



Book The Angel Investor's Handbook

How to Profit from Early-Stage Investing

Gerald A. Benjamin and Joel Margulis
Bloomberg Press, 2001

Recommendation

Gerald A. Benjamin and Joel Margulis tell the current or prospective angel or early-stage investor how to best judge pre-IPO investments. They emphasize matching investors with the right entrepreneurs to create an effective team in which the investor not only provides the seed or early-stage capital but also contributes good advice and contacts. Besides discussing effective strategies, the book includes an extensive directory of top venture forums, angel organizations, publications and Web sites. In addition, any investor will benefit from the thorough rundown of due-diligence points that the authors recommend. While the book is targeted at prospective investors, *BooksInShort* encourages entrepreneurs with start-up companies to use it as a productive guide to making more effective funding pitches, although the companion book for entrepreneurs would probably be more helpful. One caveat: Some ideas are repeated – even with similar wording – from chapter to chapter. But overall this is a solid book, even though the free flows of money it evokes have been arrested somewhat lately.

Take-Aways

- A growing number of private investors have become angel investors seeking more ventures, more available capital and better survival rates for new companies.
- The average private investment is \$100,000, ranging from \$10,000 to \$2 million.
- Most angel investors come from the nearly one million high net-worth, U.S. households.
- The riskiest angel investments are at the seed, R&D and start-up levels.
- Less risky angel investments occur when a company is more developed, and reaches the bridge, turnaround or acquisition-and-merger stages.
- Most angel investors are white males 46 to 65 years old.
- Typically angel investors not only invest but also contribute advice.
- To be a successful angel investor, assess your tolerance for risk and be strategic about your criteria for investing.
- Angel investors find deals through personal contacts and professional referrals.
- To develop good deals, set up a deal-flow process and conduct due diligence by assessing an executive summary and business

plan.

Summary

The Growth of Angel Investing

Today, a growing number of private investors are investing a growing pool of capital. About five years ago, the average private corporate investment was \$25,000 to \$50,000; now it is \$100,000, based on an average of \$10,000 to \$2 million per investment. This approach creates a great opportunity for income generation. About 90% of all U.S. millionaires gained their wealth through their own efforts, not by inheriting money. They know a successful start-up can be extremely profitable.

Most private investors in the United States come from the nearly one million, high net-worth households. Investors can participate at these stages:

- Seed - The idea stage when a company is first being organized.
- Start-up - The end of product development and the start of initial marketing.
- R&D - The product-development and financing stage for more developed companies.

“Angel investors wish to be high worth investors, not just high net worth investors.”

Or investors can join in, with less risk, at these later stages:

- Bridge - The stage where a venture needs short-term capital to become stable.
- Acquisition and merger - When a company wants funding to acquire another company.
- Turnaround - When a firm wants to move from unprofitable to profitable.

“Ninety percent of all millionaires in the United States are self-made, not inheritors of wealth.”

Currently, private investors put about \$40 billion a year into some 140,000 early-stage companies, about 4% of the 3.5 million U.S. start-ups annually. Each year some 400,000 angel investors provide entrepreneurs with pivotal funding to launch their companies when they cannot fund institutional investors or lenders. Typical angels are 45- to 65-year-old white males, including retired corporate officers or former CEOs of small high-tech companies. And, typically, angels make four investments a year or fewer.

Who Are Angel Investors?

Private investors who become angels are typically wealthy individuals or families willing to invest in high-risk deals to realize high potential returns. They have discretionary money to invest and can be patient with long-term buy-and-hold situations. They know they won't get their money back in the near term.

Generally, angels do more than just invest - They contribute advice on how to develop products or services. They may draw on their contacts to help the new business. Besides investing money, most are value-adding, active investors, who take an active role in contributing their own expertise. Often they will participate as a director, if willing to take the legal exposure, or act as an adviser or consultant. Many like investing near where they live, up to 300 to 500 miles, so they can participate more actively, including making an occasional trip to visit the company. Some help with managerial skills, such as developing strategy, making financing decisions and creating effective hiring practices. They may also help entrepreneurs by connecting them with prospective customers, vendors, suppliers, distributors and financial institutions.

“Founders, their family and their friends continue to initially finance the majority of all small businesses, start-up and expansion ventures in North America.”

These investors must cope with the lack of analysis of the pre-IPO (initial public offering) marketplace, which precludes a comparative analysis. Instead, more than 50% of all angels join deals with an entrepreneur's family members, friends, associates and

colleagues. They generally look at few plans and are thus less likely to find deals with the greatest potential.

“Angel investors represent patient money, remaining comfortable with long-term buy/hold strategies, money that often won’t be available in the near term.”

Most commonly, angels get involved once transactions are more than about \$450,000. Before then - in the seed and R&D stages, the founder’s family and friends are the major sources of funding. However, many angels get involved in smaller deals, beginning at about \$250,000, in cases where they understand and appreciate the technology. Angels also invest their own money, in contrast to institutional investors - who are really venture capitalists managing other people’s money, such as pensions, insurance funds and endowments.

Being a Successful Angel Investor

You might want to become an angel investor to pursue the chance of hitting a home run, to be involved with a new or emerging company, and to be able to influence the outcome of your investment. Some of the skills you’ll need to succeed include:

- The ability to generate or create deal flow, so you can find the potential investments most worthy of your time and money - generally only 5% of all the deals you review.
- The patience to conduct thorough due diligence, carefully reviewing the business plan, management, financial records and other factors in light of your own investment criteria.
- Skill in structuring the deal and negotiating the terms of your investment agreement.
- An ability to assess risk and develop risk-management strategies.
- The discipline to identify exit opportunities, should you want to leave the project.

When you investigate a particular deal, be sure the company has technology that can be a driving force in securing market share, a thoughtful business plan and an expert management team. Conduct an extensive check of the team’s character and personal histories.

Be clear about your own involvement. Do you want to be active or passive? Can you afford to lose your initial investment? Many successful investors provide incremental funding based on performance. This way, you give the entrepreneur more money in stages, based on achievement of projected results.

“Angel investors number in the hundreds of thousands and are proliferating at a rapid rate. These affluent individuals provide entrepreneurs and new ventures with needed venture capital, especially when more traditional sources of capital, such as investment banks and larger money management venture capital firms, are not willing to get involved.”

Define the industries, markets and technologies that most interest you before you seek deals. Spell out the level of risk you find acceptable and elucidate procedures to protect yourself from loss or to minimize your downside risks. A full 39% of the investors studied here reported a total loss, partial loss or some kind of write-off or tax benefit resulting from their investment.

“The primary objectives of venture capital or angel investing is an active investment approach, and the successful active investor requires a complex set of technical and interpersonal skills.”

Be cautious, because some entrepreneurs over-value their ventures or are unrealistic in what they project. As an investor, assess risk carefully. Many angel investors want the founders to show their commitment by investing some of their own money. In this case, look for the percentages of the person’s income that is invested - it should be a significant amount.

Still, whether you earn money or not, some non-financial returns on angel investments are also critically important, such as creating jobs, developing a socially-useful technology, contributing to urban revitalization, promoting women or minority ventures, and feeling satisfaction at helping entrepreneurs build their ventures.

Setting Your Investment Strategy

Manage the potential peril of illiquidity by using risk and hedging strategies. Never invest money you can’t lose entirely or that you can’t have put out of reach for a long time.

“When the level of investment risk is very high and the stage of entrepreneurial firm development is early - as it is in seed and R&D - the founder, friends and family are typically financing the deal.”

Ask yourself what types of risk you are willing to tolerate. If you have a low tolerance, keep your investment to five percent to 10% of your equity portfolio. If you have a high tolerance, consider investing more. To hedge against risk, consider structuring transactions with available security or collateral.

“As the deal moves closer to the start-up stage - eliminating the risk associated with the pre-seed, seed and R&D stages - we see business angels entering the picture, usually when the transactions begin to exceed approximately \$450,000.”

Do you want to invest in a single company or a more diversified group? Which industry do you prefer? Often, investors differ in their approaches based on their own expertise. Investors who are experienced in an industry may be interested in more active roles, as may more experienced angel investors. Some investors become manager/investors. Other investors use a professional services business or a development investment strategy, such as employing financial intermediaries, management consultants, lawyers and CPA's. Other strategies include making barter investments, seeking socially responsible investments or finding a fund-based investment assembled by an investment broker.

Deal Flow and Due Diligence

Typically, angel investors find their deals one of three main ways. According to International Capital Resources, of more than 9,000 angel investors, about 57% found their deals through personal contacts. Another 31% found their deals via referrals from professionals, such as attorneys, accountants, investment bankers, brokers and formal or informal angel clubs, and 12% from unsolicited contacts from non-family members of the company seeking financing.

Most angel investors have fairly limited deal flows through these traditional methods, primarily because individuals prize their privacy. As an angel, you face the danger of being overwhelmed with deals once entrepreneurs learn about you.

To obtain more opportunities without being overwhelmed, set up a deal-flow development process. Use a formal office or an alternate phone number and e-mail address to screen possible deals. Establish a positioning strategy based on which deals interest you most, company size, location, stage of development and the amount of investment needed. To get deals brought to your attention, you can use advertising or public relations. Possibilities include listing your name in printed directories and private equity databases, participating in venture forums, joining computer-matching networks, subscribing to angel and private equity newsletters, and joining venture capital clubs. Sponsor or speak at venture-related gatherings.

“Angel investors are concerned with the following classes of primary private equity classes because these classes position them in the pre-IPO market: seed, R&D, startup, first-stage, expansion stage, mezzanine, bridge, acquisition and merger, and turnaround.”

When you review deals, use the due diligence process to make a good decision. Ask screening questions. Request an executive summary, which should be organized, concise and clear. If you are still interested, carefully evaluate the company's business plan. It should contain information about the present stage of development, a description of products and services, and a discussion of venture objectives, current industry conditions, business strategy, competitors, existing and potential customers and key skills needed to reach development and manufacture. The plan should include information on the proposed marketplace, management team, source and use of funds, and financial statements and projections.

“Angel investors are usually males from 46 to 65 years of age.”

Conduct a pre-investment audit, where you carefully examine management, product and services, the industry, the market, sales and distribution, competition, human resources, suppliers, production, research and development, and financial projections. Can managers achieve their forecast objectives? Carefully assess the company's stated capital needs, balance sheet, liabilities, shareholder's equity and net worth, income statement, cash flow forecast, use of proceeds, and financial assumptions. Do reference checks on the company's investors, directors and advisors.

Next, think about how to negotiate and structure the deal and carefully express your terms. Reach a verbal agreement with the entrepreneur, but have an attorney create accurate documents. As the company develops, keep track of its value and assess its continuing financial performance. Identify your exit strategy, in case you want to cash out.

About the Authors

Gerald A. Benjamin is a senior managing partner of International Capital Resources, a capital-sourcing firm with 14 offices in North America. He is also senior editor of *The Private Equity Review*, chairman of the Northern California Venture Forum and executive director of the Private Equity Research Institute. **Joel Margulis** has written books on a range of subjects and is currently a university lecturer on writing. Both authors recently co-authored *Angel Financing*, which focuses on raising capital, the flip side of angel investing.
