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HOW TO BECOME TOUCHED BY AN ANGEL

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Most funding for early stage ventures does not emanate from venture funding or broker-dealer led private placements, but instead comes from private individuals commonly referred to as "Angels." Principals of early-stage growth companies are frequently eager to access this source of funding. We will briefly describe who Angels are, why ventures seek Angels and what Angels seek in investments so that more entrepreneurs can become touched by an Angel.

Who are these Angels?

Simply stated, an Angel is any individual who is motivated to invest in private companies. While founders with industry recognition or a track record may have the experience to generate that motivation, the inexperienced entrepreneur has a far more difficult Angelic quest. In attempting to obtain financing for an early stage venture, founders should first consider what type of person might naturally be motivated to invest in their business.

The first category of Angel is commonly known as "friends and family." Within this category, there are often two types of individuals willing to invest in an early stage venture: very close friends and family members who are more than likely motivated to invest by an interest in seeing their close friend or family member succeed (or in some cases, out of a sense of obligation), and those individuals who may be casual acquaintances or former colleagues who are motivated to invest by both financial and personal interests. A benefit to the founder in attempting to obtain financing from friends and family is that such individuals often understand the founder's capabilities, and may perceive the likelihood that the venture will succeed as high based upon previous personal or business experience with the founder.

In some circumstances, founders are unwilling to solicit funds from friends and family members, finding it difficult to allow family members and good friends to risk their capital. We remind those with this feeling that family members not asked to participate may be particularly aggrieved if they were not able to get in on the ground floor of a venture that achieves the success that the founder projects. The answer here must lie in the founder's personal sensitivities.

The next Angel category is that of the fantasized wealthy stranger who is motivated to invest. These Angels do exist. They consider themselves professional private investors of seed and early-stage capital. There may be a number of reasons for this type of Angel to invest in a particular venture. Certainly, the potential for high returns from an early-stage venture is a motivating factor; however, many Angels find it important to make an investment in a company with a meaningful vision that will make a positive

impact. Also, many Angels are former business people who are hungry to throw their hat back into the ring. In addition to investing capital into an early-stage company, these Angels desire to lend their experience and business expertise to a venture as well.

It may be extremely difficult for a founder to attract an investment from this type of Angel on his own. However, lawyers and accountants who specialize in emerging growth companies often come into contact with individuals who make up this second category of Angels, and have a firm understanding of what types of ventures these individuals are willing to support and what their criteria for investment may be. There are also financial advisors who specialize in preparing companies for Angel investments and introducing them to Angels. A referral from these professionals can help establish credibility for a new venture.

The third category of Angels is comprised of industry professionals with a strategic interest in the company. By staying alert and doing industry research, founders may also identify investors who have achieved success in the same industry or with the same kind of technology (someone who has retired after selling a business may be interested in backing similar businesses). An example is the trend of Angelic physicians interested in growth companies in medical service, biomedical and biotechnology industries.

Groups of Angels often organize to "look at deals." These groups form with the specific goal of looking for potential investments. While in the past these groups have been relatively informal and loosely aligned, in recent history many Angels have formed collaborative investment organizations in which investment decisions are made pursuant to an established set of rules and guidelines. We have found that a great number of our clients who are initially faced with a challenging search for funding work very well with the Angel groups. Exhibit A highlights certain of the area Angel groups.

Finding an Angel will require resourceful research, networking, patience and boldness.

Why Seek Angels?

In the vast majority of cases, clients seek Angels for a very compelling reason. That is, it is often the only source of available money. Frequently, the amount sought is too low for the venture fund radar (generally $250,000-$750,000) or the entity is too early stage to attract even the early stage venture funds in the region. In such cases, remaining options are (1) a strategic alliance with a deep pocket corporation, which may or may not be suitable, (2) government grant and loan programs or (3) the private Angel.

In some cases, an experienced entrepreneur with a following chooses to tap individual investors even when venture money is otherwise available. Some entrepreneurs believe that venture funds are more demanding and intrusive upon management, or that the venture will achieve a better valuation using an Angel. This may or may not be true depending on the terms and conditions upon which the Angel has made his investment. Since most professional Angels have now been crammed down or otherwise pushed

around by venture capitalists investing in future rounds of companies, they have become a lot more aggressive in protecting their future rights.

An Angel may be more willing to take risks with an emerging venture without a proven record. For an Angel, a failed venture may only mean a loss of capital, whereas a failure for a venture fund will open the door to second guessing by current investors, and may ultimately affect the fund's ability to attract future investors.

What do Angels want?

Once you have found a potential Angel, what will they be looking for? For purposes of this discussion, we will focus on the criteria used by professional Angels to evaluate an investment (and not upon the factors that may motivate friends and family to invest). Remember that there are generally no second chances, you will only have one chance to make your best impression. Typically, a seed stage, pre-revenue company is worth between $1 million (great idea) and $3 million (proof of concept and revenues), with a working prototype halfway in between.

1. Concise Business Concept. An entrepreneur must capture the Angel's imagination with a good idea. However, Angels usually have a short attention span and little appetite for long meetings or long business plans. A presentation to an Angel must be crisp, carefully rehearsed and must provide explicit reasons why the Angel should be motivated to invest. Once an entrepreneur has gotten their attention, the Angel begins the due diligence phase, and at this point, the entrepreneur will provide the Angel more detailed information about the business.

2. It is People that Make Companies Successful. Most Angels will require an entrepreneur to sell himself as a competent and credible entrepreneur. Angels do not ordinarily perform the kinds of independent technical and market due diligence performed by venture funds (although some do), therefore, it is important that the Angel understand the entrepreneur's skills and abilities. Often, the entrepreneur is an individual with significant technical expertise, but relatively little business experience. The inexperience of an entrepreneur may not be fatal to an Angel's investment decision, however, provided an entrepreneur admits his limitations and impresses upon the Angel that he or she is most interested in the Company's success rather than his or her power or position. An Angel will also attempt to assess the interpersonal and management skills of the entrepreneur, as attracting and retaining key personnel is a necessary part of shepherding a commercial enterprise to success.

3. Reality Check. Angels are often troubled by the lack of realism and overinflated financial projections. Competition should be assessed realistically. We all know that virtually all products and/or services exist in a world of competition. This fact should be acknowledged and appreciated. Marketing is also a necessity and must be considered. It is important for Angels to know how marketing will capture potential customers and generate revenue and, ultimately, scale to create profits. In the end, it will benefit the entrepreneur to reign in his optimism in presenting projections for growth,

as overly optimistic growth projections for a seed stage or early stage company are almost impossible to substantiate.

4. Reasonable Valuation. There is nothing more frustrating than to see a good business model die because the founders positioned the company with a valuation that was too high and ultimately was not funded. Valuation of seed stage companies is at best an "art" and often "random" and general rules should not be the sole valuation criteria. Basically, the value of a company is what anyone would be willing to pay for it. Angels take a lot of risk and rightfully demand reward for that risk. With the dramatic drop in VC valuations over the past couple of years, the valuations in Angel rounds have similarly declined.

5. Investment Structure that Will Avoid Cram Down. The Angel investor does not want a future venture capital investor to take away the Angel's future profit potential. In a future "down" round, management can be made whole through additional option grants, all at the expense of existing non-management stockholders who do not or cannot participate in future financing rounds. One way to bridge any valuation gap and reduce the Angel's risk of cram down is to structure the investment as a bridge loan convertible into the first venture round, with warrant coverage to compensate for extra risk. The Angel will at least be on par with the initial VC and may desire a right to participate in future financing rounds. Another mechanism is to both bridge any valuation gap and provide the Angel with some cram down protection to provide for full ratchet antidilution protection for the first venture round and weighted average (or the same as the VC) thereafter.

6. A Pleasant Experience. Most Angel investors are seeking psychic as well as financial benefit from their investment. Most Angel investors are wealthy and could realize as good a return (on a risk/return basis) through other types of investments. Even the most professional private investor is seeking to at least stay informed and share in the "highs" of the growth of the Company. A good entrepreneur will be sensitive to this in both the courting process and after the investment has been made.

There are obvious opportunities and challenges, as well as securities and tax law implications in structuring and offering Angel fundings. The details of these issues, although important, are beyond the scope of this article. We strongly recommend that you seek professional advice to ensure that you maximize your structural opportunities and minimize your legal pitfalls. Remember, an Angel investment should not be an adversarial process, but a process to set up a win-win situation for both the investor and the company.

Good Luck Being Touched By An Angel!

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