

Working with Entrepreneurs and Angels to change the world one deal at a time.

**Bytes of Wisdom -
Angel Capital Association 2009 Summit**

Two weeks ago I attended the Angel Capital Association 2009 Summit in Atlanta, Georgia. The weather was beautiful, the breakout sessions were powerful, and the opportunity to connect and re-connect with angel investors from around the country was spectacular.

Here are bytes of wisdom (really, random thoughts and observations made by various panelists) from the program:

Although fewer deals got closed in 2008 as compared to 2007, angels are optimistic: A full 55% of angels surveyed by the ACA believe that the number of deals and dollars invested per deal will remain flat (22%) or actually increase (33%) in 2009. Less than half of the angels surveyed believe that the number of deals and/or the dollar size per deal will decrease. Most angels surveyed believe the recession will end sometime in 2010. *Although one could argue that angels are simply optimistic by nature (and they are), these survey results reflect the reality that valuations are at an all time low and no angels that invest in one year reasonably expect a harvest in the next year. If you had a choice: (a) invest now at low valuations and exit when the economy has recovered; or (b) invest two years from now at higher valuations, which holds the most promise for the greatest appreciation?*

Angel deals are getting bigger: while the majority of deals closed in 2008 were \$500,000 or below, for the first time a significant number of angel deals - 5% of all deals closed in 2008 - were at \$750,000 and above per round.

Angels' appetite for new deals has actually increased in the last five months (when surveyed in November 2008, only 15% of angels reported an appetite

for new deals, but five months later in March 2009, a full 25% of angels expressed an appetite for new deals).

Most angels who invest through a group will do so as part of a "network" (70%); a smaller - but significant - percentage invest as part of a fund (22.2%). A growing number of angels invest through a network coupled with a sidecar fund (7.8%).

An angel investor from Philadelphia explained that he is in several networks because he (correctly) believes that portfolio diversification is the key to success with early stage investing (a portfolio of at least ten companies is ideal). Unfortunately, participating in only one network group which may see one or two deals per month won't necessarily produce enough high quality deals quickly to build a ten company portfolio. So his strategy is to visit two or three networks to see a lot of deal flow quickly. As a related point, by being an investor in the sidecar fund that invests along with the network that he's joined, he has been able to spread his investment dollars among many different companies (the sidecar fund invests in almost every deal the network members fund).

"Family offices" (offices created to administer the wealth of highly successful entrepreneurial families) are becoming an increasingly more important source of angel funding.

\$400,000 is the new \$1 million.

The "flat round" is the "up round."

Investors are looking more closely at valuation as part of the *screening process*, and not waiting until the negotiation stage to look at this issue.

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Angels do a good job on the front side (due diligence, deal structuring, etc.) but need help/training/new ideas on the back side (i.e., post-investment portfolio management and managing the exit). Two - perhaps contrary - views here: "Begin with the end in mind" (i.e., plan your exit even before you close on the investment), but if you focus only on the exit you will be building a company tailored to be bought by one buyer which will limit its value -- instead, focus on building a company with a strong cash flow on a stand alone basis. With that, the exit will take care of itself. Another variation of "begin with the end in mind" is to identify a growing market and then build value to that market.

Ninety percent of the angels' work occurs after the closing; the ACA has a wonderful series of seminars called the "Power of Angel Investing" (I have attended four of them) including a program on the "Post Investment Relationship."

Successful angels (and, as I will point out in a minute, successful entrepreneurs) build a "funding pathway" for their company -- they model the cap table as it changes during each investment round from friends and family, to seed, to Series A, Series B, etc. Going through this discipline helps the investor (because it demonstrates the "divergence effect" and helps better predict the investor's return on investment at the exit). It also helps the entrepreneur (because it can help the founders' team demonstrate that an aggressive angel (one who takes too much equity in the angel round) will leave nothing for the founders - after taking into effect percentages of the company that must be given up to later rounds of funding. Message to entrepreneurs: "Excel is your friend."

"Pay to Play." In this environment, investors are getting tougher with their terms, including imposing "pay to play" provisions (under "pay to play" provisions, an investor must participate pro rata in later rounds of funding, or suffer a penalty - most usually conversion of their preferred stock to common stock). But, the alternative is the "preferred stock pull forward" (warrants issued to investors in the current round, and additional warrants to them if they invested in prior rounds, to give incentive to investors to participate in later rounds of funding -- a carrot as opposed to

a "pay to play" stick).

Angels must focus on protecting their early investment (for example, by reserving dry powder for follow on funding, or avoiding pay to play provisions); otherwise, through dilution, pay to play provisions, etc., the investor may not be successful even though the company itself was a success.

Managing Portfolio Companies - Best Practice.

One angel group has a "first Friday breakfast program." On the first Friday of every quarter at the company headquarters every shareholder is invited to attend a presentation by the CEO regarding the status of the company and what's new. Alternatively, other groups invite portfolio companies to attend their monthly meetings and re-present to update the group, even though the portfolio company is not seeking money at that point. The likelihood of a successful exit becomes greater if the entrepreneur gives frequent and regular road shows and presentations regarding his or her company.

Successful angel groups include within their leadership their most active angel investors. A good strategy to keep momentum is to have a couple of members of the group get excited about a particular market and a company and act as a champion for that company to get other investors excited in the opportunity.

Dow Jones Venture Source is recommended as a good source for data to benchmark deals (ACA members get a break on subscription fees, but the service is still expensive).

Tech Transfer Breakout Session. The University of Arizona hosted a conference on the state of play of Tech Transfer and startups in their region. White papers will be available for download on June 1. One angel group out west has created an "option fund" in which the angels invest and get founders' shares for a relatively small investment - a "first look" at the company.

Academics are not in the business of tech creation, but rather in the business of training scientists who go out into industry and create tech there.

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Successful angels and successful entrepreneurs build a "funding pathway" for their company -- they model the cap table as it changes during each investment round.

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Angels can send their entrepreneurs to tech transfer officers so they can lead deals. This particular tech transfer officer noted he has never lost a deal because of a lack of funding, only because of a lack of management.

“We don’t let our professors be CEOs of spinout companies -- it’s like trying to teach a cat to swim.”



Many universities view their tech transfer office as a profit center, so there is an inherent disconnect between angels and tech transfer officers: the TTO needs revenue this year, but the angel says you’ll get your return in 6.8 years.

Fireside chat with Mark Heesen, Director of National Venture Capital Association. We can expect a contraction in the VC industry in 2009-2010 (not

surprising). This is a result of the 2001 bubble burst (not the implosion of the last six months). (This was the surprising part.)

Expect a barbell in the VC industry - a cluster of smaller agnostic funds either geographically focused or tech focused, and large mega funds who are focused on a particular industry or sector. What’s left in the middle (mid sized funds who try to be everything to everybody) will likely blow up with their staff moving either up to mega funds or down to the agnostic funds. As angels, we need to learn about and learn to deal with these focused funds for the next ten to twenty years.

Angels should focus on “clean tech” (even though it is a poorly defined sector) because it is the largest sector for VC deals and what VCs want to invest in. Clean tech presents a perfect storm: an industry in need of fundamental change, governments who want to and will subsidize change, and consumers who are willing to pay a premium for a solution today in exchange for benefits tomorrow. What has cooled off for VCs: IT.

Angels can work better with VCs by identifying which VC partners within the firm consistently do

early stage deals and have the patience for early stage investing.

Valuation. When it comes to valuation, the conventional approach is to build a cash flow projection, and compare EBITDA against multiples for publicly traded companies, etc. Another - more seat of the pants - approach would be to simply compare the amount the investor is putting into the company, with the equity percentage that the investor is asking for (or the entrepreneur is offering) (say, 20% to 30%), and then ask yourself whether those two items result in a pre-money value that is defensible.

Keep in mind that valuation is a function of the relationship between the investor and the entrepreneur: if you drive the valuation down too far, the entrepreneur will get very little equity. Then, you no longer have an entrepreneur - you have an employee. You’ll just end up giving the entrepreneur options to keep them incentivized, which is just simply a post closing price adjustment. Why go through all that?

Sales Cycles. Sales cycles are best understood with a calendar in hand. On what day will we get the customer under contract, on what day will we build the product and ship it to him? On what day will we invoice the product? On what day will the customer pay that invoice?

Despite the economy, the ACA Summit was as well attended as any I have been to and the enthusiasm level seemed just as high. These folks (and the entrepreneurs they fund) really do change the world, one deal at a time!





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Enterprise Law Partners, PLLC helps business owners realize their vision. Connecting entrepreneurs and angel investors, ELP works to bring ideas to market, using creative problem solving to get the deal done. Capitalizing on its extensive legal and business management background, ELP navigates the most complex legal issues, counsels and negotiates all aspects of the deal and produces streamlined, plain English documents.

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He looks forward to helping you and your business succeed.