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How Angel Investors Can Improve Their Returns

Angels can dramatically improve their returns on and mitigate the risks of investments in early-stage companies by using a highly disciplined approach to investing. As in most areas of investing, maintaining strict discipline can be a very difficult task. Angel investors always start with the best of intentions but either do not develop an effective discipline or stray from it when making investments. Experience has shown over and over that developing an effective discipline and adhering to it is key to generating consistently superior returns. Effective discipline ensures that the investor does not make any of the following classic mistakes made by most angels that inevitably limit returns:

- They do not select from a broad enough group of companies (do not have sufficient deal flow)
- They do not use sufficiently rigorous selection criteria
- They allow emotion to override their discipline
- They get romanced by the entrepreneur and/or the technology
- They conduct insufficient due diligence
- They have insufficient domain knowledge to accurately assess a company's prospects
- They do not know what terms to ask for when making an investment
- They have insufficient capital to demand the best possible terms
- They do not oversee their investments closely enough
- They reserve insufficient capital for follow on rounds of financing
- They do not diversify over enough companies

By developing and adhering to a highly disciplined process and set of selection criteria, angels can reduce the risk of early-stage investing and dramatically improve their returns. By putting substantial time and effort into developing deal flow, crafting effective selection criteria, doing due diligence and, above all, not allowing emotions to take precedence over discipline, angels can enjoy superior returns on their early-stage investments.

Adequate deal flow is the first step in driving superior returns. If angels do not have access to the best deals, they will not be able to drive the best returns. If angels happen to be related or good friends with a great entrepreneur, they are likely to hear about the opportunity. Since most angels do not advertise their readiness to invest, however, most entrepreneurs will not know about a particular angel to offer the opportunity. Entrepreneurs also prefer to engage with investors who can bring substantial amounts of capital and expertise to the table. This gives VC firms and angel groups an advantage over individual investors in gaining access to the broadest possible set of investments from which to choose. Selecting from a broad range of opportunities is critical to being able to select from the best possible deals.

Once consistent deal flow is in place, it is very important to develop an appropriate set of selection criteria and stick with it. Angels need to understand what kinds of deals are appropriate for their expertise, amount of capital, timeframe for exit and ability to engage with portfolio companies. Angels need to be sure they have adequate time and domain expertise to assess each opportunity. Angels need to select companies that are seeking an amount of capital, both in the present and the future, which is compatible with what they are able and willing to invest over the company's full funding lifecycle. Angels also need to be aware of a company's timeframe for providing liquidity, which can vary dramatically in terms of form and timing, and select investments that are compatible with their goals. Lastly,

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investors need to seek companies which can benefit the most from their capital and expertise, offering them a chance to deliver the most value to each company. Good selection criteria will ensure that angels only invest in companies that have a good chance to meet their investing goals.

After an angel has selected a company that meets all of their criteria for investment, it is time to set the terms of a potential investment. Coming to terms with an entrepreneur is often the most challenging hurdle once a potential investment has been identified. If the company needs an amount of capital similar to what the angel is offering, the angel will have an advantage in setting terms because the entrepreneur can then cease seeking investment funds and fully engage in the job of building their company. Angels offering amounts substantially less than what an entrepreneur needs will typically be along for the ride on whatever term sheet the entrepreneur or lead investor has offered. In circumstances where entrepreneurs have written the term sheet, it is in their interest to avoid giving investors the best possible terms. A strong lead investor can counter this situation effectively if they know what terms other companies are getting in the current market and how this company compares to others in terms of potential returns to investors. Getting the right terms on an investment is critical to getting the best returns on investment. Just like real estate, the IRR of any deal depends greatly on the price paid at the outset.

After coming to terms with an entrepreneur, the hard work of due diligence begins. Effective due diligence is key to ensuring investment in only the highest quality opportunities and, hence, driving the best results.[1] One of most important elements of success is the quality of the management team. In many cases the management team may not be complete. The ability to identify teams that include the best entrepreneurs and can be expanded to become world-class leadership teams is critical to success. This ability typically comes with years of experience in building and assessing management teams. In addition to assessing the team, angels must do due diligence on a company's legal, IP, market and customer relationships. Reviewing existing contracts, intellectual property, market analysis, plans and customer feedback are all critical to ensuring that the entrepreneur's story is accurate and that an investment is properly directed and can be put to good use. Many risks lie in the form and content of legal documents: do they have adequate non-compete and IP assignment contracts with their employees; and do they have adequate protective clauses in the contracts with their customers? More importantly, angels must validate the competitive landscape, the value their customers really see in the product, how motivated and loyal the key employees are, what the competition may do in response to the company's efforts and how likely it is for the company to achieve the goals they have set for themselves once an investment is made. It is imperative that angels validate the great stories that entrepreneurs tell during the investment process before writing a check.

Once an investment is made, angels need to help their portfolio companies as much as possible. While it is highly inappropriate to second-guess or make decisions on behalf of a company, angels owe it to themselves to bring every resource they can to the table to help the companies succeed. If they have selected companies in their area of expertise, angels can help in many ways including bringing best practices to bear, networking with industry contacts and supporting the entrepreneurs when they are faced with key decisions. One key area that almost any angel can help portfolio companies with is recruiting. Sourcing top candidates for open positions is always challenging and having a deep network to pull candidates from can be of great benefit to portfolio companies. A single referral to a customer or key employee can add dramatic value to a portfolio company.[1] Value-added investors are in great demand by the best entrepreneurs and they will seek such investors out whenever they can.

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[1] Wiltbank, Robert and Boeker, Warren, Returns to Angel Investors in Groups (November 1, 2007). Available at SSRN: http://ssrn.com/abstract=1028592

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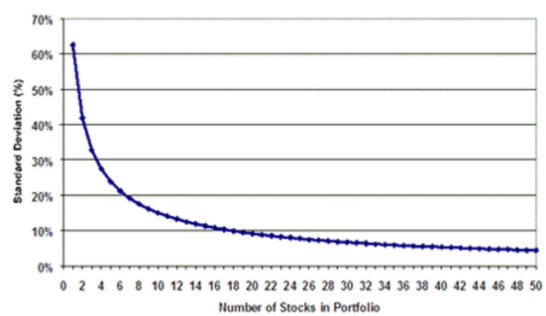
When an angel (or any other) investor first makes an investment into a company, everything seems to be terrific – otherwise they would not make the investment! All companies, even the most successful ones, however, go through tough times when things do not go as planned. Sales prospects take longer than expected to close, employees leave, expenses exceed the budget, revenue takes longer than expected to materialize and a host of other issues are inevitable in any early-stage company. Many times these issues cause the company to require additional funding in follow-on rounds of financing. These follow-on rounds often come just at the time when companies are facing serious challenges. If the problems are substantial enough the valuation will be lower than previous rounds of financing causing early investors to get crammed down. It is precisely at times like this that the emotional impact of the problems causes many angels to choose not to reinvest in their portfolio companies. Yet it is also precisely at times like this that those who do invest obtain the largest blocks of equity – blocks of equity that, when the company is eventually successful, represent the lion's share of the profits. Since almost every successful company faces serious challenges in its lifetime, it is often the investors who maintained their discipline to follow-on their earlier investments – even in the face of daunting challenges – who reap the greatest rewards when the company is finally successful.

We have outlined a variety of ways to mitigate the risks and maximize the rewards for each portfolio company an angel invests in. Even so, the possibility of a complete loss of capital is substantial in every case and it is nearly impossible to tell which companies will have dramatic growth in value and which will end up in bankruptcy. As in every other type of investment, it is always prudent to diversify your portfolio across a number of investments to mitigate the risk of a complete loss of capital. This requires putting smaller amounts of money to work in a larger number of companies or investing a larger total into a portfolio of companies. Figure 1 illustrates how increasing diversification reduces portfolio risk.

Figure 1: Diversification Reduces Portfolio Risk



It is clear that to have the best chance of success in venture investing, an investor needs to find a large number of deals to choose from, do adequate due diligence on each, aggregate capital to an extent sufficient to be able to negotiate the best terms and personally help portfolio companies achieve their goals – all across a large enough set of companies to avoid undue portfolio risk. Achieving these things takes lots of time and cannot be done effectively as a hobby or on a part-time basis. Angels are far more likely to achieve success by using professional fund managers or by banding together in highly organized groups that can attract the best deals, maintain discipline, aggregate capital and share the efforts of due diligence, negotiate terms and support the companies. Only through a long-term, well-focused and disciplined effort will angels drive the returns they seek when investing in early-stage companies.

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