able to adapt to new information. Bill Sahlman, Professor of Entrepreneurial Finance at Harvard Business School and an experienced angel investor, comments, "The journey of an emerging company is a roller coaster, not a rocket ship. Every company experiences volatility. Early stage investors need to be able to see beyond the obstacles and clearly assess the potential of the venture. The outcome is never certain; the opportunity is often not clearly defined at first. Sometimes new information blocks the original premise of the business plan and presents new opportunities."

- *Ability to assess entrepreneurs*: Many angels rank people-assessment skills as very important. The early stage investor has to be able to assess the entrepreneur's ability to adapt to new conditions without losing focus or spinning the company out of control. The angel is required to judge when to keep helping, when to advise that a change in management be made, and when to pull the plug.

- *Willingness to let someone else manage the show*: High net worth entrepreneurs are accustomed to controlling and driving their companies. As angel investors, such entrepreneurs should feel comfortable with someone else running the show, even when the situation seems bad.

  Kanwal Rekhi sums it up, "At the end, you want to make sure it is the entrepreneur's deal and not yours. The primary job of an angel is to identify winners vs. making winners. If you want to control and drive success in a start-up, you should continue being an entrepreneur."

5.1.3 Fundamentals: Learn the Basics of Angel Investing

Several angel investors and venture capitalists indicated that angels should educate themselves on the fundamentals of angel investing. James Marten, who has founded five medical companies, commented that there are aspects of angel investing that entrepreneurs may or may not have learned in their operating experience. These items can be learned by working with other angels, through interviews with members in the venture support system (lawyers, accountants, other angels and others), and ultimately through practice. Fundamentals include:

- Due diligence criteria relevant to the industry of the investment.
- Standard terms in the term sheet and their implications to the angel investor.
- Protective provisions in the term sheet (How not to get mugged).
- Deal structure, development stages, milestones and valuations for companies in high-growth industries.
- Board member best practices (Organizations such as the National Association of Corporate Directors and Stanford University have materials and programs dealing with Board membership).
- Conventions in executive compensation and options plans.
- Intellectual property: value in relevant industries.
- Raising capital and preparing the company for professional funding: the right stage, the right milestones, the right management to justify the right valuation.
- Exit Strategy: the securities restrictions on the alternatives.
- Financial Strategy: sources of capital over the life of the start-up company.

5.1.4 Experience: Build the Angel Investing Experience Base

Experienced angels recommended three ways to build an angel investing experience base:

a. Use prior business experience.
<u>b. Learn by doing.</u>
<u>c. Learn through investing with successful, experienced angels.</u>

a. Use prior business experience
A majority of the angels interviewed advised prospective angels to invest in industries and businesses they understand. Their prior experience can often provide substantial value to start-up companies. A few angels commented that their poorest investments were in areas where they lacked expertise.

The angels in our sample have extensive operating experience in growing small, high tech companies and/or founding one or more companies. Individuals who most easily stepped into the angel-investing role had business experience that taught them many of the critical success factors of angel investing. Former venture capitalists, founders of one or more successful companies or top management of successful start-ups bring several or all of the following elements:

- Track record in launching companies: credibility and operational expertise.
- Extensive industry contacts.
- In-depth knowledge of a specific technology or market.
- Entrepreneurial agility to quickly target first products or markets.
- Knowledge of terms, valuations milestones for early financings.
- Knowledge of negotiating acquisitions and/or IPOs.
- Ability to assess management talent and make tough decisions.
- Ability to create new markets with limited resources.

While it is difficult for one individual to be proficient in all of these areas, successful angels have found ways to supplement and build the skills they do not have.

b. Learn by doing
Many angels said the best way to learn angel investing was to "just do it". Several angels thought it was important to be actively involved with a small number of companies. They advised spending the time to learn how emerging ventures grow and to learn how to work with the entrepreneur and management as they dealt with obstacles. James Dow recommended paying attention both to everything that goes on both within the start-up company and in its industry. Kanwal Rekhi emphasizes that angels should be willing to work hard for their companies, "Angels should expect to match capital with energy."

Some advised to take the time to learn from disasters and near disasters as well as successes. As one angel stated, "No book can leave an imprint on you like the experience of losing fifty thousand dollars."

c. Learn through investing with successful, experienced angels
Angels employ a wide variety of approaches to the angel investing process, as discussed in detail in Chapter 3. Many commented that they gained valuable insights by working with other angels, angel groups or venture capitalists to improve their angel investing processes. Carol Sands, founder of the Angels' Forum, interviewed 200 people in the venture support system and crystallized the best practices. She then recruited a group of advisors, created a model for her angel investing process and launched her full-time angel business.

Working with experienced angels can improve the angel investing process in several ways:

- *Overall Investing Process*: Experienced angels can help new angels understand company growth issues, the investing process, investing strategies and the language.
- *Due diligence*: Experienced angels know the few important items to check in a new venture in a specific industry. They know the experts to contact to resolve critical issues. Many are fairly systematic in their due diligence processes.
- *Terms*: Experienced angels know the standard terms and valuations that apply to companies in a given industry and at a given stage. They know the terms that will allow venture capitalists to invest in later stages.
- *Post-investment involvement and follow-on rounds*: Experienced angels know how to serve as effective Board members, and how to help companies achieve the milestones required for the next financing rounds.
- *Exit*: Experienced angels know the benefits and problems of alternative exit strategies.

Members of angel clubs highly recommended joining an angel club because the members all benefit from the collective perspectives, networks and negotiating power of the group.

5.1.5 Network: Building the Angel Network

An angel's network is crucial at each stage of the angel investing process. The contacts in an angel's network can provide high quality deals, expert assessments in due diligence, and valuable perspectives on terms, valuations and Board involvement. The network is also helpful when the company goes public or is seeking to be acquired.

Angels need to build and maintain their bridges to other experienced angels, angel groups, venture capitalists, and entrepreneurs as well as to lawyers, accountants, consultants and industry experts.

Some of the best starting points for building a network are start-up related lawyers and accountants, as well as other angels and angels groups. Start-up company lawyers and accountants have a vested interest in introducing their clients to investors and especially to investors with skills and resources to help grow their client company. As with all networking, strong references help in setting up meetings.

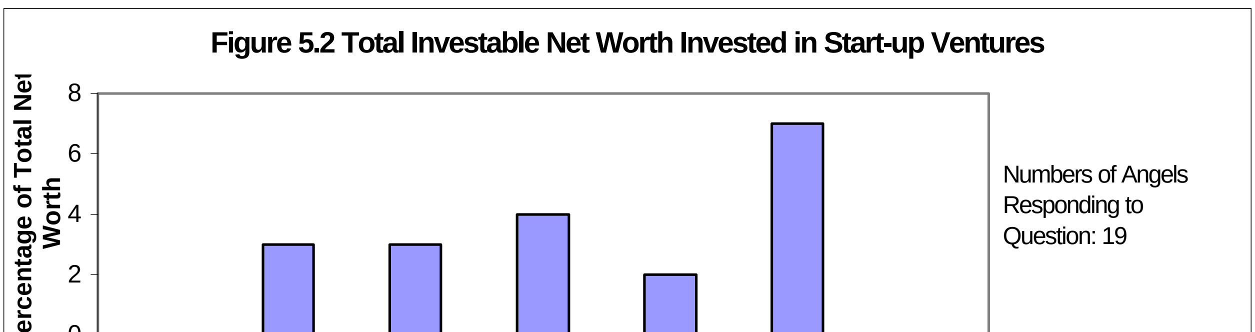
Matchmaking services such as TCN and Garage.com allow angel investors to become familiar with deals in the market. Matchmaking services are easy to join if angels meet basic criteria. Some angels build their networks by speaking at clubs (e.g., Churchill Club), the MIT Sloan Venture Capital Conference, the MIT Enterprise Forum and other venture-related sessions at universities, law firms and accounting firms. It is crucial, thereafter, to build a good track record.

5.1.6 Capital: Understand How Much Capital to Put at Risk

When investing, many angels recommend starting with small investments because the missteps in early deals can cause the entire investment to be wiped out. James Dow advises setting size of investment and risk guidelines you can live with and to start investing with small amounts because early learning can be costly.

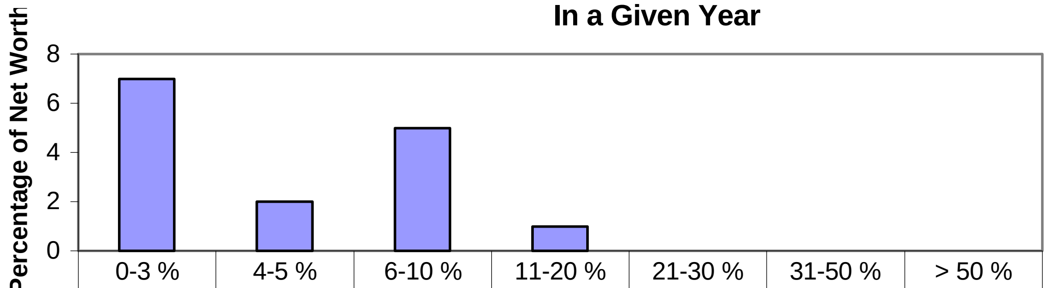
Angels in our sample set guidelines for the fraction of their net worth they are willing to place in high risk, early stage investments. Experienced angels in our sample invested 22.5% of their investable net worth in multiple start-up ventures. Typically, angels in our sample invested 4.5–5.0% of their investable net worth in a given year in start-up ventures.

Figure 5.2 shows the distribution of *total* start-up investment as a percentage of investable net worth. Figure 5.3 illustrates the percent of investable net worth that experienced angels invest in emerging ventures *each year*. Investable net worth does not include angel investment in residences and other personal fixed assets.



0-3 %	4-5 %	6-10 %	11-20 %	21-30 %	31-50 %	> 50 %
0	3	3	4	2	7	0

Figure 5.3 Percentage of Net Worth Invested in Start-up Ventures In a Given Year



0-3 %	4-5 %	6-10 %	11-20 %	21-30 %	31-50 %	> 50 %
7	2	5	1	0	0	0

Experienced angels recommended against "betting the ranch" because of the volatile nature of start-ups. One angel advised new angels to be ruthless about selling, he said he made much of his money by selling before the company value had peaked. Bernard Bausch said. "Nobody ever went broke taking a profit."

5.1.7 Financing: Understand What the Next Round Investors Value the Most

Investors in emerging companies should define the valuation and milestones needed to bring in the next round of investors. They should feel comfortable that the current round of financing will be invested to reduce the risk factors that will most improve the valuation of the company in the eyes of the next round investors.

Venture capitalists can help define valuation in subsequent rounds. The step-up calculation allows angels to understand how seed valuations set the stage of later investors. High valuations in early stages can deter later stage investors from investing in the later rounds. Low valuations do not adequately compensate for the risks taken by the angel or the entrepreneur.

5.1.8 Tools: Use Resources and Tools to Leverage Your Time

Some experienced angels have chosen to build a library of tools and resources for use and re-use. Some of the tools and resources they suggested:

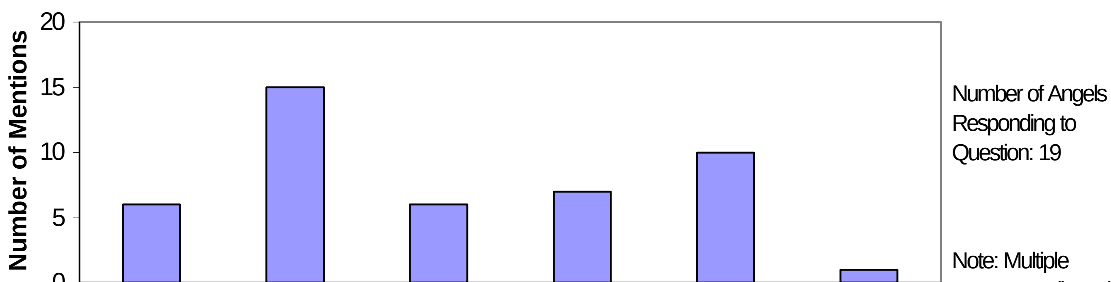
- Guidelines for types of deals they will consider.
- Due diligence outline.
- Standard term sheet as a starting point for investing.

5.2 How Experienced Angel Investors are Willing to Help High Net Worth Individuals Aspiring to Become Angels

Figure 5.4 shows how experienced angel investors in our study are willing to help high net worth individuals to become angels. Most of the angels interviewed are willing to speak at seminars or be interviewed by magazines. Experienced angels feel that seminars and magazine interviews can raise the awareness about the common pitfalls and process of angel.

Some will help aspiring angels by working with them on prospective deals, especially if the aspiring angel brings a good deal to the experienced angel and can add value. However, many indicated that they would only do this for the associates and family members they wanted to mentor. Angel club members recommend that aspiring angels join angel groups to meet other angels.

Figure 5.4 Experienced Angels are Willing to help Aspiring Angels



Speak	Speak in	Give Opinions	Invite into	Be	Not at All
6	15	6	7	10	1

5.3 Illustrative Investing Strategies Used by Experienced Angel Investors

Below, we examine two ways to build an angel investment portfolio and look at four different investment strategies. This list is not comprehensive and any one angel may use more than one investment strategy in their portfolio. We have also not analyzed which strategies are more effective or whether they are valid strategies.

5.3.1 Portfolio Management Strategy #1: Diversification

Strategy: Angels using this strategy invest in early stage deals, not in later rounds. They place small bets on many companies each year.

Rationale:

- Early stage successful deals can give 10–20x return on investment. As a result, the angel only has to have 1–2 successful deals out of 20 to make a profit. These angels feel that they can pick enough winners to beat these odds. They feel they can effectively assess the people and the concepts, which are often the basis for early stage investing.
- In the later stages, these angels feel that both the risks and the return potential decline. In their minds, the risk reduction does not compensate for the reduction in potential return. Also, in the later rounds, it is important to perform a more extensive due diligence on the management, market, company and products, which requires considerable time and effort.
- The support required in later stages is more related to building the company infrastructure. Angels may not have the time or expertise to conduct such analyses or to provide the required support.
- Angels using this diversification strategy typically will not devote much time to each company.

5.3.2 Portfolio Management Strategy #2: Targeted High Yield Investments

Strategy: Angels using this strategy invest substantial funds and effort in a few opportunities that can benefit from their industry and operational expertise.

Rationale:

- This strategy is a high involvement strategy. The angel strongly believes in the opportunity and allocates significant investments of funds and effort to help launch the company. Opportunities are in the angel's area of expertise.
- These angels feel they can leverage their network and contribute to building value/reducing risk in the company by helping build the team, finding funding and identifying potential alliance partners or customers by leveraging their network.
- Usually angels using this strategy are very focused. They will take a Board seat, work actively with the entrepreneur, and sometimes take on an interim management role.

5.3.3 Rapid "Tee Up" for Subsequent VC Funding

Strategy:

- Some angels select companies that have the potential for venture capital funding. These ventures are often too "raw" for venture capitalists to finance. Alternatively, the entrepreneur may want to engage an angel as a high profile Board member to help justify a higher valuation when seeking VC funds.
- The angel's involvement can help the company achieve key milestones more rapidly (thereby reducing risk) to qualify for VC funding.
- They structure the deal so that it is easy for venture capitalists to finance the next round (e.g., use convertible debt that converts at a discount when the VC invests).

Note: We found this strategy popular with Silicon Valley high tech angels.

Rationale:

- These angels feel they can identify winners, help build out teams, recruit the Board and position companies for financing by top-tier venture capitalists.
- They believe their involvement can accelerate company development and achieve milestones that take the company to the next valuation level.
- They position the companies for VC funding because they feel venture capitalists provide the support to quickly make start-ups successful.
- Convertible debt allows the venture capitalist to set the valuation thereby eliminating over-valuation by the angel investors

5.3.4 Invest in Retail Companies 1-Year Away from Becoming Cash Flow Positive

Strategy:

- These angels seek retail and other non-technology companies with significant growth and margin potential and real customers.
- Companies should be one year away from becoming cash flow positive.
- The are often the only investor in the company. Subsequent funding should come from cash generated by the business.

Rationale:

- They feel that they can only invest in real customers and real margins. This strategy was not mainstream to our study.

5.4 Summary and Conclusions

Angels employ a variety of portfolio management and investment strategy techniques depending on their style, time available and financial resources. Experienced angels emphasized the importance of investing with people you respect and trust, to build early stage investing expertise.

Chapter 6. Perspectives

The angel investors interviewed for this study had impressive records of business success. However, we found they were down-to-earth, approachable and very willing to share their insights on investing in emerging companies. Perhaps most striking, is their passion and commitment to "give back" to entrepreneurs and the businesses they build. Despite the fact that each of these individuals has earned the right to retire, they choose to share their experience and invest their efforts in the roller coaster world of business creation. They work hard because they want to not because they have to. These angels invest in early stage companies because they love the excitement of new venture start-ups. The insights, skills and funds they bring to emerging ventures are invaluable resources.

We were surprised at the lack of data on angel investing. As we constructed frameworks to characterize angel investors and angel groups, we found opportunities for further research:

- The impact of investment strategy and Ts & Cs on multi-year returns.
- Specific detail on the role angels play in launching companies; e.g., impact of recruiting and coaching management, accessing strategic customers, etc.
- Further research on the characterization and evolution of organized angel groups:
  - Impact of investment strategy on returns.
  - Member selection and support.
  - Evolution of angel clubs and seed financing businesses.
- The role of the MIT Technology Licensing Office (TLO) in launching new ventures.
- How angels successfully prepare and hand-off companies to VCs.
- How angels help the culture of the firms in which they invest, particularly with regard to sales.

We hope that this study will help aspiring angels quickly develop the skills to invest effectively. We also hope our work allows entrepreneurs, venture capitalists and other members of the venture support system to better understand and work with angels.

Though we conducted interviews only in the Silicon Valley and the Boston areas, the findings may be applicable to other areas of the US and overseas. Angels and angel groups in other parts of the United States (and abroad) can be located through the MIT Enterprise Forum local universities, small business development agencies, venture law firms, venture related accountants and web searches for angel funds.

We are very interested in the current evolution of organized angel groups. The organized angel group framework starts to outline the critical elements for employing the power of angels investing in groups. We would be very interested in feedback as angel groups evolve their models.

Please email your comments to angels@mit.edu. To order copies of this study please contact Lucinda Linde at lmll@worldnet.att.net.

Appendices

A. Illustrative Term Sheet: Angel Investor
(Participating Convertible Preferred)

B. Illustrative Term Sheet: Angel Club
(Convertible Redeemable Preferred)

C. Illustrative Term Sheet: For-Profit Matching and Investment Organization
(Convertible Preferred)

D. Detailed Table of Contents

Appendix A: Illustrative Term Sheet: Angel Investor (Participating Convertible Preferred)

<u>Company A</u>
A California Corporation

Terms of Series C Preferred Stock Financing

Issuer:	Company A (the "Company").
Security:	Series C Preferred Stock.
Amount of Series C Financing:	5,000,000 shares of Series C Preferred.
Price:	$1.00 per share of Series C Preferred Stock, for an aggregate purchase price of up to $5,000,000.
Dividends:	The holder of the Series C Preferred shall be entitled to receive dividends at a rate of 8% of the Original Purchase Price per annum when and if legally declared by the Board of Directors. The holder of Series C, Series B and Series A shall receive dividends in preference to any dividends on Common Stock.
Liquidation Preference:	The holders of the Series C, Series B and Series A Preferred will be entitled to receive in preference to the holders of the Common Stock an amount equal to their Original Purchase Price per share plus all declared but unpaid dividends (if any). Series B and C Preferred will be participating so that after the payment of the Original Purchase Price (plus unpaid dividends, if any) to the holders of Series B and C Preferred, the remaining assets shall be distributed pro rata to holders of Series B and C Preferred and Common on a common equivalent basis until the holders of Series B and C Preferred have received an aggregate of two (2) times their Original Purchase Price (including the preference amount set forth in the preceding paragraph). Thereafter, all remaining assets shall be distributed pro rata to the holders of Common Stock.

Conversion:	A holder of the Series C Preferred shall have the right to convert the Series C Preferred at the option of the holder, at any time, into shares of Common Stock. The total number of Common Shares into which the Series C Preferred may be converted initially will be determined by dividing the Original Purchase Price by the “Conversion Price”. The initial Conversion Price shall be the Original Purchase Price. Initially, each share of Series C Preferred will convert into one share of Common Stock.
Automatic Conversion:	All Preferred shares automatically will be converted into Common upon (1) the closing of an underwritten public offering of shares of Common Stock of the Company at a public offering price per share (prior to underwriting commissions and expenses) in an offering of not less than $10 million, before deduction of underwriting discounts and registration expenses or (2) approval of a majority of the Preferred.
Antidilution Protection:	The Conversion Price of the Series C Preferred shall be proportionately adjusted in case of subdivisions, stock dividends, combinations, consolidations or reclassifications of Common Stock. The Conversion Price shall be subject to full ratchet antidilution protection till July 31, 2000 and broad based weighted average dilution adjustment thereafter.
Voting Rights:	The Series C Preferred will vote together with the Series A and Series B Preferred Stock and with the Common Stock and not as a separate class. Each of Series C Preferred shall have a number of votes equal to the number of shares of Common Stock then issuable upon conversion of such shares of Series C Preferred.
Protective Provisions:	For so long as any shares of Preferred remain outstanding, consent of the holders of at least 50% of the Preferred then outstanding, voting as a single class, shall be required for any amendment of the Articles of Incorporation, bylaws, or other charter documents of the Company which (1) adversely alters or changes the rights, preferences, or privileges of any Preferred Stock, or (2) increases or decrease the authorized number of shares of Preferred Stock.

Restrictions or Transfers:	The Company will have the right of first refusal to purchase an investor's shares if the investor seeks to sell or otherwise transfer investor's Series C Preferred or the Common Stock into which such Series C Preferred is converted to a competitor of the Company. This provision shall terminate upon a registered public offering of the Company's Common Stock.
Registration Rights:	Demand Rights: If investors holding at least 10% of the Preferred (or Common issued upon conversion of the Preferred or a combination of such Common and Preferred) request that the Company file a Registration Statement for at least 20% of the their shares, the Company will use its best efforts to cause such shares to be registered; provided, however, that the Company shall not be obligated to effect any such registration prior to the earlier of (1) December 31, 2000 and, (2) Within six months following the effective date of the Company's initial public offering. The Company shall not be obligated to effect more than two registrations under these demanded right provisions.
	Company Registration: The holders of the Preferred shall be entitled to "piggy-back" registration rights on registration of the Company's shares or on demand registrations of any later round investor subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered pro rata in view of market conditions.
	S3 Rights: The holders of the Preferred shall be entitled to two demand registrations on Form S-3 (if available to the Company) so long as such registration offerings are in the excess of $3,000,000.
	Expenses: The Company shall bear registration expenses (exclusive of underwriting discounts and commissions and special counsel of the selling shareholders) of all demands, piggy-backs, and S-3 registrations. The expenses of any special audit required in connection with a demand registration shall be borne *pro rata* by the selling shareholders.
	Transfer of Rights: The registration rights may be transferred provided that the Company is given written notice thereof and provided that the transferee receives at least 100,000 shares.

Other Provisions: Other provisions shall be contained in the Series C Preferred Stock Purchase Agreement, the Exchange Agreement, and such other documents acceptable to the Company and the holders of the Preferred, with respect to registration rights as are reasonable, including cross-indemnification, the period of time in which the Registration Statement shall be kept effective, standard standoff provisions, underwriting arrangements and the ability of the Company to delay demand registrations for up to 90 days (S-3 Registrations for up to 60 days).

Purchase Agreement: The investment shall be made pursuant to a Series C Preferred Stock Agreement and other related documents reasonably acceptable to the Company and the investors. Such agreements shall contain, among other things, appropriate representations and warranties of the Company and covenants of the Company reflecting the provisions set forth herein and appropriate conditions of closing, which will include, among other things, qualification of the shares under applicable Blue Sky laws and filing of Amended and Restated Articles of Incorporation. Unless expressly excluded by this Term Sheet, such documents shall contain such other provisions as are customary in connection with venture financings. Purchasers who purchase in the aggregate more than 300,000 shares may elect to purchase a portion of their shares in equal monthly installments provided that the first installment is purchased by July 15, 1998 and all of the remaining shares are purchased by December 31, 1998. The installment purchase arrangement shall accelerate with the closing of a Series D financing, or, at the decision of the Board, if the Board reasonably believes that the undelivered portion is necessary to execute its Plan.

EMPLOYEE MATTERS:

Employee Pool: At July 2, 1998:

(a) 2,300,000 shares of issued and outstanding Common Stock held by the Founder;
(b) 65,000 shares held by relatives of the Founder;
(c) 2,935,000 shares of Common Stock reserved for issuance pursuant to the Company's 1997 Stock Plan to employees and contractors of which 436,128 have been granted.

Proprietary Information and Invention Agreements: Each officer and each employee and consultant of the Company with access to proprietary information of the Company shall enter into an acceptable proprietary information and invention agreement.

Appendix B: Illustrative Term Sheet: Angel Club (Convertible Redeemable Preferred)

<u>Company B (the "Company")</u>
<u>Summary of Terms</u>
Series A Convertible Redeemable Preferred Stock
To be Purchased by Individual Early-Stage Investors (Collectively "Angels")
January 14, 1999

Summary:	This Angel round is intended to be provide Company B with seed capital and advice from the Angels to help Company B grow rapidly and attract additional Venture Capital ("VC"). It is proposed to be done at a valuation of the lower of: $3,000,000, or a price such that there is a 30%-50% step-up to the next VC round, depending on its timing, at terms no worse than future rounds of financing. In the event there is no next round, because the company self-funds or is sold, then the terms and conditions proposed are those typically entered into in a VC round.
1. Amount and Security:	$500,000 -$750,000 Series A Convertible Redeemable Preferred Stock. Company is or will be incorporated as a C Corp. in Mass. or Delaware. Angels consists of individual accredited investors who are, individually, solely responsible for their investment decisions and who each understand the risks and have experience with investments in early-stage companies. They are affiliated with Angel Club X, which has no involvement in this transaction whatsoever, other than to have facilitated introductions between the Company and Angels. Total investment amount to be estimated at time term sheet is accepted. No commitment to close at this amount can be made, and the amounts may vary as Angels make their decisions individually based on terms, due diligence and advice of their counsel.
2. Price:	$3,000,000 pre-money valuation. Share price to be based on the fully diluted, as-converted basis of: all equity, options, loans (if convertible), share commitments to founders and lead employees, and a 20% option pool for key employees to be recruited; by dividing $3,000,000 by the fully-diluted total number of shares.
3. Adjustable Warrant:	To provide an incentive to Angels for their early involvement and advice, each Series A investor will receive an adjustable warrant to purchase additional Series A at a price of $0.01 per share, the number to be determined by the next round valuation. The next round to be considered as the basis for a final computation of the adjustable warrant, shall be the next one in which at least $2,000,000 is raised by the Company (the "New Round"). The warrant shall expire and not be exercisable if the New Round is raised at a per share price of at least 50% above the share price of the Series A shares, on an as converted basis. Otherwise, the warrant will convert into sufficient shares so that there is a 30% step-up in the effective

	price per share to the New Round, if completed within 3 months of closing; or, the warrant will convert into that number of shares so that there is a 40% step-up in the effective price per share if the New Round is completed between 3 and 6 months from the closing; or if there are over 6 months until completion of the New Round, into sufficient shares so that there is 50% step-up in the effective per-share price. The warrant shall be exercised immediately after completion of the New Round and will expire 60 days following its closing.
4. Timing:	Company B will have until January 29, 1999 to accept this term sheet or renegotiate its terms and return a signed mutually agreed-upon copy. Company counsel will deliver initial document for review by Angels within two (2) weeks from acceptance of this term sheet to John Doe, who will coordinate the Angels review and negotiation of terms, but has no responsibility for the decision of other Angels. The financing will be completed within 1 week of when definitive closing documents are delivered to interested Angels by the company's counsel. The terms and conditions will be structured as defined herein.
5. Board of Directors:	Three initially: the CEO, One Angel designate, and one unaffiliated chosen by mutual agreement during negotiations, and whose future replacement will be chosen by majority vote of the Board.
6. Redemption:	Series A will be convertible into common stock at any time at the holder's option, initially on a 1-1 basis with common. The Series A shall be required to convert automatically to common stock in the event that shares are offered to the public at a minimum price of 5 times cost, as adjusted, with an offering size of not less than $15 million. A mandatory redemption, with 10% annual cumulative compounded dividends, will be made at the sixth anniversary of the closing of this round.
7. Voting Rights:	One vote per common equivalent share.
8. Anti-Dilution:	Preferred stock will have standard anti-dilution protection in the event of stock splits, stock dividends or similar recapitalizations. In the event that other shares (except to employees or under a board approved stock incentive plan) are sold at less than the prevailing per share price, the conversion price of the Series A shall be adjusted using the weighted average method.
9. Liquidation Preference:	Series A Preferred has liquidation preference, including any dividends if declared, on merger, sale or liquidation.
10. Negative Covenants:	Approval by majority of holders of Series A Preferred on a common equivalent basis of all major organic changes outside normal course of business, including but not limited to sale, liquidation, or merger, increase in board seats or change in election procedures, creation of new securities and any material loans, investments or capital expenditures.

11. Preemptive Rights:	Standard.
12. Representations and Warranties:	Standard.
13. Financial Statements:	Monthly actual vs. plan and prior year, until New Round. Also quarterly financials within a month of quarter-end and annual budget prior to beginning of fiscal year and annual audit by national firm distributed to all investors. All recipients of financial statements to execute non-disclosure agreement acceptable to Company counsel.
14. Registration Rights:	Two demand registrations, subject to $2 million value trigger, unlimited piggybacks, and evergreen S-3 if requested and possible all at company expense. Investors will agree not to force an initial public offering.
15. Best Term Offered:	In the event investors in a future round negotiate better terms than the Series A Investors, at the time of closing, the Series A Preferred Stock terms will be amended and adjusted to terms no worse than those obtained by new investors and all new rights will be apportioned *pari-passu* to Series A shareholders. In the event the New Round is negotiated on substantially different terms and to facilitate investment by VC's, Angels will, on recommendation of its Board Representative and upon approval of a majority of Series A shares outstanding, modify terms of the Series A Preferred Stock to coincide with those of the venture investors, with the exception of the share price and warrants.
16. Founder's Stock:	All equity allocation to founding employees is to be completed prior to closing and to have vesting (or repurchase rights) similar to employee vesting.
17. Options and Vesting:	In addition to founders' shares, a pool for future employees of 20% of total post-financing shares will set aside. Options will vest over four years with a one-year blackout.
18. Employee Agreements:	Proprietary information agreements from everyone and two-year non-competes from key employees holding at least 2% common stock equivalent at grant time, in a form satisfactory to counsel.
19. Legal Fees:	Company will prepare closing documents. Company pays fees (not to exceed $5,000) and reasonable expenses for one Angel's counsel.

Appendix C: Illustrative Term Sheet: For-Profit Matching and Investment Organization (Convertible Preferred)

Term Sheet for Private Placement of
Series A Convertible Preferred Stock of Company C

This Term Sheet summarizes the principal terms with respect to the private placement of Series A Convertible Preferred Stock of Company C (the "Company") a Massachusetts corporation. To the extent that any terms herein comprise a summary of the definitive agreements referenced below and attached to the Company's Business Plan, such terms shall be qualified in their entirety by reference to the terms and provisions of such definitive agreements. In the case of the rights, preferences and restrictions relative to the Series A Convertible Preferred Stock, prospective investors are invited to review the Company's Certificate of Incorporation, copies of which are available upon request.

Issuer:	Company C.
Amount of Investment:	$4,202,000 (of which $2,202,000 was closed in 1998 at the same share price with different warrant coverage).
Type of Security:	Shares of the Company's Series A Preferred Stock ("Preferred A"), convertible into shares of the Company's Common Stock ("Common")..
Purchase Price:	$5.00 per share.
Warrant Coverage	33.3% (i.e., every 3 shares of Preferred A will be accompanied by a warrant to purchase one share of Common of $5.00).
Manner of Offering:	The remaining available shares of Preferred A are being offered to a limited number of "accredited" investors to be issued and sold in one or more additional closings.
Capitalization of the Company:	Series A Convertible Preferred Stock Issued and Outstanding: 440,000. Additional Series A Convertible Preferred Stock Authorized: 400,000. Common Stock Warrant Coverage Authorized for Additional Series A Convertible Preferred: 133,000. Common Stock Issued and Outstanding: 646, 036. Common Stock Reserved for Previous Warrant Coverage: 166,296. Common Stock Reserved for Employees Options: 300,000.

Rights, Preferences, Privileges, and Restrictions of Preferred A Stock	(1) *Dividend Provisions:* The holders of the Preferred A are entitled to receive dividends at the rate of 10% per annum of the Purchase Price whenever funds are legally available and when as declared by the Board or upon the sale or liquidation of the Company. Dividends on the Preferred A are cumulative. Dividends are forfeit if not paid prior to conversion. (2) *Liquidation Preference:* In the event of any liquidation, dissolution, or winding up of the Company, the holders of Preferred A will be entitled to receive in preference to the holders of Common an amount ("Liquidation Preference") equal to the Purchase Price, plus any dividends declared on the Preferred but not paid. (3) *Conversion:* A holder of Preferred A will have the right to convert Preferred A, at the option of the holder, at any time, into shares of Common. (4) *Automatic Conversion:* The Preferred A will be automatically converted into Common, at the then applicable conversion price, upon the closing of a sale of the Company's shares of Common Stock pursuant to a firm commitment of underwritten public offering by the Company at a public offering price per share (prior to underwriter commissions and discounts) that is not less than $10.00 and in which the total gross proceeds to the Company are at least $20,000,000 (a "Qualified Public Offering"). (5) *Antidilution Provisions:* The conversion price of the Preferred A will be subject to adjustment (I) for stock dividends, stock splits, or similar events; and (II) on a weighted average basis to prevent dilution in the event that the Company issues additional shares at a purchase price less than the applicable conversion price. Conversion prices will not be adjusted because of (a) conversion of Preferred A Stock, or (b) the issuance and sale of, or the grant of, options to purchase shares of the Common pursuant to the Company's employee stock purchase or option plans (the "Reserved Employee Shares"). (6) *Voting Rights:* Except with respect to election of Directors (see "Board Representation" below), a holder of Preferred A will have the right to that number of votes equal to the number of shares of Common issuable upon conversion of its Preferred A at the time the shares are voted. (7) *Protective Provisions:* Consent of the holders two-thirds of the outstanding Preferred A will be required for any action: (I) to sell or merge or consolidate the Company with another entity; (II) to change the rights of the Preferred A so as to affect adversely the shares of such series; (III) to create any new series or class of shares having a preference or priority as to voting, dividends or assets superior to or on a

parity with that of the Preferred A including any security convertible into or exercisable for shares of stock with any preference or priority as to voting, dividends or assets superior to or on a parity with that of the Preferred A; (IV) to redeem any shares of Common or Preferred Stock, except as contemplated by the terms of the Preferred A or from employees, advisors, officers, directors, consultants, and service providers of the Company on terms approved by the Board; (V) to in any manner alter or change the terms or other rights of the Preferred A; or (VI) to reclassify any Common or other "Junior" Stock into shares with a preference or priority as to dividends or assets superior to or on a parity with that of the Preferred A or which in any manner adversely affects the rights of the Preferred A; (VII) Any additional rights granted to past or future classes of stock that are superior to rights granted to Series A Preferred will also be granted to holders of Series A Preferred.

Registration Rights:	The Investors shall have certain demand, piggyback, and S-3 registration rights and related rights, and information rights, all as detailed in the Registration Rights Agreement (available on request).
Board Representation:	The Preferred A (voting as a class) have the right to elect two directors, on of which will be a representative of Investing Organization A.
Use of Proceeds:	The proceeds from the sale of the Preferred A will be used for working capital.
Right of First Refusal:	In the event that subsequent to this private placement, the Company offers equity securities (other than Reserved Employee Shares, or upon conversion of outstanding Preferred, or upon exercise of outstanding options or warrants, or in connection with an acquisition or in a public offering), each investor who holds the Preferred A issued in this private placement shall have a right of first refusal to purchase the same percentage of equity securities issued in such subsequent offering as the number of shares held by such investors bears to the outstanding securities of the Company. This right will terminate upon a firm commitment of an initial public offering as described above.
Co-Sale Agreement:	The founders of the Company have executed a Co-Sale Agreement (copies available upon request) in which if any founder proposes to sell more than 25,000 shares of the Company, each investor will be entitled to participate in such sale by selling the same percentage of his stock as such founder is selling of such founder's Common. This right will terminate upon the Company's Qualified Public Offering.

The Stock Purchase Agreement:	The purchase of the Preferred A will be made pursuant to a Stock Purchase Agreement (with exhibits) as amended by certain Instrument of Amendment to the Stock Purchase Agreement (copies available upon request). The Stock Purchase Agreement contains, among other things, representations and warranties of the Company, covenants of the Company, and conditions to the obligations of the investors.

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