Angels: An Entrepreneur's Best Friend

By Joseph B. LaRocco

Entrepreneur's looking for funding amounts under $200,000 generally start with family and friends to raise needed capital for their business enterprise. They may need the capital to begin their business operations, start development of their product or service, or expand into other markets with their product or service that has already proven itself in the marketplace on a small scale.

Raising money from family and friends may be okay for a small amount of funding, but careful consideration should be taken if you go this route. An attorney should be used to draft the funding documentation so there are no misunderstandings later on if the business fails. Also, you have to give careful consideration to the affect on your relationship with those closest to you in the event your business fails and you are unable to pay them back.

Although entrepreneur's family and friends may be relied on for raising small amounts of capital, what happens when they need to raise significant amounts of capital, say $200,000 to $1,000,000? If they don't have enough assets or credit to obtain bank financing or don't want to put their personal assets at risk, then their best option is to seek "private equity financing." Private equity financing can be broken down into two main categories. These categories are Venture Capital firms and Angel investors.

Most Venture Capital funds, like hedge funds, manage large sums of institutional money. They are structured so that investors have to keep their money invested for five years during which time the Venture Capital firm invests the money for which the investors are charged management fees and performance fees. The investors in a Venture Capital fund do not have any input as to the investments that the fund is making on their behalf. Venture Capital funds also take significant equity positions (sometimes as much as 70 percent) in the companies they invest in, as well as management positions. Many Venture Capital funds now call themselves "Private Equity firms", probably because they didn't like the nickname "Vulture Capital" that was given to them by entrepreneurs.

Angel investors, on the other hand, typically take less control of the companies in which they invest, usually don't ask for management or director positions, conduct due diligence faster and can make their investment decisions quicker than Venture Capital firms. I guess you can see why they have been given the honorary nickname of "Angels."

Angel investors evolved as a result of wealthy private investors wanting to invest in start-up companies without having to invest through a Venture Capital firm. Many Angel investors come from an entrepreneurial background themselves and want to be involved in helping start-up or development stage companies. Angel investors share the entrepreneurial spirit and passion for success that a start-up company usually has, but of course, Angel investors still want to make a healthy return on their investment.

Evaluate your choices carefully, however. Usually, Angel investors are capable of funding $200,000 to $1,000,000, but anything above that may be difficult to raise from Angels. Also, they probably won't offer managerial expertise unless their background is in the same business field as your company. During your search for funding, you may need to talk and meet with many potential Angel investors. This will increase your chances of finding a few Angels who are willing to fund your start up company or provide the working capital or expansion capital you need.

If your management team does not need over $1,000,000 to execute their business plan or expand into other markets, then you should focus on meeting with as many Angel investors and Angel investor groups as possible. Locally, there is the Houston Angel Network, a non-profit organization that provides its members a forum in which to efficiently evaluate promising early-stage investment opportunities. Its membership consists of active and SEC-accredited angel investors who share the goal of making informed, collaborative investments in promising early stage Texas-based companies. Founded in late 2001, it is the largest and most active Angel network in Texas. Its members have provided 27 rounds of funding for 19 companies. Visit www.houstonangelnetwork.org.

There are numerous Angel Associations located throughout the United States. For a list of other Angel Associations located throughout the United States visit www.angelcapitalassociation.org. One word of caution though, your chances of success in raising Angel financing are much more likely if you meet with Angel investors in your area. Also, it will cost you less in travel. Imagine having to take a plane flight to meet with five or six Angel investors located in various states.

The process begins by submitting your business plan to potential Angel investors. If there is interest, a meeting is usually scheduled and then due diligence begins. Angel Investors usually conduct less due diligence than Venture Capital Firms, which usually means several weeks rather than several months. Preparation of the business plan is a vital first step in your quest for capital, so a great deal of time and effort should be spent preparing the business plan.

An alternative to sending out your business plan is to start out by sending potential investors an executive summary, which is a condensed version of your full blown business plan. This is a good way to get your “story” out there to interested investors. It also helps to narrow the field of potential investors before you send them your business plan.

Another important reason for going after Angel capital is that it is usually available on terms that are more acceptable to a management team and funding can be obtained in a much shorter time frame. Venture Capital firms may meet with you several times over several months. The due diligence process they put you through will be extremely painful; however, if you were seeking funding of $5,000,000 or more you should expect to be examined under a microscope.

Sometimes groups of as many as five or 10 Angel investors may act together to invest in several companies. Investing as a group in several companies allows them to diversify their investments and spread their risk of loss.

In determining the amount you want to raise when you approach Angel investors detail in your business plan at least that amount that you feel will help you to achieve a net profit. This is a common mistake many start-up companies make. They don’t plan ahead for when they run out of capital and cannot sustain growth from cash flow. Going for a second round of financing when you couldn’t achieve your goals with the first round will greatly reduce your bargaining power on financing terms and will probably result in loss of voting control of your company.

It is very important to carefully analyze the amount you need in your first round of financing. If you can't raise the full amount you need, you are probably best advised not to start out undercapitalized.

Seven Essential Angel Investor Tips:

1. Talk with and meet with as many Angel Investors as possible. Raising capital is just as difficult and arduous as running a successful company. If you can meet with 50 potential investors do it. Listen to what they say and learn from their reasoning why they won't fund your company. This is valuable information. Adjust your business model if necessary. You don't know which investors will show interest and possibly fund your company. This process will be a little less formal than if you were going to a Venture Capital firm for funding. Angels will still conduct significant due diligence, however. Also, if you are lucky enough to have several Angel investors interested in funding, you can choose those that offer you the best terms, although usually several invest as a group all on the same terms. Example: You may have five Angels invest $100,000 each, but all on the same terms.

2. Find out if they have funded any companies that are your competitors. Maybe they are currently considering funding a company that could be considered a competitor. Ask them to sign a non-circumvention and non-disclosure agreement. Although it is always hard to know if they honor it, most people do. If you feel they do have too close a connection with one of your competitors then you might be wise to drop them as a possible funder. In that case do not send them your full business plan.

3. Time to call in legal counsel. At this stage you have one or more interested investors. You have a rough draft of a term sheet you are working off of, although not yet final. Either before or immediately after you start drafting the term sheet obtain competent legal advice. The money you spend on legal counsel to help you with the deal terms and understanding all the implications is money well spent. It will actually save you money and/or equity in your company. Just make sure counsel knows what "clawbacks" and "super preferreds" are; otherwise they won't be that helpful.

4. Ask for subsequent rounds of financing based upon milestones of gross or net profits. This gives you a built in funding source if you meet certain goals. It's great to have funding lined up for your second round so you don't have to go through this painful exercise again. If they cannot promise subsequent financing then offer them a right of first refusal. They will appreciate you trying to protect their interests in subsequent financing rounds.

5. Try to have a term sheet ready when the time comes to discuss financing terms. State the equity percentage you are willing to give up in your company. Find out if they want board representation and anti-dilution provisions. The questions you ask during the fund raising process will show your thoroughness and attention to detail. Also, how you negotiate with potential investors reveals to them how savvy and knowledgeable your management team is overall. Although you should negotiate aggressively on the terms that you feel are fair, it is easier to negotiate with Angel investors than it is with Vulture Capital firms, I mean Venture Capital firms.

An angel investor (business angel in Europe, or simply angel) is an affluent individual who provides capital for a business start-up, usually in exchange for ownership equity. Unlike venture capitalists, angels typically do not manage the pooled money of others in a professionally-managed fund. However, angel investors often organize themselves into angel networks or angel groups to share research and pool their own investment capital.

See Wikipedia, Angel Investing

6. Always ask for a "Clawback". A clawback allows you to buy back shares from the investor at a minimal price if you achieve a certain milestone. For instance, if you reach $4,000,000 in gross revenues in the second year after funding, then your company may repurchase 10 percent of the shares from the Angel investors for $.10 per share.

7. Can they also be a strategic partner or introduce you to potential strategic partners? In addition to being a funding source, they are also a strategic partner that may be able to help you with sales through either their own company, another company they have funded or through an overseas contact. Some Angel investors have great contacts and connections. Look at them as a funding source as well as a networking source. Maybe they can help you with advertising, marketing, manufacturing or internet sales.

It is important for your management team to be actively engaged in the money raising process. Funders like to see a management team with "fire in their belly." Be persistent and aggressive not only in your search for funding but also when it comes to negotiating financing terms. **N**

Mr. LaRocco has represented and advised numerous private companies concerning the internet, funding, and securities structures. He also has extensive experience advising hedge funds on numerous trading and investment strategies. More information is listed on angel-and-venture-capital-guide.com. Mr. LaRocco is an attorney who practices law in New Canaan, CT, and is currently General Counsel and a Director of NetSky Holdings, Inc. (netskyholdings.com).