



Why Successful Angel Investing Matters to Northeast Indiana

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Northeast Indiana Innovation Center

Presented to



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A Financial Resource Research Product of:



“Angel/Risk Capital”

Two Phases of Our Project

Phase 1: Best Practices and Critical Success factors for angel investing and angel networks (syndicate)

Phase 2:

- A) Data Collection from regional angel investors, entrepreneurs, and angel networks**
- B) Capital Access Directory**
- C) Recommendations for Northeast Indiana**

Today, we will cover Phase 1

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Keep in Mind...

Most people looking for money today are not entrepreneurs, yet.

...Many frustrations we all experience in our community are due to this reality!

We can't just focus on the capital investment but need to train angels/community on the channeling and coaching necessary to create and sustain business ventures.

This reality is both an opportunity and a challenge!

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“A region’s success is driven by the supply of capital.”

[Source: Greater Cleveland VC Report]

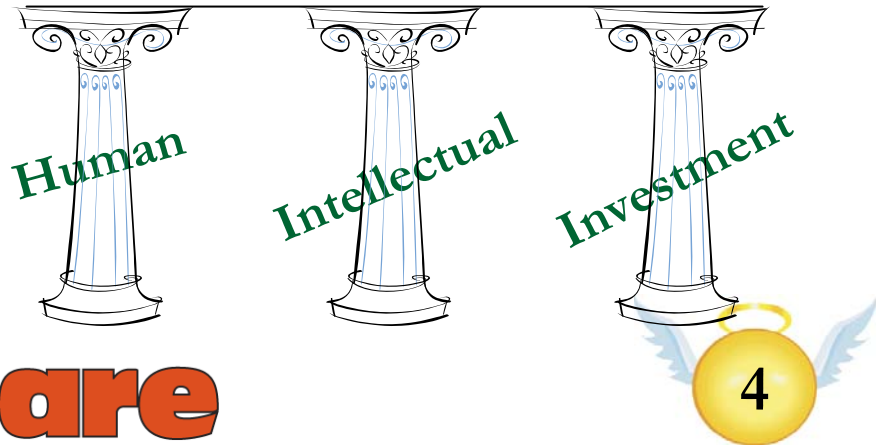
Three Pillars Of Success

- Human: education/skill levels of its citizens
- Intellectual: levels/capacity of research/innovation
- Investment*: in all of its forms (healthy continuum of capital)

In NE Indiana, There is a shortage of well prepared and packaged proposals ...

Entrepreneurs need to be prepared when seeking money and the community needs to properly source these opportunities to find the right investor for the transaction

Source: Greater Cleveland VC Report (06)



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“ Perceptions are Reality: *Milestones or Minefields?*”

Most Angel deals have 4 steps or stages – which can be **Milestones** on the road to a successful deal, or **Minefields** that can blow the deal up.

Step 1: DEAL SCREENING

- **Scarcity Mindset:** Inadequate or lack of deal flow causes fewer referrals to others; shortage of well prepared and packaged proposals
- **Poor Access:** Entrepreneurs don't know how to find “target” angel investors interested in the right deal types and investment stages
- **Lack of Urgency:** Angel investing is viewed by some as an amusement rather than a real business

Step 2: DUE DILIGENCE

- **Technical Due Diligence:** Lack of local expertise to evaluate broad range of applied technologies
- **Private Placement Memorandum:** Often entrepreneurs are advised to put in place expensive PPM documents before terms are agreed to by angel/entrepreneur

Step 3: TERM SHEET

- **Valuations:** Future funding/rounds; poor angel-round structure leads to dilution or problems with future funding rounds with more sophisticated investors or early stage VC's
- **Fund Raising:** Entrepreneurs require too much capital and give up too little ownership in exchange for the investment
- **Regional Co-investment:** Angel investing as a team sport through cooperation across regions located in Midwest and local angel/angel groups/syndicates

Step 4: POST-INVESTMENT MONITORING

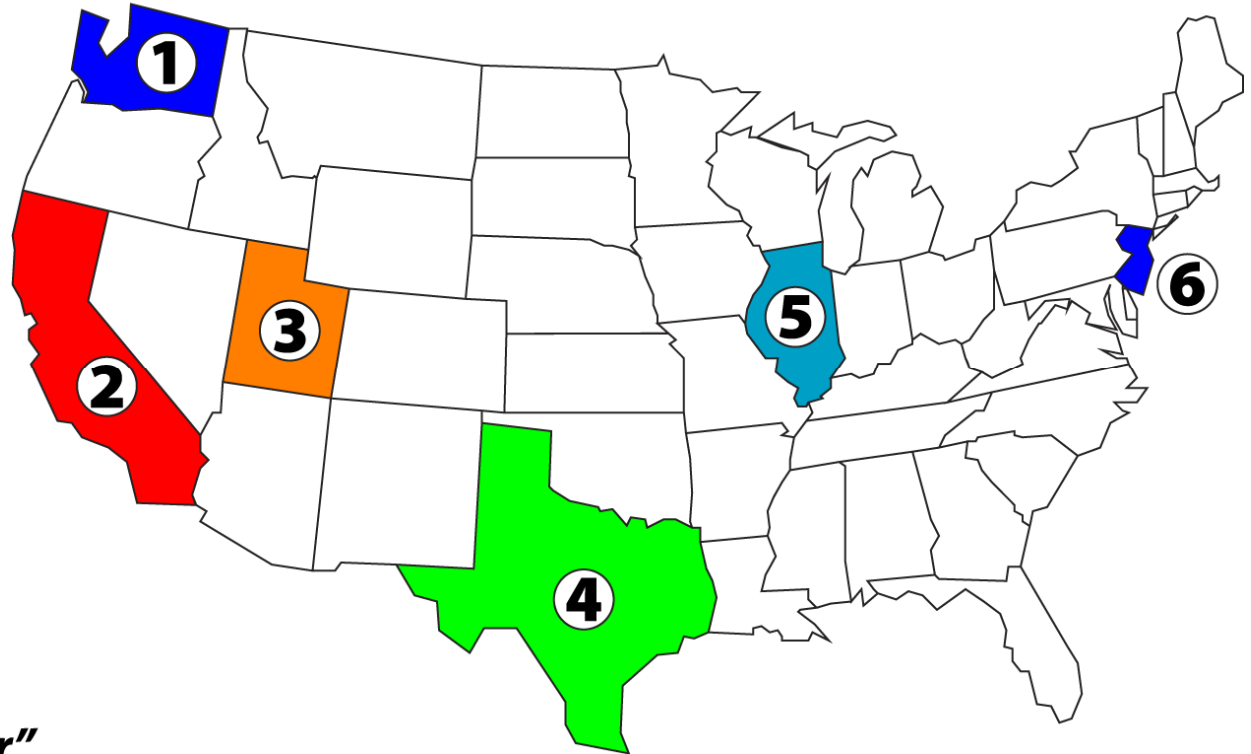
- **Board of Directors:** Putting best person to advance Company's needs and goals versus well-intentioned angel investor to serve on the board; frequency of reporting (depth of reporting, variance analysis, implementation of board governance practices)

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Regional Tech Clusters Exist Around the U.S.

- 1. Washington**
"Tech Corridor"
- 2. California**
"Golden Triangle"
- 3. Utah**
"Software Village"
- 4. Texas**
"Silicon Hills"
- 5. Illinois**
"Silicon Prairie"
- 6. New Jersey**
"Princeton Corridor"



Our goal in NE Indiana needs to be to establish a pipeline of venture-quality companies in various stages of development

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Five Components of Silicon Valley's Success: *It's Not About Mountains and Oceans*

- 1) **Corporate/government research institutes and universities**
 - Train engineers who make up the pool of entrepreneurs
- 2) **Availability of “risk capital” and venture capital community**
 - multiple forms of lending
 - management know-how
 - network of contacts
 - follow-up financing
 - funding entrepreneur's next start-up
- 3) **Sophisticated service infrastructure that allows start-up firms to focus on their expertise rather than dissipate their energies across a broad range of activities**
 - Executive search firms, legal, prototyping, contract manufacturing, real estate/physical infrastructure
- 4) **Diverse talent pool of professionals that have gravitated to Silicon Valley from all over the globe**
- 5) **Pioneering spirit and relentless work ethic – “entrepreneurial culture”**

The inventor produces ideas, the entrepreneurs get things done – Schumpeter

Understanding Silicon Valley: The Anatomy of an Entrepreneurial Region © 2000

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Successful Regional Angel Investing

Seasoned Entrepreneurs *

- people with ideas for new business
- people with an understanding of how to build those businesses

Seasoned Managers

- access to talent pool to find people who can help new ventures grow

First Generation of Wealth

- need people who have made money in their own lifetime
- people are willing to invest more as their net worth increases

Scale

- need enough angels to match to entrepreneurs



Strong Universities

- source of smart people, new technologies, and training people to become entrepreneurs

Relevant Industrial Base

- regions need entrepreneurs in the same industries that there is a critical mass of local companies

Entrepreneurial Culture

- fiscal state policy
- supporting networks/infrastructure
- increasing the pool of investment opportunities

Successful Experience

- initial successes to build on
- creates a pool of capital from which active investments could be made
- more experienced investors from successful angel investors

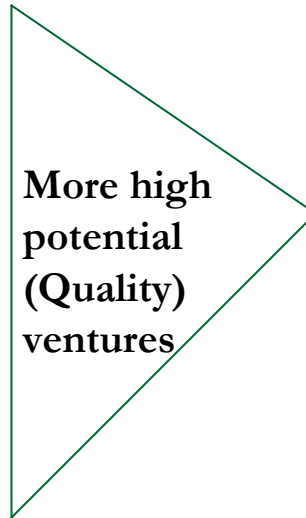
Angel Investing: A report prepared for the Federal Reserve Banks (www.clevelandfed.org) February 2006

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Attractive Business Angel Market

“Angel” Investor Competency Gaps . . .

- Lack of business proposals matching their investment criteria
- Lack of quality business proposals
- Lack of trust in the entrepreneur/management team
- Lack of experience in pricing deals
- Lack of experience in due diligence and monitoring
- Lack of available funds



GOAL
Create wealth for both
Investors and Entrepreneurs

. . . “opportunity to close the gap”

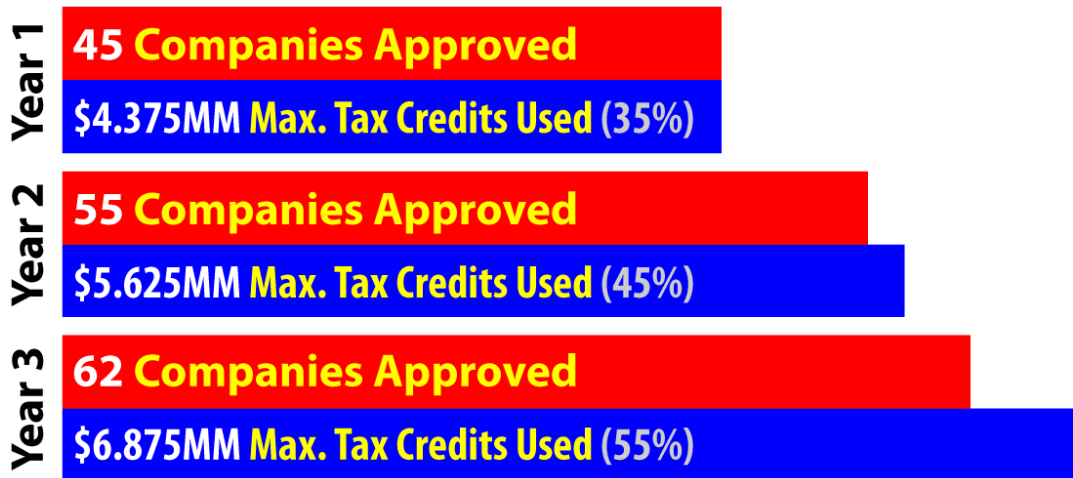
- Four times as many offers are made by Angel investors than are accepted by entrepreneurs
- 70% of Angels could have made more investments if there had been more suitable investment proposals
- <10% of an asset allocated portfolio should be in private equity; of that amount, business angels invest <80% of their available private equity funds in high risk capital ventures
(\$312,000 average available for angel investing)

Source: *Angel Investing: Matching Start-up Fund with Start-up Companies*

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Angel Investing in Indiana

Venture Capital Tax Credit



Indiana Angel Profile

- 800 angels in the VCI database
- 6 “formal” angel syndicates in Indiana; many informal groups emerging
- 7-10 investors/deal (lower level); 5-6 (more frequent ones)
- Average investment round: \$350,000
- Average Fundraising Round: \$500,000
- Indy Groups: 3 deals; average \$1.5 MM split among 10-15 investors

- One Time Angels: \$25K to \$50K/investment
- Portfolio Mentality Angels: 5-10 investments over 2-5 year period; \$1MM investment (not seeing enough in Indiana’s VCI program)
- Max Indiana Credit/Year; \$12.5 MM
- 59 angels identified in Allen County through the VCI database
- 12 companies approved for the VCI tax credit in Allen County
- \$16.5 Million in angel investment (\$2.8 Million in tax credits)

Source: IEDC, VCI Database (2008)

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Trends/Importance of Angels – *NE Indiana Cannot Afford to Fall Behind*

Angels...

- As a class of accredited investors, it is increasing each year by 10%
- Bring a small group of investors to each deal: average is 4 – 5 investors/per deal
- In terms of angel groups has increased from 50 (1997) to over 275 (2007)
- Fund 30 times the number of deals as the Venture Capital industry
- Invest 3 – 5 times more money in total as the Venture Capital industry
- Are the largest source of seed and start-up capital
- Consummate transactions:
 - 7.3; number of investments
 - \$266,000 average funding per round
 - 3.0 deals of 7.3 (on average) received follow-on funding

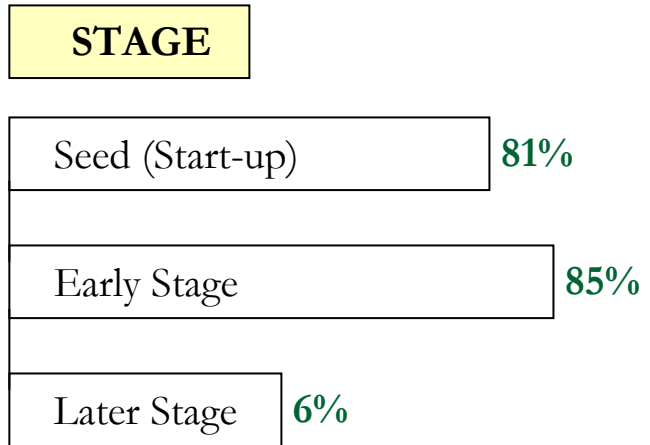
Source: ACA/Google Searches

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Stages of Investment: Angel Preferences

Traditionally Angels Prefer . . .

Angels Invest In . . .



2007 Angel
Investments

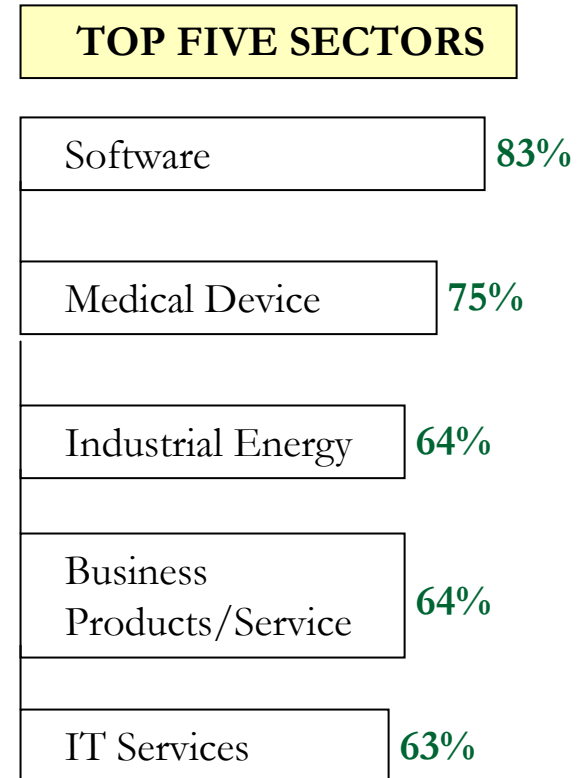
27%

19% (HC)

12% (Bio)

8%

7%



New Trend: **21%** of Angels invested in expansion stage;
35% invested in post-seed (start-up)
More conservative in their investment patterns

Factoids

- 3.3 jobs created per Angel investment
- Women Angels are 12% of the Angel market
- Preference is **new** not **follow-on** investments

- Average annual return on Angel exits: **27.7% (IRR); 3.5 yrs.; 2.6 x** invested capital
- **63.3%** of all investments were **new** in 2007)

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Source: ACA (2007) Survey: Center for Venture Research

Angel Networks*-- *Growing at 19%/Year*

1997: **50**
Networks

2002: **170**
Networks

2007: **275**
Networks

What should we model an Angel Group after?

Why is it growing?

- Attract better deals and generate higher returns than Angels acting alone
- Access to infrastructure, expertise, talent, & capital
- Widening “Capital Gap”
- Legal/economic complexity of investments
- Volume of deals
- Social camaraderie (interactions between investors)

Syndicate Profile

- <80 people
- Must be an accredited investor
- \$200 - \$3,000 dues per year per member (up to 2.5% of investment amount per annum)
- Investment of \$25,000 - \$1,000,000 in a deal
- Expected angel investor turnover of 10 – 20 % of members per year
- Meetings typically are monthly (2 – 3 presentations at a time)
- Targeted returns: 25 – 75% (5 x to 10 x cash on cash returns; time horizon: 4 – 8 years)

* University of New Hampshire – Center for Venture Research

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Steps in an Angel Investment

1

Deal Screening

- Network Referrals
- Advice/Counsel
- Deal Flow
- Knowing your investment criteria

2

Due Diligence*

- Median: 20 hrs.
- Mean: 60 hrs.
- Time/Scope
- “Standard” Due Diligence Plan
- “Technical” Due Diligence – viability of IP, technology, market
- Management Team

3

Term Sheet

- Valuation Difficulties – Return & Expectations
- Co-investment Requirement
- Structure (equity, convertible debenture)
- Milestones

4

Post Investment Monitoring

- Level of Involvement (relationship)
 - board seat
- Frequency of Information
 - analytical reports
- Exit Strategies
- Additional Fund Raising

* Returns to Angel Investors in Groups (November 2007)

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Deal Screening

Attract Better Deals

Generate Higher Returns than Acting Alone

1

Best Practices

- Like-minded investors with a unified purpose (directory of local capital sources, risk appetite, and criteria)
- Angels/groups should have a directory site outlining their Mission Statement Along with a set of investment criteria and application/visual process diagram
 - Main Street Venture Fund
 - NIIC Leap Fund
 - AdVenture Fund
 - 21st Century Fund (not diluted capital)
- Step 1: Provide a coordinated approach to the entrepreneur (initial screen/vetting process)
 - Referral (if not a fit); directory of sources
 - six common areas of review of business plan (marketing opportunity, management team, competitive advantage (something unique), growth potential, expertise in industry, and exit strategy); creating a great business plan is 1% inspiration and 99% perspiration
- Step 2: Private meetings with management team
- Step 3: Commence due diligence on promising companies
- Step 4: Monthly meetings hosting angels/potential ventures pitching their business

Perception Issues for Northeast Indiana

- Scarcity mindset hampers “referrals” – reinforcing “poor deal flow”
- Lack of co-investment opportunities—“silo investing:”
- Underwriting competencies
- “First-time” entrepreneurs believe Angels are philanthropist and have “deep pockets” to be charitable - “rich people owe me or owe the community” [mindset]

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Due Diligence

Mitigate Investment Risk

Determine suitability of investment

2

Best Practices

- Development of “open source standards for due diligence
- Analysis should be proportionate to the stage of the deal: **Later = More**
- Entrepreneurs need to live, but their salary should not consume an inordinate amount of resources
- Many Angels don't do enough due diligence
 - Three **major** areas of focus in due diligence:
- Commence due diligence on promising companies
- The acid test of a good deal is management – “small business owner mentality” versus “entrepreneurial mindset”

Management team, industry trends, and growth potential of company

Perception Issues for Northeast Indiana

- Often entrepreneur has spent all of his/hers own funds to secure IP before determining viability of a business/existence of a market for the product
- Entrepreneurs “poorly” understand the art/science of due diligence.

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Term Sheet

Valuation Method
Definition of a good
deal

3

Best Practices

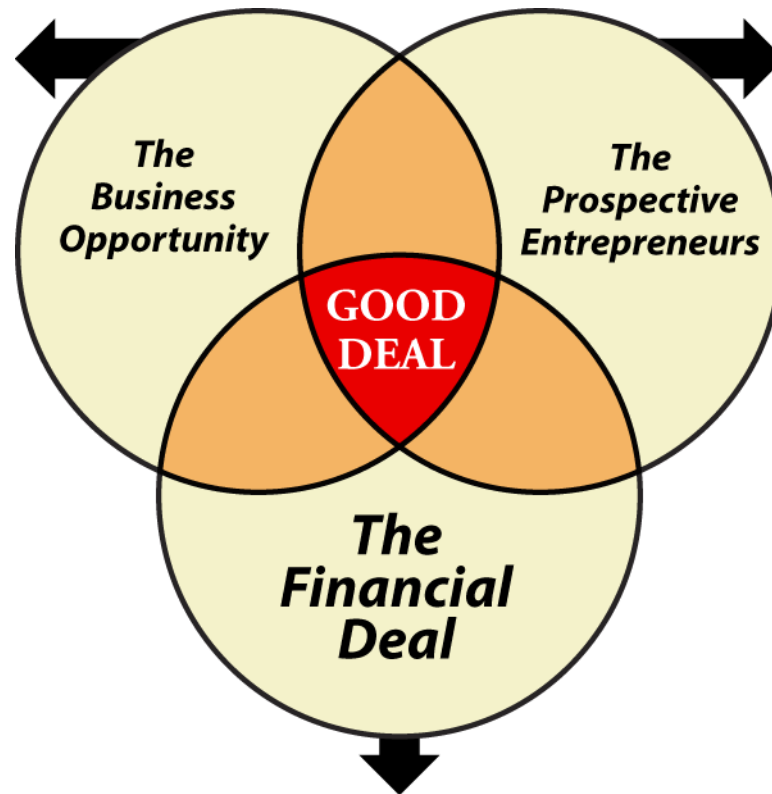
- Encourage cooperation between regional Angel groups (intrastate, interstate)
- Standardize term sheets to reduce legal fees
- Angels take **20 – 50%** ownership stake of early-stage companies
- PPM Wrapper/PPM-Lite (wait until agreement between parties)
- Best deals happen usually when no one gets exactly what they want—trusting relationship where neither party gets an upper hand

Perception Issues for Northeast Indiana

- What is criteria for judging success of the venture? Invest to build & grow or to speculate & flip?
- What are the characteristics of a “good deal”? [See page 18 as an example]
- Entrepreneur is often “counseled” by legal to spend **\$10 - \$50K** on PPM only to have the Angels term sheet “trump” the entrepreneur’s PPM **after the numbers/strategy are scrubbed (underwriting)**
- Entrepreneurs want “control” and don’t understand the “discounting process” [cumulative discounts for ownership control and liquidity]
- Unrealistic time periods for performance/exit (**3 yrs vs. 7 yrs.**)
- Traditional valuation methods yield poor results and investor frustrations over valuation (discounted cash flow method before sale = \$1)

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Characteristics of a Good Angel Deal*



- Recurring Revenue
- Sustainable competitive advantage
- Scalability > \$XXMM in 5 years or less
- Offer a solution to a real problem of importance
- Not marketing intensive
- Not involving a commodity product
- Not personal services
- Not in a declining market
- Evidence that somebody wants the product

**Based on a research report prepared on the Federal Reserve Banks of Atlanta, Cleveland, Philadelphia, Kansas City, and Richmond (Oct 1, 2005)*

- Good rate of return at a reasonable valuation
 - Expected and realistic pre-money valuation
- Time horizon – 3 to 7 years
- Return of “x” times the capital invested
 - 1 – 15x
- Typical Exit – IPO or acquisition

- Experienced entrepreneurs who have built successful companies in the past
- **A strong management team with good skills**
- Entrepreneurs known to the Angel(s)
- Good communicator (open & honest) works well with others
- Has charisma, passion and vision
- Good at overcoming obstacles
- Self-aware (understand own shortcomings and know what skills they need to find in others)

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Post Investment Monitoring

Governance Practices

Coaching/Access to Expertise

4

Best Practices

- Network of resources (mentoring, coaching, and advice) is critical to ongoing success
- Performance by the entrepreneur is key to a successful exit
- Establish metrics/milestones on a “company by company” basis (burn rate, cash on hand, revenues etc.) versus a “generic rule of thumb” applied equally to all ventures
- Board compensation (Two camps: no additional compensation or 5% of the CEO’s cash salary)
- D&O insurance is a requirement
- Entrepreneur needs to provide the investor with frequent updates about the company (monthly financials, expert analysis, customer relations, employee management, etc.)

Perception Issues for Northeast Indiana

- Entrepreneur does not always realize he/she is in the “investor relations” business when a check is cashed
- Annual reporting/tax return is sufficient for investors [“Less is Better”]

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Local Capital Sources [Selected Examples]

	Main Street Venture Fund www.mainstreetventurefund.com	adVenture Fund www.adventurefund.net	NIIC LEAP Fund www.niic.net
Stage	Growth & Expansion	Pre-Seed / Seed / Startup	Seed / Startup
Sector	Product Companies	High Tech	High Tech / High Growth
Max. Investment	\$500,000	\$100,000	\$50,000
Follow-On Dollars	\$500,000	\$100,000	\$50,000
Fund Size	Investor Deal-by-Deal	\$850,000	\$550,000
Investment Horizon	<5 Years	<5 Years	5–7 Years
Deal Structure	Equity Mezzanine	Equity w/ Put Option	Equity w/ Put Option Convertible Debenture
# of Angel Investors	20–30	28	—
# of Active Investments	2	6	1
Co-Investment	Yes	Yes	Yes
Organization Structure	Manager-Led	Manager-Led	Manager-Led

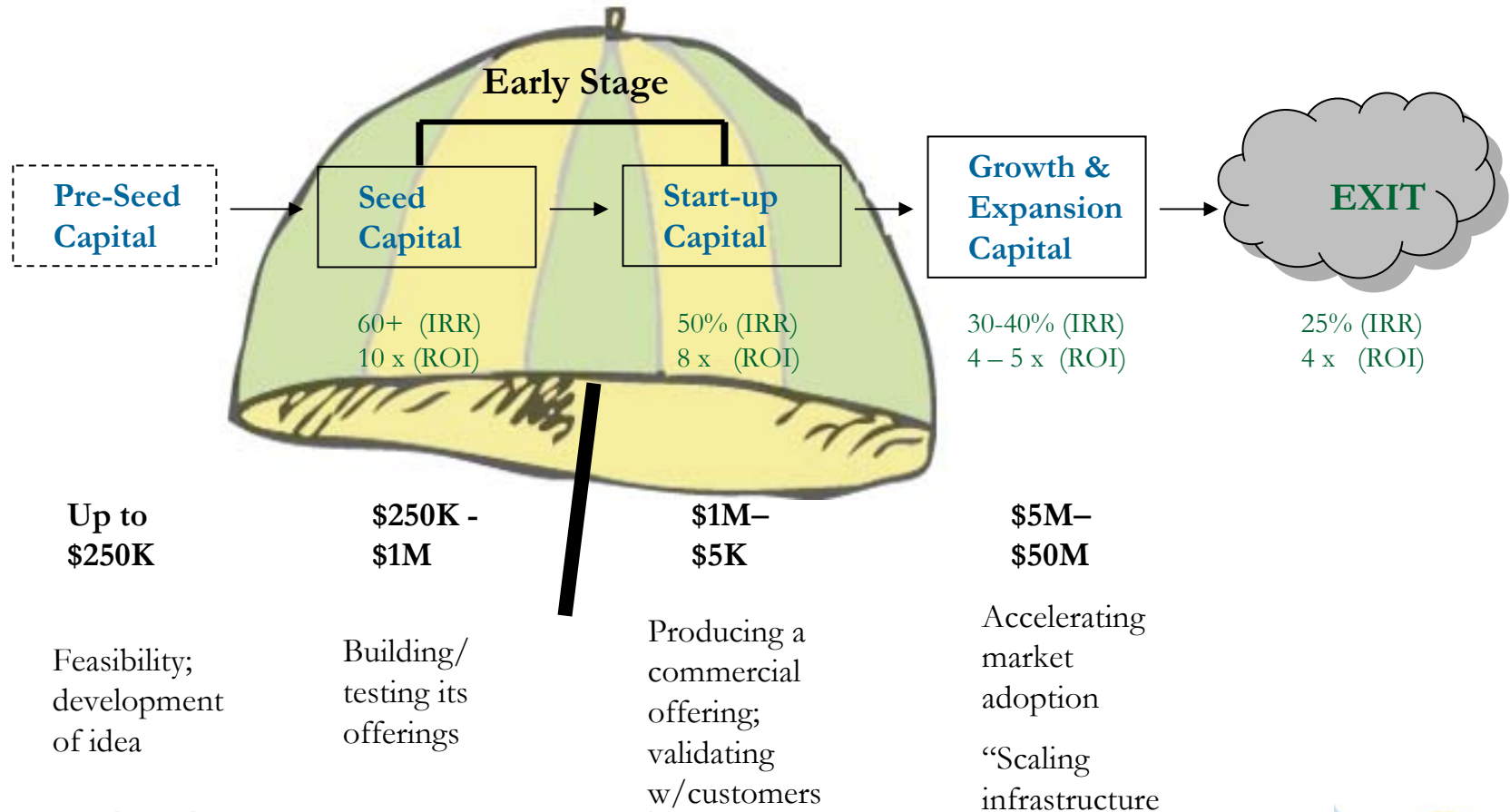
Potential Investment Amount: **\$3.5MM**

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Risk-Capital Continuum*

Capital Access & Continuum



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Summary

- **Organized Angel networks are key for regional economic growth**



- New jobs → create a buzz
- More entrepreneurs receive funding
- Improved prospects of developing regional Venture Capital industry
- Larger rounds can be completed to reduce the “risk capital” gap

- **Education, awareness, and tools/knowledge will improve climate for early-stage investment**

- seminars
- workshops
- state tax credits
- networks



- Builds investor confidence and knowledge
- Increases investment activity
- Improves entrepreneurs’ understanding of markets, connects them to resources, and know-how (networks); prepares company for investment
- “De-complexes” financial, legal, underwriting processes

- **We need to facilitate better access between Angels/entrepreneurs**

(- investors, - entrepreneurs, - Venture Capitals)



- Referrals to one of the “tribes”/syndicates
- Mentorship/Access to expertise
- Investment focus (targeted sectors/stage)
- Quality deal flow (ideas → innovation → new firm formation)
- Angels will only invest in the companies they think grow exponentially

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Next Steps

- Survey regional angel investors, entrepreneurs, and angel networks
 - Attitudes/climate
 - Investment/risk appetite
 - Return expectations; returns achieved
 - Sector experience/stage
 - Mistakes/frustrations/lessons learned from entrepreneurs
 - Talk with accredited investors not formally in a syndicate about their Angel investing experience and objectives

- Develop framework for entrepreneurial engagement/readiness
 - Investor-ready academy (workshops/seminars)
 - Open access to Angel syndicates
 - Capital Access Directory (internet accessible)
 - Better coordination/more cost effective professional services
 - Legal: PPM/term sheet
 - CPA/Accounting: Valuation

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Questions ???

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