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“Finding the Money: Fundraising for Early Stage Capital” was the topic of discussion during a winter presentation of the Foley Executive Briefing Series. Foley & Lardner LLP Boston office managing partner Susan E. Pravda, chair of the firm’s Emerging Technologies Industry Team, led the discussion with Foley partner Gabor Garai, chair of the firm’s Private Equity and Venture Capital Practice. The briefing outlined solutions for navigating and understanding options for finding and approaching early stage investors. This document discusses and provides a follow-up to the points raised in that dialogue.

Angels: What Does and Does Not Define the Investor

Angel investors are typically one of the earliest funding providers for promising would-be or established entrepreneurs. Angels are individuals—often cashed-out entrepreneurs themselves, with expertise and insight into a given industry—who seek to provide seed capital to fledging companies.

A defining characteristic of Angels is their active interest in the investment and a desire to be part and parcel of the business as it develops. An Angel is someone who made money in a particular industry, cashed out, and is looking to retain involvement in that industry. Rarely will Angels choose to invest outside their expertise—or far from home. When seeking potential Angels, consideration of Angel location and industry experience is paramount.

Recent years have seen an advent in Angel groups: bands of individual Angels that pool their personal investments into a larger Angel fund. This institutionalization of Angels presents pros and cons to potential entrepreneurs; groups can offer more money than a single investor but that money will come with more institutional bells and whistles attached.

An understanding of what defines an Angel is important; an understanding of what does not define an Angel is critical. An Angel is not a purveyor of institutional money and, unlike a venture capital (VC) investor, is not a committed source of capital. Angels are interested in funding entrepreneurs today and will not necessarily retain interest in the venture 6 months, 12 months, 24 months from the time of first finance. In the most common scenario, Angels cannot be counted on as a continued source of funds.

Given this, it is important to mention alternatives to Angels for later rounds of capital raising:

- **Venture debt**
  Venture debt is a bridge between rounds of equity funding or a non-diluting alternative to another equity round. It grants the start up a debt instrument from a non-conventional debt lender—as the VC makes its investment in the form of debt rather than equity. Similar to a traditional venture equity investment, venture debt is an investment in the management team and business model rather than collateral and operating history.

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- **Conventional debt**
  If a company's founders are credit worthy, debt lenders may be willing to make very early stage seed level credit line for a company because there will be personal guarantees associated with that. Once the company has developed product and demonstrated receivables, those receivables can be used to leverage more debt.

When considering Angel and alternative financing options, it is imperative that entrepreneurs consider what is intended to be accomplished? Securing funding is important, and it is equally important to consider how investors expect to be repaid in terms of a long term strategy. For example, when financing through debt is being considered, the long term consequences of dilution must be considered along with the priority of payout. Also, founders should consider how VCs might react to the financial involvement of certain Angel groups. Might Angel involvement build or destroy credibility in the eyes of VCs?

Angels versus Venture Capital, After the Bubble
Angel investors as a group might fund 50,000 investments a year, while VCs might turn 1,500.

(Incidentally, as an investor an Angel might expect to fund 10, 20, 30 deals experiencing only a single success—it's an investment game that demands high volume for any sort of return).

When the investment bubble burst in 2000, Angels were severely burned. As a group, Angels were the first investors to be washed out—crammed down by later VC rounds. Some VCs blamed the Angels' loss on inexperience—and some VCs continue to suggest that Angels are an inexperienced lot, and that their involvement complicates the capital structure of a fledgling company. Since the bubble bursting, most Angel investors have been out of the market, attempting to nurse their wounds, and have only recently returned.

With renewed perspective the post-bubble Angel investors are seeking better valuations and more protections against investment. Angels now might have more respect for the game than their late 1990's counterparts, but VCs do not necessarily have more respect for them as game players.

What is the Value of an Angel—What do Angels Offer?

A Supply of Dollars and Knowledge
The increasing pool of Angel dollars is filled by successful former business executives who are actively interested in pouring their money into fledgling ideas. These investors are also eager to supply their insight, experience and knowledge.

It is guaranteed that Angels will want to be involved in the business of whatever company they choose to fund (which is a positive or negative corollary to Angel funding, depending on the founders' perspective). Acknowledging that these financial backers will almost inevitably want a voice in the company, entrepreneurs who seek Angel funds must seek a knowledge fit.

Furthermore, when weighing options for a first round of financing (among Angels or between sources) entrepreneurs must consider that all dollars are not made equal. VC dollars might come with dilution while Angel dollars may amount to more than their dollar value—in the form of a rolodex, industry connections, industry experience, strategy and introductions.

A Reaction to Entrepreneurs' Capital Demands

The capital gap has widened—and Angels have stepped to fill in that gap. The VC definition of "early stage" is incongruent with, and more developed than, the entrepreneurial definition. VCs might be looking for a built out management team, revenue producing assets, data, and a completed market analysis from an early stage company. But what happened to A round financing?

In many cases, the A round is gone and those dollars have largely been replaced by Angel investors, who are the ones now willing to support a venture from zero to a developed idea. There are still VC players who will look at, consider, and fund an innovative idea itself—but those players are rare.

What are the Negatives of Angels—What are the "Costs" of Angel Dollars

The Persistent Capital Gap

In general, Angel dollars will only partially fill the capital gap. An Angel investment typically measures between $0.5 million and $1 million. But the typical series B round is between $3 to $5 million. That gap, which Angels do not fill, totals $2 million—an amount that is tremendously difficult to raise, though it can be done.

One way to fill that gap is through networking to secure piecewise support—founders must find a venture player who has faith enough in the fledgling idea to offer partial financing until the idea can be further developed and potential more clearly demonstrated. Alternatively, the company's founders might themselves fill in that gap.

And as has already been stated, Angels do not provide a long-term capital commitment and cannot be relied upon to provide continued investment. A VC might invest $5 million in an early stage start-up, and he or she will set aside additional funds, say $10 million, for potential future rounds. This pattern of investment does not hold true for Angels.

The Persistent Business Presence
VC investors might request a presence on the company board, but an Angel investor is likely to spend hours in executive offices in an attempt to understand a developing product and business strategy. Angels will want to be heavily involved in their investment (as can be expected from their own entrepreneurial roots). But while Angels might possess an insider's sense of the industry, they may lack the sophistication of an investor and present company founders with unrealistic expectations. Entrepreneurs must approach an Angel investor with a certain sensitivity towards their perhaps stereotypical desire to control the business.

Angel Investors, Within Venture Funding Landscape

The early stages of the venture funding landscape (seed capital and start up stages) offer overlapping possibilities for funding from investors: friends and family, high net worth individuals, and formal Angel groups. Of those initial investor possibilities, only Angels can carry an entrepreneur through the first round of funding. Friends and family and high net worth individuals typically cannot provide the funds to take an idea so far. The amount of financing, including follow on investments, that can be expected from any group of potential investors is related to their level of sophistication (experience in industry, potential for involvement in the business, and network potential).

Friends and Family
Friends and family put in the least amount of money and have the lowest level of sophistication—which is not to say that family and friends are unsophisticated, but they usually invest in the entrepreneur, not in the merit of the idea.

The pros and cons of friends and family money are rather obvious: small dollars are secured by virtue of the familial relationship, but the investors remain for life in a position to remind entrepreneurs of any failure. From an investor point of view, there exist virtually no guarantees on a friends and family investment and returns can be expected only rarely. But despite the potential informality of family relations, it is still important for entrepreneurs to approach these investors with a degree of professionalism, if only to convince later investors that there exists some investment experience within the start up.

High Net Worth Individuals
High net worth individuals can be expected to approach the table with slightly more sophistication and slightly more money.

Angels Investors: Clubs, Groups and Organized Angel Alliances
Angel clubs and groups have roughly the same financials as but less experience then Angel Alliances, which have arranged themselves to be almost as sophisticated and financially viable as VCs. As has been stated, Angels generate return on their investment over the course of 10, 15, 20 investments—so they have experience and a reasonable idea of what can fail. Angel Alliances can be expected

to demand the same level of oversight that might be expected from a VC, in terms of board presence and requested financials.

It is important to note here that sophisticated investors (Angels, VCs) can be expected to ask for documents and reports that they consider relevant to their investment. They want to be involved and want to be informed.

Venture Capital Funds
VCs will provide entrepreneurs with the most money for any single round (early stage, B round, C round) but they invest less often and more selectively than Angels. VCs will typically request a board presence and expect regular and detailed financial reports. Company founders or executives must make a point to provide investors with those requested documents even if those reports seem irrelevant to or unreflective of the company's financials.

Angel Investing Trends: How have Angels invested over recent years?

2003: 220,000 Angels invested roughly $18.1 billion in 42,000 ventures
2004: 225,000 Angels invested roughly $22.5 billion in 48,000 ventures
2005: 227,000 Angels invested roughly $23.1 billion in 49,500 ventures
2006: 234,000 Angels invested roughly $25.6 billion in 51,000 ventures
2007 (Q1-Q2): 140,000 Angels invested roughly $11.9 billion in 24,000 ventures
Source: Center for Venture Research (University of New Hampshire), MIT Entrepreneurship Center

Figures for Q3-Q4 of 2007 were unavailable at the time this publication was submitted. It is considered unreasonable to attempt a prediction based on the performances of past years.

Target Opportunities: How to Attract Investments

What to Expect from Angels and Early Round Investments
Angels and high net worth individuals focus their investments according to industry and geography. For example, it would be extremely unusual for a life-sciences player to make an investment in the technology sector and even more unlikely for a California Angel to invest dollars in the bay state. New York-based Angels might be willing to fund new technologies in Massachusetts because the nearby Bay State has proven itself a hotspot for innovation. But it's best to look for Angels close to home.

First round financiers (from friends and family to Angels) typically invest $250,000 to $1 million. Angels might support an initial investment with follow-on capital, although (as has been stressed and repeated) continued support from an Angel is not guaranteed.

But, it is guaranteed that a company will encounter glitches in taking an idea to market and entrepreneurs should be advised to take more money than initial budget estimates suggest, without concern about dilution. It is not necessary to own a majority stake in one's own company in order to realize financial success, as some successful entrepreneurs have demonstrated—sometimes a 15 to 20 percent interest is all that is needed.

Finally, time is money. If founders cannot quickly raise the money to take an idea through its development to product, they might risk losing market share. The balance is time versus money, and the right move depends on the state of the market and the pace of a given industry. Will the idea or product lose value if it is not quickly introduced or can its entrance be delayed without harm to revenue potential? There is not a clear right answer to this question, but it is always important that entrepreneurs be sensitive to the market climate and to the position of potential competitors.

Criteria for Investment

Exceptional management team with demonstrated track records
A demonstrated track record is something investors will demand to see. In the absence of an exceptional management team with a demonstrated track record, a founder might bring in a partner who does have a clear track record and credible reputation.

Directors and advisors who actively advance the company
This is where serious networking becomes critical—the development of real relationships is important. A list of a dozen well-established big shots on an advisory board might not impress savvy investors who realize that the big names have little actual involvement in the company. But investors will be impressed by two or three industry players who have committed their time and energy to a fledgling company. Entrepreneurs should be advised to search for industry gurus who demonstrate interest and are willing to be involved.

Ability to attract co-investment and follow-on capital
Before approaching Angels or other early investors, company founders must consider where the next round of financing will come from. It might be appropriate to present the idea to an investor audience and get a sense of how investors might react to the idea in its later stages. The question becomes, do VCs and investors appear willing to fund the gap? An Angel who senses that the gap will have no bridge may be unwilling to waste funds on product concept that will eventually go down a hole.

Clear intellectual property (IP) strategy or position
IP is a challenge for start up companies, as founders must consider how much of their early dollars should be spent protecting and developing IP. Sometimes a provisional patent is all that is needed, though it might later prove duplicative in terms of cost. The critical question is, how important is an IP position for what the company is doing? Is patentable IP central to the company's competitive edge—in which case it should be protected—or does some the company rely only in small part on some eight generational product for which IP protection would be meaningless? Before spending money on IP, founders must ask, why should the IP be protected and how much can reasonably spent out of early dollars to protect it.

Defensible competitive position in an emerging or growth market
Entrepreneurs must be able to describe the potential longer term market success of a product. If there is no credible explanation as to why another company can't get to the market more quickly with more money, then there is no guaranteed market share and the idea won't get funded. Is the product so imitable that the market will be flooded with competitors once the product is introduced?

There are sectors in which the market share is so large than even a small hold on the market will produce a return on investment. That also must be demonstrated.

Clearly articulated value proposition
The value of an idea must be clearly communicated to investors in two sentences. Even well established existing technologies (social networking, e.g.) once had to be explained.

Achievable exit in the next three to five years
Company founders must always have an exit strategy, and that strategy should be constructed under the assumption that the IPO market, often volatile and unpredictable, is not an exit option. If the company might be sold, who might it be sold to? It is essential that entrepreneurs conduct due diligence into market transactions to get a sense of what potential buyers might be out there and what milestones might a company need to reach before it constitutes a valuable sale.

Market-validated equity valuation
Friends and family investors will be uninterested in market valuations but more sophisticated investors will want to understand the supportive evidence behind that valuation. Validating a valuation is a difficult but worthwhile project. Financing from later rounds may refer back to original or earlier stage valuations, which can become particularly damaging if those valuations were drawn too high.

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Investment that offers a preferred or protected equity position
Angel investors were once content with common stock but now expect preferred stock, such that the seed or early stage round of financing might resemble a traditional VC round. The point of this preferred stock, from the Angel's point of view, is to protect the Angel investor once the VCs have signed on board. Angels retain buyout rights and have the same terms and protections attached to their investment as the VCs (its possible that VCs might simply tweak series A documents into series B documents, changing little in terms of offerings).

Entrepreneurs must understand that while financing has changed, and today's Angels might expect the sophisticated protections that were previously seen only in later rounds of financing, that does not change the traditional definitions of series A (a somewhat organized raising of $3-5 million), series B (follow on), and series C rounds (roughly $30 million, a bridge to IPO).

"Need to have" product as defined by customers Entrepreneurs must demonstrate to investors why consumers' lives will end without a particular product. There must be a demonstrable need—even if that need is the need for a more simplified version of an existing product.

The Pitch—Promoting Ideas to Investors

These critical elements must be clearly and quickly communicated to the investor audience. Investors will have questions, so a sharp peppering should be expected, but a well designed and thorough pitch will calm investor nerves and demonstrate that company founders possess business and financial sophistication.

If investors possess technical expertise it is appropriate to use technical jargon to an audience, but company founders must be prepared to distill their idea to a level at which the press and general public might understand it and its market implications. To simplify the idea might require that 90 percent of what makes the product technically unique be stripped away. What should remain are the most relevant and marketable elements for the intended audience.

Use of Intermediaries
In some instances pitches might better be delivered by an intermediary to the company. Perhaps the management team does not have marketing skills, though they do have the business expertise. Perhaps a founder does not want to present herself as company CEO because that is not a role she intends to fill long term. Intermediaries can sometimes communicate effectively with investors where management would otherwise be unable to do so.

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The use of an intermediary should be carefully considered because some VCs are opposed to the idea of paying a fee to an intermediary to hear a pitch for a product that, according to some VCs, would stand on its own without an intermediary if it were a good enough product. However, some well respected intermediaries are known to endorse only those products they expect will succeed. Their representation is thus a sort of endorsement, one that VCs and investors will recognize.

Inclusion of Strategic Investors
Strategic investors can offer opportunity and financing to fledgling companies but their support can be costly, in terms of the provisions they request and how their involvement might affect a company's reputation. The inclusion of strategic investors could prohibit later rounds of investment; requested provisions could flatten sales as they request right of first sight of sale or right of first refusal. The possibility of follow-on rounds is uncertain. If strategic investors are to be included in an audience of investors, their invitation must be carefully considered.

With the above considerations, the pitch should include a discussion of::

Problem to be solved and definite customer need

The company solution to that need
Without technical detail, the overall picture should be concisely communicated

Key employees, advisors and their applicable industry background
Level of commitment from industry advisors is important

Market opportunity
A discussion of opportunity in the intended market necessitates a discussion of market size, growth, and characteristics as well as current competition within that market.

Market competition
Who are the competitors, what is the expected advantage and how will the company protect its competitive position.

Market strategy
What sales channels and partnerships do exist and will be built

Current status
As of the time the pitch is given, what is the state of product, who are the current customers, who are the current partners and investors, etc

Critical risks
What can go wrong and how will you manage—what strategies are in place to overcome the guaranteed glitches?

Financials
5 year financials, what will it take to get positive cash flow, what are the funding requirements, what are the pre-money valuations and how are funds being used.

Early round financing is a great challenge with potentially long term implications. It is at this first financing stage that some company founders realized, a great idea is not enough. It must be supported by a thorough and well researched understanding of the product market and investment climate. Presentation of ideas must be supported by demonstrated consideration of management experience, advisor experience, potential future and long term investors, and exit strategy. There do exist several possibilities for early stage and follow on financing, but securing money involves careful time at the drawing board. Appropriate legal counsel should be approached as needed.

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Angel Organizations
Foley & Lardner LLP does not intend to endorse these New England-based Angel group

- Angel Healthcare Investors LLC
  www.hcangels.com/
  Newton, MA (healthcare)

- Cherrystone Angel Group
  http://cherrystoneangelgroup.com/
  Providence, RI

- CommonAngels
  www.commonangels.com/
  Lexington, MA (software)

- HubAngels www.hubangels.com/
  Brookline, MA (technology)

- Launchpad Venture Group
  www.launchpadventuregroup.com/
  Wellesley, MA (technology)

- Maine Angels
  www.maineangels.org/
  Maine

- North Country Angels
  www.northcountryangels.com/
  Vermont

- River Valley Investors
  www.rivervalleyinvestors.com/
  South Hadley, MA

- TiE-Boston www.tie-boston.org/
  Wellesley Hills, MA

- Walnut Venture Associates
  www.walnutventures.com/
  Wellesley Hills, MA (technology)

- Breakfast Club
  Nashua, NH

- Keiretsu Forum
  www.k4forum.com/
  Boston, MA

- Investors' Circle
  www.investorscircle.net/
  Brookline, MA (socially responsible investments)

- Beacon Angels
  www.beaconangels.com/
  Boston, MA

- eCoast Angel Network
  http://www.ecoastangels.com/
  Portsmouth, NH

- Granite State Angels
  www.granitestateangels.com/
  Hanover, NH

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