

The Perspective from BlueLake® “Angel Investors”



Reader,

This is the eleventh edition of the BlueLake Partners' Newsletter – **The Perspective from BlueLake**. The Newsletter is published periodically and focuses on subjects ranging from the economy, to the stock market, to trends in technology, to strategic investment and management issues or other topics that we think timely and relevant to our readers. We hope you find it informative and thought provoking, and we welcome any suggestions or thoughts on the content.

Sincerely,

BlueLake Partners, LLC

Straight to the Point

Characteristics that arouse angel interest:

- Not too much money
- “Protectable” aspects
- Well-developed offering
- Experienced team
- Sound business model
- Focus
- Prospect of big return
- Right time horizon

Introduction

This paper is intended to help entrepreneurs in young companies understand angel groups and how they work. It's one person's feel of the angel investing elephant.

First, some definitions and statistics.

An angel investor is a private individual, frequently a technology or real estate entrepreneur, who has had a liquidity event, or someone acting on behalf of family money, who provides limited amounts of equity investment to early stage companies. Angel investors should be accredited investors as defined by Rule 501(a) of Regulation D under the Securities Act of 1933.

Accredited investors (see your lawyer for a detailed, legal definition) are individuals who meet one or more specific criteria, such as (1) having a net worth, individually or with your spouse, greater than \$1,000,000 or (2) having had income in the two prior years of greater than \$200,000 individually or \$300,000 with your spouse. There are other criteria.



An angel investment group is an organized group of angel investors. Usually an angel group has regular meetings and activities.

The number of angel investing groups seems to be increasing. The economy is picking up; a lot of entrepreneurs have some cash available; and stock market returns of late haven't been wonderful, so people with cash are seeking other ways of finding good returns.

The Center for Venture Research at the University of New Hampshire indicates that in 2003 there were:

- 220,000 active angel investors in the U.S.,
- funding 42,000 ventures,
- with an average of 4-5 investors joining forces to fund each company.

About half of the angels in organized groups invested in 2003.

Another term: you'll see the term "due diligence" used frequently. It's the process of finding out about the company under consideration in depth to determine if there are any hidden problems that would make investors shy away. Due diligence usually involves activities such as:

- lots of meetings
- interviewing staff and board members
- reference checks on the staff, and checking to see that they've signed employee agreements
- a detailed review of financials
- checking the company's intellectual property position
- talking with customers (if any)
- reviewing the equity situation – who owns what portion of the firm's equity?
- possibly reviewing the basic corporate documents – incorporation, board minutes, etc.
- checking for lawsuits or other liabilities
- and more...

How do angel groups work?

Angel groups are all different, and when you contact a group, find out how it works.

Most groups are set up as a loose association of members. (There's a chair or manager who does a lot of the work of tracking deal flow.) The members pay a fee annually and invest in ventures as individuals. One result of this approach can be that ventures find enthusiasm among a small number of angels in a group, without a large enough amount of money involved to make investing



worthwhile. The interested investors will say, “Find enough additional investors to bring the total round up to \$X, and we’ll invest; otherwise not.” The venture, meanwhile, has ridden the roller coaster of excitement about investor interest, followed by the long process of due diligence, followed by the realization that the fund-raising process must continue.

A few groups require their members to place funds in a pool that is invested by a committee of the group. In this kind of group individual members may invest alongside the group investment.

Typically, an angel group will have a meeting once a month, at which the members hear presentations from some number of companies; possibly as few as one, possibly as many as five or more. Meetings also include news about ventures in which the groups have invested, due diligence progress reports, and some networking time.

For a venture presenting in one of these meetings, there’s usually a limited time slot in which to describe the company, 10-20 minutes, plus time for questions and answers. The ventures that have presented their plans are then asked to leave while the angel group members discuss the venture.

(By the way, some groups charge a fee for presenting to their angels. Be sure to check in advance to see if this is the case.)

After discussion, there’s a mechanism for expressing interest. Sometimes the angel group leader will ask for a show of hands of those interested in both finding out more and taking on the task of due diligence. A leader of the due diligence team is selected and the leader deals with issues of scheduling, process, coordinating inputs from due diligence team members, and writing the report to the angel group.

One group I know passes a clipboard around to get sign-ups of those interested and lets the company contact those individuals. Due diligence in this group is done more on an individual basis, with some of the interested angels comparing notes. (Most angels groups are constantly striving to make sure that their process is useful for presenters and efficient and useful for their members.)

Deal flow

Business plans and executive summaries come in to angel groups through a variety of channels. Members see companies and refer them. Some angel groups have web sites with opportunities for plan submission. Some professionals, such as attorneys or accountants, refer plans to groups. Individual



angel groups usually have criteria, formal or informal, for what constitutes a venture they'll look at. Most Boston-area angel groups have a strong interest in technology-based companies and are unlikely to consider, for example, a dry cleaning establishment as a possible investment.

Usually the head of the group will do a quick screen in a phone conversation and deter those companies that just don't fit.

As there are usually many more companies submitting plans than agenda openings, most angel groups have screening or review committees that work in one of several ways. Each review committee member may be sent all of the plans received during the month for review, comment and a vote of yes, no, or maybe, which is shared with the other screening committee members. In some groups, the ventures that have passed the initial screen are invited to make abbreviated presentations to the committee. In other groups, the review committee meets collectively to discuss the candidates based on the documents received and initial reviewer comments, but in either case, the ventures that will present to the main angel group are selected.

A note for entrepreneurs: it helps to be known to someone on the review committee. Find out who's on the review committee, and if it turns out there's someone you know slightly, it won't hurt to e-mail or phone the person and let them know that you're applying to present. Ask for advice; ask for comments on your presentation (if the review committee member has time); ask if there are any questions. It will help in the committee meeting to have someone say, "I've talked with them. They sound interesting and although the plan doesn't really emphasize it, they've got some new ideas. I think our members would find this an interesting presentation."

How angels look at investments

I've noted below eight characteristics of an investment that will arouse angel investor interest:

1. The company doesn't need a lot of money.
 - Why is this important? Angel investors don't have deep pockets. Consider the following scenario. An angel group digs deep and comes up with \$500K for a seed round investment in a biotech venture. The pre-money valuation is \$2 million, so the investors get 20% of the company for their money. But the company is going to need \$40 million over its life, before its drug gets to market. Angel investors can expect that the folks with big dollars will perform a "cram-down" diluting the early



- investors' equity position significantly, and the angel investors wind up with a tiny percentage.
2. The venture has “protectable” aspects or barriers to entry.
 - When little companies without a lot of money enter the market, they need an advantage if they're going to compete with the big companies. If there's nothing protectable about what the little company is doing, a big company can enter the market and out-spend the little one by so much that they vanish.
 3. The offering has been completely developed, or nearly so.
 - Ideas are cheap. Implementation is important. Why would an investor take both the development risk (Can they complete the product?) plus the marketing risk (Can they sell it to anyone?)? Investors would much rather take only the market risk. They'd rather invest at the point where their money will create revenues, not invest to create a product which will then require another round of funding to make an impact in the market.
 4. The venture has a team we feel really good about.
 - Investors love experienced teams that have made money before and can be articulate and compelling, discuss business models, markets, sales, competitors, execution, and all the other aspects of a successful venture. It's trite (because it's a true statement that's been said so often) but investors invest in people, not products.
 5. There's a good business model.
 - Angel groups see lots of technical founders who come to the group's meeting and say, “Here's my product. It's protected and there are barriers to entry. Isn't it great? Give me money.” If the presentation stops there, it's unlikely that investment will follow. Investors look for a solid execution plan that takes advantage of the company's unique qualities and focuses realistically on growing the company and making money.
 6. Focus focus focus.
 - Especially with technical entrepreneurs, one often sees the creation and protection of interesting technology that has broad general application. General capability doesn't sell. Specific products or services for specific buyers sell. Saying to an angel investor, “We could do this. Or this. Or that. Or the other thing,” makes the investor turn away. Focusing on a specific market and plan is key. Investors realize that you may change your plan later, when the market responds to you. That's fine. But you need to show that you can focus on a particular path to market.
 7. The company has the prospect of big returns.
 - Why invest in a company that has the potential to be worth \$10 million when you might invest in one that could be worth 10 or 20 times as much? There are perfectly good firms which will always be small, but if an angel group sees 200 plans every year, there are bound to be some



- with significant possibilities of being elephants when they grow up. Everything else being equal, these are going to be more appealing.
8. The venture's growth and increase in value will happen soon.
- Timing is important. Timing is one of the reasons why few angel groups fund biotech ventures that are 8-10 years from entering the market. Investors want to see a return in 1-4 years so that they can take the returns from the liquidity event, keep some, and plow some back into more young companies. If you have limited funds to invest in your own early stage portfolio, you'd much rather get the good and bad news soon and be able to do more than sit on the sidelines for a number of years.

In summary, an exciting venture for an angel group is one with a great team with a clear path to a specific market, protectable technology, not needing a huge amount of funding over the company's time to liquidity, prospects for big returns, and ready to go as soon as they get the angel funding.

Thinking to yourself, "Well, it's an angel group – they'll invest in riskier companies than a venture capitalist will..." has some truth to it, but not much. If there's a match between a company and the deep career-spanning knowledge of one or more of the angels, investment may follow. Both the angel investors and the venture have a chance of benefiting. But in general, angels are as risk-averse as anyone.

Angel investors: who are they?

In my experience, angel group members have some of the following characteristics:

- They are accredited investors. (This is a requirement.)
- Many have been successful in their fields – often technology of various sorts (software, hardware, biotech, life sciences, telecom,) sometimes real estate or manufacturing or professional services.
- Many angel investors are interested in hands-on investing; they want to help the companies in which they put their money.
- They have a variety of attitudes and personalities. They run the gamut on scales such as quiet-outspoken, enthusiastic-dour, arrogant-unassuming, dismissive-probing.
- They are focused on different issues. Some want to delve into the technology; others concentrate on sales and marketing issues. Others are most interested in the details of projected financials. These interests tend to relate to their previous careers.
- It's not uncommon to find angels who volunteer for activities, care about charitable work; they look to give back.
- There are regulars and members who attend meetings only occasionally.



In most groups there are leaders and followers. And there'll be leaders in different market or technology areas. There are the software experts, the medical device experts, the retail experts, etc. When these individuals get excited, it has an impact on the group.

It's not uncommon to hear someone say, "I wasn't interested in this company, but if so-and-so is interested, I've got to take it seriously."

Your venture and angel investors

You've seen a quick review of how angel groups work and what they look for. If your venture appears to fit, great. The criteria which angels use for investing is based on accumulated experience and make sense. If your endeavor doesn't approach a desirable profile, perhaps you should rethink what you're planning to do. Or at least, revisit where you're planning to raise money.

Even if your venture doesn't match, you may want give it a try anyway. You may not make it through the screening process, but you'll probably get some useful feedback.

Don't try to slap a veneer on what you're doing in order to please potential investors. These are pretty experienced folks, and if your product really isn't done and you have no team and no business model, they'll find it out pretty quickly. The due diligence process is thorough, and in fact, you should know that it frequently takes 4-5 months to get to a "yes" or "no".

Pay attention when you fill out the forms that the angel group e-mails to you. Provide information in detail, knowing that no one is going to read much more than an executive summary during initial screening. "Spell check" your work. Answer all questions. Be interesting.

Because due diligence takes so long, don't pin all your hopes on a single source of funding. Have a back-up plan in case the angels don't come through. Talk with several groups at once. Some of the groups in the Boston area stay in touch with one another, and there's usually no problem if a venture is in due diligence with several groups. They'll cooperate and share the load. You may have more of a chance of finding a champion if you're talking with several groups at once. But let them know.

Make sure you have a good executive summary that is clear and describes your current thinking. Have a decent business plan, including financials – it doesn't have to be long – which you can share with the group. Have team members and



some advisors lined up, but remember that advisors, no matter how prestigious, don't substitute for full-time, committed team members.

Good luck! May you enjoy and learn from the experience, build a great company, and make money for yourself and your angels.

—*Peter S. Miller*

About BlueLake Partners: BlueLake Partners is a boutique investment bank focused on providing merger & acquisition advisory services, raising growth equity capital and providing other financial advisory services.

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