Angel Investing 101

February 26, 2015

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Agenda

- Capital Sources For Entrepreneurs
- Who are Angel Investors?
- Why Angels join groups
- What is an Angel deal?
- Portfolio strategy for Angels
- Keys to success

Acknowledgment

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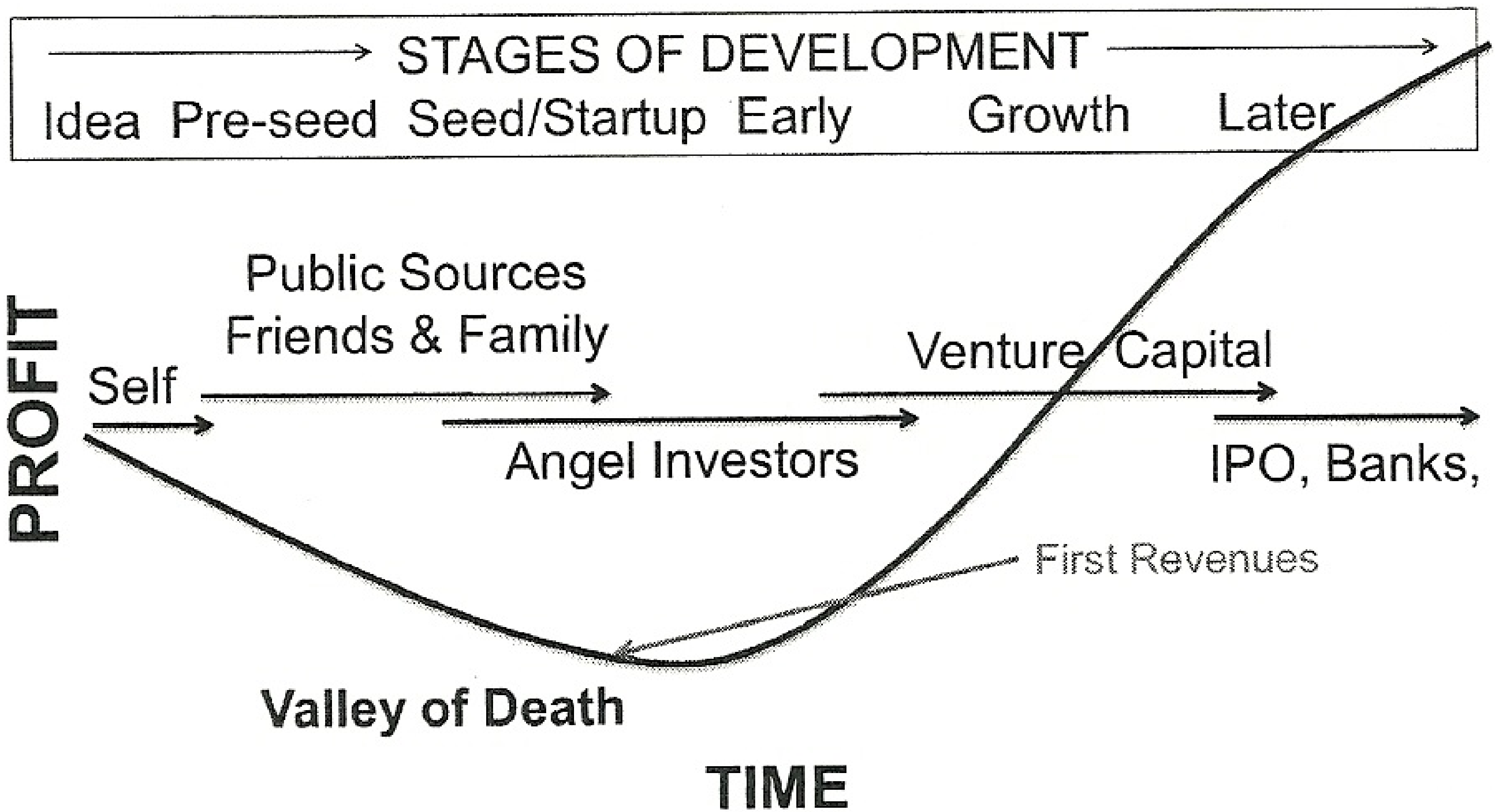
Capital Sources For Entrepreneurs

The Capital Lifecycle



Self Funding

- Proof-of-concept (Idea) Stage
- Bootstrapping
  - Keep day job/Consulting
  - Savings, RRSPs
  - Mortgage house, credit cards
- Full or Part-time commitment – sweat equity
- Government funding – i.e. IRAP, OCE, Fedev etc.

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Friends and Family

- $1000 to $250,000
- Huge source of Capital: $50 billion/year

  (Source: Global Entrepreneurship Monitor)
- Generally funding pre-revenue stage (pre-seed)
  - Sometimes F&F fund later stages as well
- Develop product, identify users, preliminary business plan
- Generally unsophisticated investors
  - May or may not have business experience (generally no professional investment experience)
  - Often structured as simple common shares or debt with little protection for investors

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Angel Investors: $100K - $1 million

- $20 billion per year (J. Sohl, CVR, U of New Hamp.)
  - 20,000 seed/startup ventures
  - 30,000 early and growth stage companies
- More sophisticated equity investors
  - Entrepreneurs and business people
  - Often have private equity investment experience but may or may not have Angel investment expertise
  - Expect to help and be fairly hands on
    - Mentoring & Director participation
- Most invest as customers begin to engage and the company is generating early revenue

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Venture Capital

- ~$20 billion/year (from NVCA)
  - 1000 first time investments
  - 2000 follow on investments into portfolio companies
- Seed stage venture capital: $500K to $2 million
  - Sometimes invest in pre-revenue companies (invest after Angels)
- Later stage venture capital (Series A or later): $2 million and up
  - Fund commercialization and growth stages
- Sophisticated fund managers
  - Will engage as Directors and have tight control over company via shareholder agreement/budgeting process

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Who are these Angels?

Angel Profile

- High net worth individuals – "accredited investors"
- "Been there, done that" entrepreneurs
  - Typically built and sold a business
- Generally want to be active investors – invest to engage
- Often prefer to invest in industries they are familiar with
- 85% white male aged 45 – 60
  - 10% - 15% women

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Level of Involvement

- Studies* show time invested in a company worth much more than money
  - Experienced entrepreneurs can save early stage companies from making critical mistakes
- Angel investor involvement ranges from:
  - Passive investor
  - Active investor/advisor
  - Board member
  - Lead investor – Chairman of the Board

*Source: Josh Lerner, Harvard Business School (2010)

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Angel Asset Allocation

- Should be non-critical "Mad money"
  - High risk/High reward
- Generally $25K-$100K per deal per angel
- Most Angels make several investments and take a portfolio approach
  - Research has shown that successful angels generally build a portfolio of 15 – 20 investments
  - 3-10% of personal assets
- More than 250,000 practicing Angels in N. America

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Motivation of Angel Investors

- Return on Investment is the primary metric
  - Expect higher returns than stock market in exchange for higher risk profile
  - Believe they can mitigate risk through active involvement and domain expertise
- Staying involved (sense of usefulness)
- Like to see new technologies/companies
- Give back to community
- Affection for entrepreneurs

Altruistic Motivations

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Types of Angel Investors

- Lone wolves – solo angels
- Informal Angel investment groups (2 – 10 investors)
- Professional Angel Groups
- Angel fund managers (very few of these)
- Incubators and Accelerators ($100K/7%)
- Super Angels (most are now VCs)
  - High profile wealthy tech industry entrepreneurs
  - Most now managing small seed or venture funds

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Solo Angel Investing (lone wolves)

- Process is very time-consuming as all functions including deal sourcing, reading plans, due diligence, term sheet negotiation, and post deal mentoring must be done by one person
- Due diligence is very difficult
  - Finding vertical experience
  - May require using outside experts
  - Legal support is expensive
- Don’t know other angels who would be investing
- May have to invest larger $ in less deals resulting in higher risk and less diversification

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Why Angels join groups

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Why Angels Join Groups

- Dividing the work eases the pain
  - Typical Angel group has 30 – 50 members
- Variety of vertical experience available
  - Can dramatically reduce risk
- Standardized processes and term sheets
- Administrative infrastructure to organize screening process, DD and investment meetings
- Pick and choose the deals you like from large deal sampling
- Much higher quality deal flow as all Angels are encouraged to bring in opportunities
- Great camaraderie among the like-minded

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What is an Angel Deal?

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High Growth vs. Lifestyle Companies

- Lifestyle companies:
  - Great income source for entrepreneurs
  - Organic growth
    - Generally no unique technology/channel to market
  - Flexible exits
    - Sell/Stay engaged into retirement/Give business to children
  - Not fundable by Angel investors (no anticipated exit)
  - No 10X - 20X return potential

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High Growth vs. Lifestyle Companies

- Fundable High Growth Companies:
  - High growth potential – Can become a $20M - $50M revenue company
  - Need investor's capital to grow
  - Exit strategy generally defined at outset
    - IPO (very unlikely)
    - Sell to public or private company with targets identified
  - Entrepreneur builds wealth through equity but not high income during growth phase
  - Generally want to make sure entrepreneur has significant "skin in the game"

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Typical Angel Group – Investment Criteria

- Geographical boundaries (i.e. within reasonable driving distance)
- Limits to capital and valuation
  - Raise amount of not > $1.5 million
  - Valuation between $1 - $4 million (median Angel valuations in the $1.5 - $2 million range in S. Ontario)
- Must be within certain industry verticals (often where Angel members have domain experience)
- Scalability ($20 - $30 million sales within 5 years)
- Development stage (e.g. seed/startup, early revenue)
- Some competitive advantage and not a lifestyle business

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Scorecard Valuation Method – Angel Rating System

Management team	**0-30%**	*Key metric – sometimes higher
Size of opportunity	**0-25%**	
Product & technology	**0-15%**	
Marketing/sales channels	**0-10%**	
Competitive environment	**0-10%**	
other	**0-10%**	

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Fundable Management Teams

- President/CEO
  - CEO experience - more than just technical expertise in the field
  - Has been successful in the past
  - Coachable (very important)
  - Strong leadership capabilities
- Management Team
  - Balanced and complete
    - No major holes
  - Experience working together

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Size of the Opportunity

- Scalable
  - $20 million (min.) in revenue in 5 years
  - Potential to get to > $50 million (VCs look for >$100 million)
- High gross margins (recurring revenue model ideal)
- Not extremely capital intensive
- Competitive advantage in the form of unique technology/IP, channel to market, untapped niche market, etc.

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Product/Technology

- Needs to be unique or have distinct competitive advantage
- Customer validation critical
  - Traction is everything!!
- Intellectual Property
  - Do we necessarily need protectable IP?
    - Patents: difficult to defend
  - IP: Can be valuable at exit
- Technology/Product differentiation versus IP is more critical

Sales/Marketing/Competition

- Must have clear sales strategy and channels to market
  - Needs to be scalable to facilitate rapid growth
- Customer acquisition costs need to be low and quantifiable
- Value proposition must be compelling and market position clearly defined
- Need to either be in an under serviced niche market or clearly have a significant competitive advantage in a crowded market space or a unique business model

Portfolio Strategy for Angels

Classic Assumptions

- Angel investments are a high risk asset class
  - Need to be able to afford to lose the investment
- A high percentage of Angel investments fail
  - Some studies suggest as high as 7 out of 10
- Shooting for home runs = 10X – 20X
- Seed/startup investment target IRR of 20% - 30%
- Not a lot of hard data as Angel investment as a practice has only been around for approx. 15 years

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Two studies by Prof. Rob Wiltbank, Willamette University

Nov. 2007

“Returns to Angel Investors in Groups”

North American group affiliated angels

Funded by the E. M Kauffman Foundation

May 2009

“Siding with Angels” (UK)

Funded by National Endowment

for Science, Technology and the Arts and

the British Business Angel Association

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Wiltbank Study

	US Angels (07)	UK Angels (09)
# of Angels	539	158
# Investments	3097	1080
# of Exits	1137	406
ROI	2.6X/3.5 yrs.	2.2X/4 yrs.
IRR	27%	22%
% of Deals /% of Returns	7% of Deals/ 75% of Returns	9% of Deals/ 80% of Returns
<1X	52%	56%

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Conclusions from Studies

- Returns are skewed
  - Over 50% do not return invested capital
  - Less than 10% provide > 75% of the ROI
- Therefore:
  - Angels need to focus on deals that will scale with potential of at least 10X return
    - No Lifestyle businesses as virtually same risk with less return potential
  - Angels should invest in many companies (10 – 20) in order to diversify portfolio and reduce risk

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Possible Portfolio Strategy

- Invest in 15 - 20 deals (lifetime objective)
  - Expect 50% to not return capital invested
  - Expect 30% to break even or deliver modest return
  - Expect 20% to provide all of the upside
- Investing in greater number of deals is better
  - Conversely, a small number of angel investments inappropriately increases risk
- All deals must have potential for 10X - 20X

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Size of Angel Investments

- Invest in at least 10 companies (lifetime)
  - Leave some powder dry for follow on investments
  - Average of two investments per company
  - Allocate funds for at least 20 investments in total
- Determine total personal assets set aside for angel investing (3%-10% of total assets is typical)
- Divide total commitment by 20 investments
  - Write cheques averaging this size for Angel deals

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Key Success Factors

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Keys to Success

- Thorough due diligence up front is critical
- Post-closing mentoring and coaching is a key success factor
  - Studies have shown that the amount of time spent on due diligence and mentoring is directly related to ROI
- Some additional success factors may be:
  - Investing in what you know
  - Coachability of the entrepreneur
  - Verifiable customer traction
  - A viable exit strategy
  - Amount of dilutive capital required
  - Unique IP, market or channel strategy

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Patience is required

- 1X return typically takes 2 - 3 years
- 10X is expected to take 4 - 5 years
- 20X could take 7 years or more
- Hint: Angels should not expect high portfolio yields (IRR) after only three years of investing!
  - This is a game of critical mass and patience

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Questions/Comments?

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