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CLAREMONT McKENNA COLLEGE

ANGEL FINANCING: MATCHING START-UP FIRMS WITH ANGEL INVESTORS

SUBMITTED TO

PROFESSOR GEORGE BATTA

AND

DEAN GREGORY HESS

BY

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FOR

SENIOR THESIS

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Chapter 1: Introduction

The hardest time to receive financing for a venture seems to be the time it is needed most: throughout the development and start-up stage. Unlike relatively established firms, new ventures do not have past performance to rely on to easily show potential investors its merits. Additionally, these businesses are among the riskiest investments that investors can make. Because of this, finding financing for an early venture requires lots of time and hard work, which can be frustrating at times.

A typical entrepreneur begins by using personal savings or borrowing from friends and family to fund his/her venture. As the venture takes off, more financing will be needed. Until it proves successful, however, it will be hard to receive funding from banks and venture capitalists—firms that are organized as limited partnerships that provide funding for well developed firms usually in early-growth and rapid-growth stages of development. This creates a gap in financing that is often bridged through a source of funding called Angel Financing.

One of the best providers of early stage funding is angel investors. In the chapters that follow I will explain what angel investing is, how they work, and what angels look for. This information will help entrepreneurs be better equipped to find an angel investor that matches with their venture and ultimately result in financing. However with all the angels that are out there, it is important to note that no two angels are exactly alike or will have the same investment criteria. This paper will discuss an array of criteria that goes into an angels decision to invest and will look specifically into Tech Coast Angels, an angel network, and what factors are most important to them based on their history of financing.

Chapter 2: All Possible Forms of Financing for Entrepreneurs

The term entrepreneur has a wide range of meanings. It originates from the French word, entreprendre, which means "to undertake" (Quick MBA). In a business context, an entrepreneur is simply a person who starts a new business venture. A more elaborate definition however, is "a process through which individuals identify opportunities, allocate resources, and create value" (Entrepreneurship, Education, and Ethics). When we think of this definition we usually think of famous entrepreneurs such as Bill Gates, Steve Jobs, and Oprah Winfrey, among many others. When it comes to entrepreneurs, such as these and their new ventures, it is crucial to gain the most comprehensive information about the various funding options available. Options can range from internal funding options—self-funding, bootstrapping, friends and family—or external funding from investors such as angel investors and venture capitalists. Available financing will be based primarily on the venture's stage of development. Although there is no typical life cycle for a new venture, firms often go through five main stages: Development, Start-up, Early-growth, Rapid-growth, and Exit (Smith, Smith and Bliss 2011, 15).

Funding is critical to the success of a start-up firm, yet the earlier the stage, the harder it tends to be for the entrepreneur to acquire funding due to the high risks involved. Figure 1 shows the type of financing available at each stage. In the early stages of the venture, self-funding (also known as bootstrapping) will be the most common form of financing available. This means that the entrepreneur will need to invest private funds which include savings, credit cards, second mortgages, and personal loans (Preston 2007, 71). Doing so can be risky if the venture is unsuccessful, but without taking any risk investors will be less likely to invest: why would an investor want to risk money when the entrepreneur is not willing to do so?

Figure 1.1 Sources of new venture financing

	Development	Start-up	Early Growth	Rapid Growth	Exit
Bootstrapping					
Friends and Family					
Angel Investors					
Venture Capital					

Red shading indicates main form of financing available. Gray shading indicates secondary sources for financing.

Although bootstrapping is risky, "74 percent of U.S. firms use private funds at the start-up stage" (Osnabrugge and Robinson 2000, 38). This is because bootstrapping offers many advantages for an entrepreneur which is why entrepreneurs at times choose to rely on bootstrapping as their first option even if outside investing is available at such an early stage (24). The earlier a start-up firm obtains outside financing, the more control an entrepreneur must surrender. By waiting, the entrepreneur can retain a larger share of his or her equity stake. The reasoning behind this is that the riskiness of the venture decreases dramatically as it develops. Therefore, the cost of acquiring outside financing should also plummet. In addition to holding more equity, the entrepreneur will have more bargaining power in any decision making by waiting. It would be much easier for the investor to pressure an entrepreneur if the investor is providing most of the financing at the beginning because he is too vital to lose or upset. Lastly, deciding early on to bootstrap the initial growth of a firm will allow the entrepreneur to put all of his or her time and resources into growing the firm instead of spending lots of time in trying to attract investors, which could prove futile because many investors may not want to provide financing so early on (24). Common ways of putting off the need for external financing from

investors are: “forgoing or delaying compensation, buying used equipment instead of new, leasing equipment instead of buying, buying on consignment from suppliers, obtaining trade credit from suppliers, deliberately delaying payment to suppliers, and obtaining loans from relatives and friends” (28).

While bootstrapping is a very effective resource of financing, it cannot be the only source of financing as the start-up continues to grow. When a company grows it will tend to have more revenues which will lead to higher costs. These costs will require more money in order for the company to be able to run efficiently. As a result, eventually the entrepreneur will need to turn to external sources for financing. The first outside financing entrepreneurs tend to obtain come from friends and family. The amount of money attained from this source is usually a small sum that can be used to help “finish the business plan, create a prototype, or conduct validating research” (Preston 2007, 71). Furthermore, the money provided is often referred to as “love money” because their investments are made out of affection rather than based on the merits of the venture (71). In return, friends and family will either receive a promissory note or common stock depending on whether their investment is categorized as a debt instrument or as equity.

Unfortunately Aunt Sally and Uncle Mike’s contributions to a new venture are limited and eventually their resources will be exhausted. When this occurs, the entrepreneur will need to look for larger amounts of financing. By this stage, Angel investors may start to get interested. These types of investors are wealthy individuals or sometimes networks of individuals that can contribute funds of anywhere from several thousand dollars to a few million. This source of financing will prove vital to an entrepreneur as he prepares to expand his venture.

Chapter 3: What is Angel Investing?

Once the business plan is written, the market research is conducted, and a prototype is developed, the entrepreneur's venture has passed the development stage and resides in the start-up stage. Unfortunately, new businesses rarely show profits when operations first begin. Generating sales takes time and sale receipts are usually not enough to offset start-up costs and expenses. Because of this, the entrepreneur needs money to help the company grow. That's where an angel investor comes in.

The term angel investor originally referred to wealthy people who invested in Broadway productions. Today, however, angel investors do much more. "An angel investor is a person who provides capital, in the form of debt or equity, from his own funds to a private business, which is often an early-stage company but not exclusively, owned and operated by someone else, who is neither a friend nor family member" (Shane 2009, 14). These investors form a diverse population of wealthy individuals who fill a void in the venture capital market by providing early-stage private equity financing for new ventures. They are often thought of as an entrepreneur's best friend because they are by far the most important source of capital for early stage ventures (Hill and Power 2002, 3). In addition to providing entrepreneurs with capital, they often divulge their business knowledge, industry expertise, contacts, and ongoing support (Shop and Bell 2007, 5). For this reason, the best type of angel investing is a relationship rather than simply a capital investment. The entrepreneur should welcome mentoring and encourage the angel investor to be actively involved. After all, for the typical entrepreneur, angel investors represent one of the most attainable and friendly sources of capital financing.

Angels often have many years of experience running and investing in companies. Entrepreneurs can take advantage of this and benefit by using the expertise of their angel investor's business insight to help in areas in which they may not be as familiar. In addition to

offering business knowledge, the angel investor can provide industry expertise. This is because angels usually invest in an industry in which they are familiar and will have a "sound working understanding of how things really work in that industry" (5). Not only do angel investors provide advice and information, but they also provide introductions. It is not uncommon for them to introduce entrepreneurs to their network which could lead to potential customers, suppliers, lenders and key employees (5). Suppliers and lenders will be especially important because through networking, entrepreneurs may be able to secure special discounts or prices which could ultimately lower costs. Lastly, angels are very supportive because they believe in the necessity of entrepreneurship and want the venture to succeed. This is because they enjoy seeing entrepreneurs and businesses thrive in addition to seeing a return on their investment (5). "Financial angels have earned their wings through prior business success, accumulating wealth and wisdom that they re-deploy in ventures founded by the next generation of entrepreneurs. They willingly, even cheerfully, assume financial risks that would frighten off even some of the most experienced venture capital firms" (Hill and Power 2002, 3).

Why Angels Invest

Both entrepreneurs and angel investors know the riskiness involved with new ventures, so why do angels continue to invest? The main reasons angels invest can be summed into three main categories: opportunity for financial gain, playing a role in the entrepreneurial process, and certain nonfinancial factors. Most business angels are very motivated by financial gains. These angels hope to realize high gains within a few years. For this reason, at times the word angel is a bit of a misnomer. It may lead others to think that angel investors refer to people whose main motivation is altruism, when in fact they are more commonly referred to as angels because they

are willing to take such a big risk with their wealth. Making money is a very strong motivator, but it is not the only motivator and for some it isn't even the primary incentive (Shane 2009, 23). In addition to seeking high financial returns from investing in start-up companies, angels are motivated by the opportunity to get involved in the building process of a new venture. These angels may not want to go through the hassle of starting another venture of their own. Being an angel allows them to "stay in the game", without all the time and sweat that goes into developing a successful company. Other angels are motivated by their desire to learn new things. Whether its learning about new technology before it reaches the market or learning how companies get started, many angels simply like the challenge of learning something new (26). Angels also invest because they want to support their community by means of investing in new ventures (27). In doing so, they hope to help create more jobs, improve technology, and keep residents in their community (27). Lastly, some people become angels because they have recently retired and simply want to make angel investments as their hobby (26).

The funding that angel investors provide come from three types of angel investing. The first type is an individual angel, in which an angel investor is investing on his own behalf. Angel investors like these are wealthy individuals who tend to regularly invest in entrepreneurial ventures with their own money in sums typically ranging from at least $25,000 to over $1 million, and sometimes much more (Conway 2011, 13). The second type is when angel investors invest as part of an Angel Network. Like an angel investor investing on his own, angel investors that are part of an Angel Network can invest individually. However, they have the added advantage of working collectively in the screening process and reviewing deals, and having the option of investing together in new ventures. The last type of angel investing is called an Angel Fund. In an Angel Fund, angel investors pull their resources together but act as one

investor. This means as a whole they decide on each investment and no individual investments are made. By doing so, each venture that receives funding will receive a much larger sum. Being able to pull capital resources together is beneficial because it prevents the entrepreneur from needing to seek further outside financing from other sources such as venture capitalists. This ensures that angel investors will reap a greater return on their investment.

In all cases, angel investors expect to realize a significant return on their investment. This usually occurs when the venture is sold, goes public, or merges with another company. Since angel investors usually provide capital in the form of equity rather than debt, if the company fails the entrepreneur does not need to repay the money. This is one of the greatest advantages of having angel investors (Shop and Bell 2007, 4). Given that most new ventures are somewhat risky, not having to repay angel investors if the business proves unsuccessful is very appealing to the entrepreneur. However, these entrepreneurs should know that angels are aware of how risky new ventures can be, so before they invest they'll want to know exactly how their money will be used in order to make the company grow.

Age

Through interviews of over 1200 investors conducted during 1999 and 2000, the principals of International Capital Resources (ICR) found that the typical angel investors are usually men aged between 46 and 65 years old (Benjamin and Margulis 2001, 32). Angels tend to be slightly on the older side mainly due to the fact that acquiring wealth takes time. The interviews also showed that those aged between 56 and 64 were much more likely to play a more active role through management (32). This should not be surprising because the older these

investors are, the more likely they are to be retired. This allows them to devote more time to their capital investment projects.

Despite this interview and other resources mentioning that angel investors are commonly older businesspeople, there is a relatively recent phenomenon where "a younger group of high-tech millionaires have decided to reinvest some of their winnings from taking their own companies public" (Hill and Power 2002, 4). These millionaires emerged out of the market boom in the late 1990s (despite the dot.com downfall) which sent the assets of many upper-middle-class individuals up to levels that made it possible to join other wealthy individuals (4). These stock market gains gave these individuals the option to become angels. In addition, there's another recent phenomenon of "not-so rich individuals who are trying to invest into ventures indirectly by buying public shares in entities that, in turn, put capital into early-stage deals" (4).

Educational/ Occupational Background

Angel investors often have postgraduate degrees and used their educational background to make significant strides in their careers (Benjamin and Margulis 2001, 33). Their occupations range anywhere from having extensive professional executive careers and operating established companies to creating a successful business (these angels have often just completed their journey of entrepreneurship filled with longs hours and huge responsibilities) (33). Because many of them started their own company at some point, they tend to have lots of experience in trying to raise money and know the difficulty of acquiring early-stage, high-risk money. As a result, they can sympathize with the entrepreneur and see the benefits of the early-stage investing from the investor's side. Thus, angel investing is very alluring because it gives investors the potential to

harvest extremely high returns while acting as mentors to entrepreneurs for a cause they truly enjoy.

Conclusion

Angel investors should not be stereotyped into fitting one particular mold. They are all distinct individuals with different motivations for providing greatly- needed financing for entrepreneurs. Some of them invest purely for the hope of a high return while others invest to give back to their community. Although generalizations can be made about them, it is important to keep in mind that their demographics do reflect a highly idiosyncratic group because for every rule there will always be an exception.

Chapter 4: Trends in Angel Investing

In the last 30 years, the United States has transitioned from an industrial and manufacturing economy to an emerging entrepreneurial economy in which the idea of innovation and being your own boss is highly prized (Sohl 1999, 101). This transition led to the emergence of the early-stage equity market, also known as the angel investor market. "Angel investors are by far the most important source of capital for early-stage ventures, and as such are vital contributors to our economy's continued growth and prosperity (Hill and Power 2002, 3)." Every time an angel investor supplies capital into a new venture it is as though he earns a new pair of wings.

These investors come in at the riskiest time but also the most exciting time because they can see the development of the company from the very beginning. Because of how imperative angel investing is and the big role it plays in entrepreneurship, having data regarding the angel

investor market is important. It is challenging, however, to gauge exactly how many angel investors there are and how large the angel market is in the United States. Many studies have been conducted to try and extrapolate such data, but it has been challenging because angel investors prize their privacy and are not legally required to publicly disclose their activity (Benjamin and Margulis 2005, 40).

The Climate Today

The Center for Venture Research is part of the Whittemore School of Business and Economics at the University of New Hampshire in Durham. On its website, it states that their main area of focus and expertise is early stage equity financing for high growth ventures. According to its website, since its beginnings in 1984, the Center has published multiple studies in the area of early-stage equity financing of entrepreneurial ventures, including research on the angel investor market. Their work is so well trusted that they have been quoted in several publications which include Forbes, Fortune, Red Herring, Business Week, the Wall Street Journal, and the New York Times, among others (Center for Venture Research). In the Center's most recent academic research, they have studied and analyzed the angel investor market for the first half of 2010. According to the analysis, "The Angel Investor Market in Q1Q2 2010: Where Have All the Seed Investors Gone?", total investments in the first half of 2010 were $8.5 billion, a decrease of 6.5 percent over the first half of 2009. Moreover, according to the Center 25,200 entrepreneurial ventures received angel funding in the first half of 2010 which was a 3 percent increase from the same period in 2009. And lastly, the number of active angel investors in the first half of 2010 was only 125,100, a decrease of 11 percent from the same period in 2009. By grouping each of these points, it is clear to see that angels invested "fewer dollars in more deals

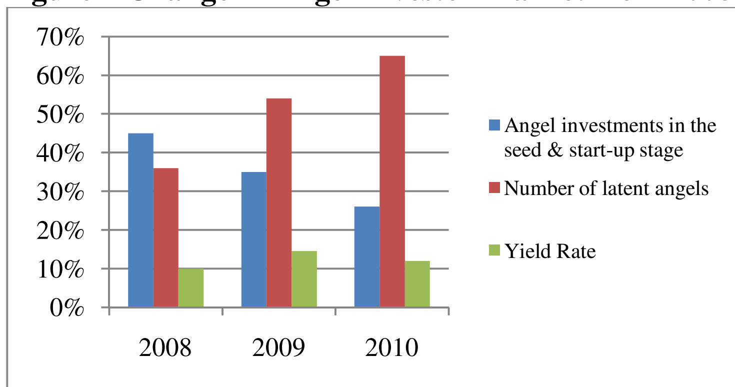
in the first half of 2010, with seed and start-up stage investing declining to its lowest level in several years" (Sohl 2010, 1). This is not promising, because this trend could have a profound effect on new ventures if enough capital is not being supplied.

It is not surprising that for the first half of 2010 fewer dollars were invested. Less funding by angel investors is a direct result of the health of the U.S. economy. Over the past few years people's net worth has been dropping. This has made it increasingly difficult for angels to invest their money into risky transactions because even if they are successful they do not produce returns for several years (lack of short-term liquidity). Because of this, rather than focusing on trying to induce angel investors to increase the amount of capital they are currently providing, it may be more beneficial to find ways to increase the number of active investors. "While the number of angel organizations, and individuals that are members of organized angel groups, is increasing, there is a significant percentage of latent angels" (2). The term latent angel refers to individuals who have the necessary net worth to invest in new ventures, but have not done so. For the first two quarters of 2010 the percentage of latent angels within angel groups was 65 percent, an increase from the previous year by 11 percent and by 29 percent from 2008 (2). This is significant because if the rate continues to increase there will not be enough participation in the angel investor market.

According to Jeffrey Sohl, the director of the Center for Research Venture, "angels have decreased their appetite for seed and start-up stage investing, with 26 percent of quarter one and quarter two angel investments in the seed and start-up stage, marking a steady decrease in the seed and start-up stage that began in 2008 (45 percent) and 2009 (35 percent)" (1). This is the smallest percentage in seed and start-up stage investing in the past several years. This is further shown by an increase in investments made toward post-seed and start-up ventures with 56

percent of investments in this stage (1). This is a bad sign because angel investments are the main source of capital for new ventures. Friends and family usually do not have the necessary funds to help jump start a new venture and venture capitalists do not want to invest at such an early stage. Without some sort of impending reversal of this trend, entrepreneurs will be greatly affected which may cause individuals to halt their efforts of entrepreneurship which leads to less new ventures, which could ultimately lead to fewer job creations. Sohl goes further to say that "this change in investment behavior is likely an indication of both a need to increase investments in existing portfolio companies in order for these portfolio companies to survive the recession and an extended exit horizon".

Figure 1 Change in Angel Investor Market from 2008 to 2010



When angel investors decide to pour thousands of dollars and sometimes hundreds of thousands of dollars into a fund they usually have a specific industry in mind. Although multiple industries receive capital from angels, in the first two quarters of 2010 the Healthcare sector received 24 percent of total angel investments which was the most funding received in any other sector. The other top funded sectors were Biotech (20 percent), Software (12 percent), Industrial/Energy (11 percent), Retail (9 percent), and Media (5 percent) (Sohl 2010, 2). This breakdown shows which industries angel investors believe will give the highest return on their investment or the industry in which angel investors care the most about. Not only is it

convenient to know which industries receive the most funding, but it is also important to know the percentage of investment opportunities that are brought to the attention of angel investors that result in an actual investment (yield rate). In 2010 the yield rate was 10 percent, whereas in 2009 it was 14.5 percent and 12 percent in 2008 (2).

Size of the Angel Capital Market

Some of the best known companies emerged in great part because of angel investing. In 1874 when Alexander Graham Bell came up with the idea of the telephone, banks did not want to give him financing (Sohl 1999, 102). They felt that the idea was foolish and too risky and turned him away. Fortunately, Bell did not give up and was able to get financing from Boston attorney Gardiner Green Hubbard and leather merchant Thomas Sanders of Salem, Massachusetts (102). Although the term "angel investor" was not used at this time, angels are what Hubbard and Sanders were. Without their investment Bell may not have invented the telephone. There are numerous stories like these (Henry Ford with the Model T, Anita Roddick with the Body Shop, and Jeff Bezos with Amazon) in which great ideas may have gone unforeseen because of lack of capital. These and other stories serve two main purposes: to continue to show the importance of angel investing and to provide the motivation for the research on early-stage equity markets.

The study of angel investors was spearheaded by William Wetzel, a now retired business professor from the University of New Hampshire. His work conducted in 1983 is generally regarded as the first study to "establish the existence of private investors" (102). From this, more research was conducted to give a better understanding of the US private market. This market has

grown tremendously since 1980 and its growth is attributed to the transition to an entrepreneurial-driven economy.

> "From 1954-1979, the share of GNP represented by the Fortune 500, the 500 largest companies in the USA, grew from 37 to 58 percent. The payrolls of these 500 largest US industrial corporations peaked in 1979 at 16 million jobs. Since 1979, Fortune 500 employment has exhibited a steady decline as employment decreased by over 25% or 4 million jobs. In 1996 the percentage of employment represented by the Fortune 500 was a scant 10%. From 1979 to 1995, the invisible entrepreneurial economy generated over 24 million new jobs as the number of new businesses created increased by 200%" (102).

The increase in new ventures is an indication that the size of the private capital market is expanding. Conservative estimates indicate that roughly 250,000 angel investors fund about $10-$20 billion each year in more than 30,000 new ventures (108). The growth of new ventures also leads to a growth in the number of entrepreneurs who are potential future angel investors, because if their venture proves successful they reap the rewards and have the potential to accumulate enough wealth to invest in other early-stage ventures. "Estimates suggest that the number of latent or potential self-made, private investors exceeds the number of active investors by a factor of five to one" (108). This means there is tremendous potential for growth in the angel investor market.

Inefficiencies in the Market

One of the problems angel investors face is the lack of an efficient private venture investor market (Benjamin and Margulis 2005, 39). There are two main inefficiencies in the private equity financing market. The first problem at hand is the prominent capital gap between

the needs of early-stage ventures and the suppliers of early-stage capital (Sohl 1999, 109). While there are numerous estimates as to how many newly formed ventures there are in the US, it appears as though "the number of high growth entrepreneurial ventures that need equity financing is estimated to include roughly 70,000 start-ups per year (5–10% of total start-ups) and about 300,000 ventures growing faster than 20% per year, including 80,000 growing faster than 50% per year" (109). Furthermore, estimates suggest that "US entrepreneurs need around $60 billion per year of patient, high-risk value-added equity capital, over twice the venture financing currently available" (110).

The second inefficiency is an information gap. For the market to be efficient, reliable information must be made easily available regarding financing sources and investment opportunities. Because an entrepreneur cannot find angel investors simply through Google and no public records of their previous engagements exist, finding angels is difficult. Furthermore, few vehicles exist for bringing together potential investors and entrepreneurs seeking funding. This is significant, because without this efficiency, entrepreneurs cannot access all the capital available angels cannot invest to their fullest potential which leads to underinvestment. Entrepreneurs need to have easy access to finding angel investors and more importantly, angel investors need information readily available on venture opportunities and pre-IPO (Initial Public Offering) companies. "Extensive studies by International Capital Resources suggest that more than 50 percent of private investors' deal flow comes through family, friends, associate, and colleagues—an extremely limited source of deal flow" (Benjamin and Margulis 2001, 95-96). For this reason, numerous angel investors indicate having additional capital available to dispose but limited opportunities to invest. However, because angel investors want to retain certain anonymity, information becomes difficult to obtain and causes a funding gap in both the seed

and start-up financing stage. This gap ranges anywhere from a conservative $100,000 to over $1,000,000 at the high end (Sohl 1999, 110). Hopefully, with more studies being conducted on the angel investor market, specifically regarding its inefficiencies, some of these problems can be rectified.

Chapter 5: What Attributes do Angel Investors Seek?

In 2010 only 10 percent of investment opportunities brought to the attention of angel investors resulted in an actual investment (Sohl 2010, 2). In 2009 the yield rate was slightly higher at 14.5 percent and in 2008 the yield rate was 12 percent (2). These low yield rates illustrate how entrepreneurs are often rejected by investors. This does not mean that there is anything necessarily wrong with their ideas but simply that their new venture does not fit that angel investor's particular investment criteria (Hill and Power 2002, 61). After all, there is minimal access to angel investors and finding them usually takes lots of time. Their preferences can include, the amount of capital needed, geographic limitations, the industry the company is in, and exit strategies among many others. Because of this, entrepreneurs can save themselves a lot of time and aggravation by doing research as to which angels match well with their new venture. Each angel investor however is influenced by his/her own personal criteria and investment characteristics. This makes it more difficult on entrepreneurs because there isn't 'a one-size-fits-all' checklist that fits every investor's criteria.

Investment criteria are the characteristics of investment opportunities that attract angels to invest. Before investing thousands of dollars into a new venture, angel investors consider an array of criteria. These angels hope to realize high gains within a few years and because they are willing to take such big risks with their personal wealth they want to be very careful about each

investment they make. For this reason, angels greatly emphasize *both* the attributes of the venture and the attributes of the entrepreneur when deciding to invest in any proposal.

Capital Investment

Some elements in an angels' investment criteria center around how much angels can afford to invest, how much they can afford to lose, and how long they can afford to lose access to their money. Knowing these elements goes hand in hand with knowing their level of acceptable risk. Angels are very interested in building small start-up companies into medium sized or large valuable companies that can be exited from with a high return on investment; however, the highest risks occur when the company is in the pre-seed, seed, R&D, and start-up stages (Benjamin and Margulis 2001, 40). Because the risk associated with investing in a start-up venture for extended periods can create anxiety and pressure, it is important for angels to be sure they can afford their initial investment. This includes the ability to pour more funds if the venture merits it, as well as the ability to lose access to their money over an extended period, perhaps five to ten years (41). Often, investors try to mitigate their risk by structuring funding on performance. In other words, rather than presenting the entrepreneur with all the capital at once, realistic milestones are made and incremental capital is provided each time the entrepreneur reaches each target (41). If, however, the entrepreneur fails to meet a milestone, the angel investor is given the option to continue to invest but is not required to. Moreover, the angel investor "may receive the right to negotiate a lower-priced deal" if this occurs (41). This may make structuring and negotiating the deal more complex, but it will allow the angel investor to enter into an investment with more ease (41). Another way angels reduce their risk is by playing an integral part in the decision process. Angels want to have the opportunity to

contribute to the venture because they feel that "their involvement can contribute to the success of the venture. This is why "the non-financial value that an angel investor can bring to a project is the third most important factor in an angel's decision to invest" (Mason and Stark 2004, 233).

Geography

Angels usually prefer to invest in companies near where they live. Angels prefer to invest locally for two main reasons. First, angels like to be heavily involved. They want to be able to share their knowledge rather than be a passive investor. This involves meeting periodically with the entrepreneur and management team of the new venture and visiting the company firsthand to see how it is doing (Hill and Power 2002, 63). Often angles prefer this as a means of reducing risk (Mason and Stark 2004, 232). Investors who would rather take on a passive role, "are trying to diversify their portfolio, or have co investment contacts in other geographic regions" (Benjamin and Margulis 2001, 42) may feel comfortable investing in companies further away. Secondly, since angel investors typically hear of investment opportunities through business contacts and other people they know, it is reasonable that they mostly learn of deals in their own geographic area anyway (Morrissette 2007, 58). Historically, angels have found their deals in three ways. Research by International Capital Resources of over 9,000 angel investors found that approximately 57 percent found deals through personal contacts (Benjamin and Margulis 2001, 96). This includes primary sources such as family, friends, and coworkers. Around 31 percent of angel investors found deals through referrals from attorneys, accountants, investment bankers, and brokers (96). Lastly, only about 12 percent of angels found out about a deal of an unsolicited contact from a nonfamily representative of the firm seeking financing (96).

Market/Industry

Angel investors want to understand the industry that they invest in. It allows angels to evaluate how they can add their own knowledge and experience to the firm. By doing so, these investments are seen as less risky than investments in industries that are foreign (Shane 2009, 112). This sentiment was acknowledged by one of the survey angel respondents from Mason and Stark's 2004 study, who commented, "'the more unknowns that you can take out, the less risk you are running'". Moreover, studies show that the number of years of experience that angel investors have in the industry in which the investment is made is positively correlated with their return on the investment (112). Equally important however, is that angels want to invest in ventures in which the market for the product is either large or has great growth potential (Hill and Power 2002, 66). If the entrepreneur is trying to establish a new market, angels will scrutinize the new market and try to determine whether there is significant potential for fast growth (Benjamin and Margulis 2001, 39).

On average, angels like to invest in high-tech industries because they have large and rapidly growing markets. Conversely, angels tend to shy away from retail and personal service industries. This is because these businesses "sell at a low multiple, require rapid growth to generate enough revenue to be sold at a good price and lack economies of scale" (Shane 2009, 107). In fact, "experts claim that only a small minority of angel investments—15 percent—are made in all nontechnology businesses combined" (107). Some analysts have gone as far as to say that certain industries are inappropriate for angels (107). Angels try to avoid ventures that sell commodity products because the market treats these goods as equivalent or nearly equivalent, so it does not matter who produces it and yet these companies tend to lack the scale to compete on price (107). Lastly, ventures in slow-growth industries or in small markets would

not be fitting because of the intense competition and large share of the market that would be needed to succeed which makes it difficult for new companies to survive (107).

Without looking at more data it would be a mistake to prematurely cut out the industries mentioned above. When researchers conducting the Entrepreneurship in the United States Assessment asked a representative sample of angel investors about the businesses they have backed over the previous three years, the results showed that angels had invested in a very wide range of industries and were not necessarily biased toward high-tech companies (108). Moreover, in the first half of 2010 the top funded sectors were Healthcare (24 percent), Biotech (20 percent), Software (12 percent), Industrial/Energy (11 percent), Retail (9 percent), and Media (5 percent) (Sohl 2010, 2). This shows that Angels invest in a wide array of industries.

Technology/Product/ Service

Angel investors try to identify companies that are doing something or have something unique and special that customers will easily see the difference and gravitate toward that product or service (Hill and Power 2002, 67). In order to get the attention of these angels it must be clear how this product or service will benefit an individual or company. Ideally, the company has a monopoly, has by far the largest market share, and customers are very satisfied with the product or service offering. For most companies, this enviable position does not last long, if at all. However, if there is a slight monopoly great profits can be earned and great value can be created. Because of this, angel investors commonly search for investment opportunities with a proprietary advantage, whether it is in the form of patented technology, a unique technology handled as a trade secret, a competitive strategy advantage, or a head start in the market that acts as a barrier to competition (67). For this reason, technology companies are often highly sought after.

Exit Strategies

The exit strategy simply tells angel investors when and how they can finally harvest the rewards from their initial investment. It also keeps the entrepreneur weary of the fact that the investment will not be forever. Angel investors recognize that several years (usually 5-10 years) will pass before they can realize a return on their investment. Because of this, angels seek ventures with high growth opportunities that could be attractive to prospective acquirers or have the possibility of an IPO (Sudek 2006, 96). Given that IPO's are rare, not all investors, may want to wait for a possible IPO to see a return on their investment. Because of this, angel investors will want to see if their liquidity options match with the investment opportunities presented to them. If the angel investor is looking for pre-IPO situations, the criteria will differ widely from the criteria of a venture that will provide returns through a buyback of the stock from investors or through a merger and acquisition (Benjamin and Margulis 2001, 43). Since angels cannot harvest a return on their investment until a liquidity event occurs, emphasizing possible exit strategies to an angel investor is very important.

Characteristics of Entrepreneurs who Receive Angel Financing

Angel investors weigh heavily into the man behind the idea. Beyond having a good idea and investment preferences that match up well with the company, angel investors are also very concerned about the entrepreneur. "Based on evidence from focus groups with angel investors, people in the project are the most critical factor in an angel investor's decision to invest" (Mason and Stark 2004, 233). Because angel investors, on average, spend considerable time with the entrepreneur it is important that the entrepreneur's attributes be weighed heavily. This will ensure that the angel and entrepreneur have the right chemistry and can work well together.

Thus, angels often look for people who are "honest, exhibit a strong work ethic, understand what it takes to make the business succeed, have invested in their business, and have a realistic notion of how to value the business" (233). Angels want to know if they can work with the entrepreneur and whether or not the entrepreneur has a good track record. Because angels are stringent with the attributes of entrepreneurs they will be less deterred by gaps in the management team because they can contribute missing expertise through their own involvement (234).

Although research on how angel investors select their investments is limited, out of the characteristics mentioned above, angels tend to value an entrepreneur's passion and trustworthiness the most (Sudek 2006, 95). Entrepreneurs who show passion and commitment are typically able to capture more interest because of the perception that starting a new venture is so difficult that without immense commitment and enthusiasm the chances of failing are more likely. This is because entrepreneurs may want to give up rather than work through all of the problems they may encounter. Almost as important was trustworthiness. Often times, a lack of trust would be a deal breaker for an angel investor despite any of the merits the business opportunity may offer such as growth potential or return on investment potential (95). Trustworthiness is vital because angel investors are very concerned with agency risk—"risk that is caused by the separate and possibly divergent interests of entrepreneurs (agents) and investors (principals)" (Mason and Stark 2004, 231). This is especially so because most contracts between angels and entrepreneurs tend to be simple and informal (231). Without trust it would be difficult to enforce contractually unbinding agreements (231).

It seems reasonable for angel investors to perceive the entrepreneur as the most important member of the venture; however, the team is also very important to the venture's success.

Angels realize this and place a high emphasis on the management team as well. As with the entrepreneur, angels seek passion and commitment from the team members. It cannot be stressed enough how important these two attributes are, since investors feel these are the critical attributes needed for the venture to succeed. Other important aspects include coachability, experience of advisors, track record of the individuals of the team, and experience of the team working together—especially if teams struggled in rough times but kept persevering (Sudek 2006, 96).

Conclusion

After looking at what criteria angel investors value, entrepreneurs should realize that a good idea alone is not enough to obtain funding. Fortunately for entrepreneurs, angels invest in plenty of companies that do not meet all of these criteria (Shane 2009, 103). Unfortunately, results of surveys taken over the past years of angels on investment criteria do not always show agreement as to what angel investors seem to value most (103). Table 5.1 shows the top ten investment criteria as identified by business angels participating in three different studies.

Table 5.1

Investment Criteria	**Van Osnabrugge and Robinson Ranking**	**Hill and Power Ranking**	**Sudek Ranking**
Enthusiasm of the Entrepreneur	1		3
Trustworthiness of the Entrepreneur	2		1
Revenue Potential	3		5
Expertise of the Entrepreneur/Quality of Management	4	1	2/6
Degree to Which Entrepreneur is Liked	5		
Growth Potential of the Market	6	2	7
Quality of the Product	7		
Return on Investment (ROI)	8	7	8
Presence of a Niche Market	9		
Track Record of the Entrepreneur	10		

Proprietary Nature of the Product/ Competitive Protection		3	10
Size of the Market		4	
Presence of Barriers to Entry		5	9
Nature of the Competition		6	
Industry the Venture is in		8	
Stage of Company Development		9	
Potential Exit Routes (potential liquidity)			4

Source: Taken from information contained in Von Osnabrugge, M., and Robinson, R. 2000. *Angel Investing: Matching Start-up Funds with Start-up Companies—The Guide for Entrepreneurs, Individual Investors, and Venture Capitalists*. San Francisco: Jossey-Bass; Hill, B., and Power, D. 2002. *Attracting Capital from Angels*. New York: John Wiley; and Sudek, R. Angel investment criteria. 2007. *Journal of Business Strategy*, 17(2); 89-104.

Van Osnabrugge and Robinson found that four out of their top five investment criteria related directly to the entrepreneur, whereas Hill and Power found their top three factors to be quality of management, growth potential of the market, and competitive protection (Morrissette 2007, 60). Sudek's findings are more similar to those found in Van Osnabrugge and Robinson with two key differences. Before listing these differences it is important to note that Sudek's study was conducted on U.S. angel investors while Van Osnabrugges and Robinsons's study was conducted on U.K. angels. The first item that was rated on opposite ends of the spectrum was "Potential exit routes". Sudek's study found that angels rated "Potential exit routes" at fourth, while Van Osnabrugges and Robinson's study found that angels rated this criterion at twenty-fourth (Sudek 2006, 100). This difference could imply that U.S. angels view success with having a clear exit strategy. The second item dealt with the rating of "Degree to which the entrepreneur is liked" (fourteenth by U.S. angels and fifth by U.K. angels) (100). In many cases, after a venture moves past the start-up and early-growth stage, the entrepreneur and management team can be replaced. Because of this, U.S. angels may be less concerned with initially liking the entrepreneur and more interested in whether the entrepreneur is trustworthy and passionate. Although the ranking orders of these eleven items do not necessarily overlap perfectly, there is certain agreement. Entrepreneur's should understand by now that a lot of the criteria is subjective to each angel

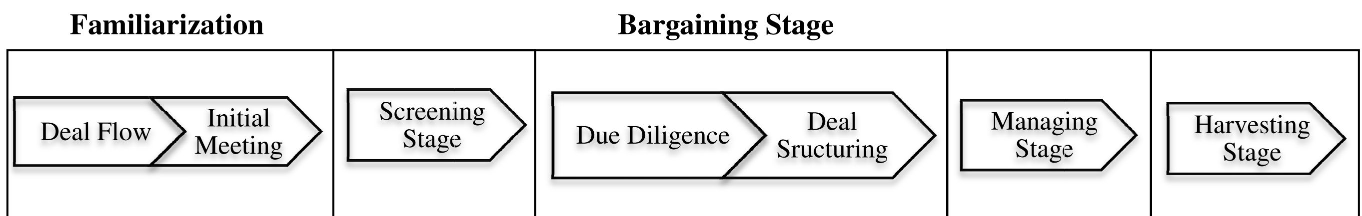
investor's preferences, however they should also be weary of overall themes that angels as a whole are inclined to favor. Knowing these themes will help entrepreneurs in their quest to raise capital for their venture.

Chapter 6: Angel Investor's Selection Process

While there has been a growth in interest in the private market and the interaction of entrepreneurs and angel investors, there are still areas of their activities that remain under-researched. One of the most significant of these is the angel investment process. Understanding the different components of the process is useful because they are the working parts integral to reaching an agreement. This helps entrepreneurs to raise money and angels to make sound investment decisions efficiently and effectively (Shane 2009, 126).

Based on prior studies conducted on angel's investment process, five stages are said to represent the process. These stages are: familiarization, screening, bargaining, managing and harvesting (Paul, Wyper and Whittam 2007, 113). These stages, shown in Table 6.1, highlight the main steps angel investors take before providing entrepreneur's with capital financing. It is important to underscore that angel investors have the opportunity of terminating the process at any time through the investment process.

Table 6.1



Familiarization Stage

The first step in the angel investment process is learning about the opportunity. While some angel investors find investment opportunities by networking, "Extensive studies by International Capital Resources suggest that more than 50 percent of private investors' deal flow comes through family, friends, associate, and colleagues—an extremely limited source of deal flow" (Benjamin and Margulis 2001, 95-96). An additional 31 percent of angel investors come across early-stage venture opportunities through referrals from professional service providers, such as lawyers and accountants (96). Lastly, approximately 12 percent of investors have received an unsolicited contact from a representative of the firm (96). Historically, because angels reject many proposals they are presented with, these informal means have left angels investing below their full potential. To increase deal flow and better find new ventures that merit capital investment, angels are resorting to more formal means of deal flow. These formal strategies include participating in venture forums, joining venture capital clubs and participating in investor networks (Benjamin and Margulis 2005, 224).

At this early stage in the process most angels begin assessing these opportunities. This begins namely with angels scoping a summary of the business plan to see if their key investment criteria are met (previously discussed in chapter 5). If the proposal meets the preferences of the angel, most likely the angel will contact the entrepreneur to arrange a meeting (Paul, Wyper and Whittam 2007, 115). This gives angels the opportunity to form a first impression about the entrepreneur and possibly the management team. When the overall sentiment among angels stresses the importance of investing in entrepreneur's who exemplify key attributes, entrepreneur's need to be able to show these angels that they can work well together.

Screening Stage

After their initial meeting, angel investors will decide whether to move forward and engage in more formalized screening. According to the Angel Capital education Foundation (ACEF), 10%-25% of entrepreneurs who apply reach this stage (Shop and Bell 2007, 68). If angels decide to continue, another meeting is arranged in which the entrepreneur and management team will be asked to make a presentation. Every angel and angel group has slightly different screening procedures (Shop and Bell 2007, 68). These depend on whether the angel is part of an angel group or network, how sophisticated the angels are, and the amount of applications they receive (68). At this stage angel investors will look past first impressions and try to thoroughly study all aspects of the business opportunity at hand. A compilation of most common red flags that raise serious questions about the merits of a potential deal is shown in Table 6.2. By now, they will have the full business plan including financial statements (68). In addition, angel investors are likely to evaluate how they can contribute to the venture beyond the scope of their financial investment. Most angels like to be actively involved and want the opportunity to contribute to the venture because they feel that their involvement can contribute to the success of their potential entrepreneur's venture. All and all, this portion of the investment process usually takes anywhere between one and three weeks.

Table 6.2

Red Flags for Angel Investors
• **Numerous small investors:** Having a complicated current ownership/ stock structure may make deals more complex than investors are will to bother with.
• **Claiming there is no competition**
• **Plans to use investor funds to pay off past debt:** Angels want money to be used to grow the company
• **Unrealistic valuation-**Demonstrates that entrepreneur has unrealistic sense of the marketplace
• **Entrepreneur's unwillingness to relinquish any control or reasonable percentage of ownership-** Shows entrepreneur is difficult to work with
• **Unrealistic expectation of projected market share**

- **Unclear or unbelievable business model**
- **Misrepresentation-**Entrepreneur's need to be open and honest. Accurate financials, previous business failures , and any legal disputes should be disclosed

Sources: Taken from information contained in Preston, Susan L. 2007. *Angel Financing for Entrepreneurs, Early-Stage Funding for Long-Term Success.* San Francisco: Jossey-Bass; Shop, The Planning, and Joseph R. Bell. 2007. *Finding an Angel Investor in a Day: Get it Done Right, Get it Done Fast!* Palo Alto: Planning Shop.

Bargaining Stage

In this stage, due diligence is completed and negotiations are finalized with regards to the valuation of the venture. Since, the dot-com and technology bubble burst, angel investors have become more skeptical of entrepreneurs' enthusiastic claims (Benjamin and Margulis 2005, 226). It is routine for angel investors to conduct detailed investigations which can consist of full legal and financial audits, assessment of market potential by an industry expert, background and reference checks on founders and entrepreneurs involved, interviews with outside parties involved, and research with customers, suppliers, competitors, and technology experts (226). This may seem excessive to the layperson, but angel investors need to go to these lengths in order to make informed decisions. Unlike public firms, early-stage ventures in the private market are not subject to the same level of rigorous disclosure rules. Therefore, it is the responsibility of the angel investor to conduct due diligence in order to identify the risks in the venture and potential deal. If red flags do not emerge and angel investors wish to continue they will move onto the valuation phase of the bargaining stage.

During the valuation stage, how much an angel is willing to invest and how much they expect to receive are always integral issues. The valuation of the company determines how much the venture is worth, how much money can be raised, and how much ownership the entrepreneur will retain (Shop and Bell 2007, 93). It will also set the stage for how much financing the entrepreneur will be able to obtain in subsequent round of financing (93). Valuations that are too

high may deter future investors and may cause down rounds (valuation in subsequent round is lower). On the other hand, if valuations are too low, entrepreneurs will be giving up a higher percentage of the company than is needed. This makes negotiations difficult because at such an early-stage in the venture's development a lot of the value is based on what the venture expects to achieve rather than established merits.

At the end of this stage, a formal agreement between the entrepreneur and angel is formed and legal documents are in place. With the economy in a recession, people don't have as much patient money to spend on these investments. Due to the current economic condition and recent downturns, deals have become more investor friendly because demand is outweighing supply. Once the valuation is agreed upon, the security to be used in the transaction is determined. Typically, when structuring the deal, angel investors receive equity for cash. The most common investment security used is convertible preferred stock (Benjamin and Margulis 2005, 234). This is preferred by angel investors because it provides them with leverage to influence management when agency problems (defined in next section) arise and it requires the entrepreneur to remain in contact with the angel investor (234). Other terms and covenants that may appear in the agreement are anti-dilution provisions, preemptive rights, and rights of first refusal. Anti-dilution provisions are set to protect investors from the possibility of a lower valuation in subsequent rounds of financing. The most common method is through an anti-dilution ratchet. A ratchet provides the investor additional shares of stock either for free or at a reduced price so that the average cost per share is the same as the new investor or the weighted average price of subsequently issued shares (Conway 2011, 62). Preemptive rights give angel investors the right, but not obligation, to purchase up to its pro rate share of any offering of stock at the same price and terms as the venture offers to other potential investors (62). Lastly, right of

first refusal offers angel investors the right to purchase any shares offered for sale by other shareholders of the venture (at the same price and terms as they are offered to third parties), prior to them being sold to an outside party (62). After all this is provided for, angels and entrepreneurs enter into the managing stage.

Agency Problems

The two most common agency problems are moral hazard and adverse selection. Moral hazard occurs when the agent does not put forth the effort originally agreed upon in the contract (Van Osnabrugge 2000, 94). The agent may also have personal incentives to withhold or modify crucial information such as missed milestones in order to continue receiving financing. Conversely, adverse selection refers to the misrepresentation of personal abilities by the agent (94). The agent may falsely claim to have certain skills or lie about his/her knowledge or background in the industry in order to appear more marketable to the angel investor. Adverse selection arises because the principal cannot completely observe and verify these skills or abilities of the agent even with due diligence.

Angels can reduce agency problems through the principal agent approach, in which the angel tries to produce the optimal contract coupled with active involvement in the investment (95). These contracts can be designed as behavior or outcome based. In behavior based contracts, appropriate behaviors of the entrepreneur (agent) are stated in order to limit any devious behavior. This will only work if the principal is able to observe and verify the agent's behavior, which is why angels prefer to invest in local companies. Because of this, principals often establish outcome based contracts in which incentives are given to agent's based on

performance. This generally refers to completing set milestones. By doing so the principal limits the agent from pursuing his or her own agenda.

Managing Stage

Most angels take an active post-investment role in the venture they invest in. In fact, often times angel investors become part of the board of directors (Shop and Bell 2007,139). The younger the venture is, the more involvement there tends to be. To manage risk, investors implement monitoring strategies to track the performance of the venture (Benjamin and Margulis 2005, 238). At a minimum angel investors expect monthly financial statements and sales reports (Shop and Bell 2007, 139). This allows angel investors to see how capital is being used. Angel investors will also track costs, sales, earnings, profits, orders, and budgets to detect any signs of problems early on. In addition, angel investors prefer to have quarterly or monthly board meetings to discuss performance against planned milestones, and receive timely reports if any unexpected challenges arise or milestones are missed (139). This is a great way to not only reduce risk but also to assess how management is doing and how to help if needed.

Harvesting Stage

Angel investors realize returns on their investments through an exit strategy. Possible exit strategies include: “IPO, sale of investor’s stock back to the founders, sale of the company, merger or acquisition with a publicly traded company in exchange for liquid or tradable stock, or transfer of stock to other investors” (Benjamin and Margulis 2005, 240). Because IPO’s are rare, harvesting usually occurs through merger, acquisitions, and LBO. Returns to investors are long-term capital gains that are usually realized after a five to ten year horizon. Angel investors

understand that their capital provides no liquidity for quite some time, but discussions about exit routes should still occur in early stages of the investment process in order to avoid any confusion.

Conclusion

These five stages outline the investment process that takes place between angel investors and entrepreneurs. Cumulatively these stages can take anywhere between three and eighteen months. This is because lots of capital is usually involved which requires strategic planning. Angel investors want to be weary of perceived risk and entrepreneurs want to be careful when it comes to relinquishing too much control. Although the investment process can be grueling, after the agreement is reached the entrepreneur can finally return to focusing all of his attention back into making the venture successful.

Chapter Seven: Tech Coast Angels

The term angel investor is predominantly used to describe a wealthy individual who invests in entrepreneurial ventures with their own money. In recent years, angels have begun to band together to form angel networks and angel funds. This allows angels to work collectively by pulling their resources—time, knowledge, and capital—together. By doing so, angels garner more deal flow and can make larger investments.

Tech Coast Angels (TCA) is the largest angel investment network in the United States. It was recently ranked the number one investment group in Southern California by Pricewaterhouse Coopers' report entitled *Shaking the MoneyTree*. TCA is an alliance made up of three independent networks: Los Angeles, Orange County, and San Diego, all linked together. This

organization is managed by a board of governors composed of representatives from each of the three networks in the alliance (May and O'Halloran 2003, 57). Members from each network are required to pay membership dues, attend a minimum amount of meetings, and invest at least $50,000 each year (58). Currently, TCA has nearly 300 members and has grown tremendously since its inception in 1997.

One of the greatest aspects of TCA is its ability to present entrepreneurs with an efficient source of funding. The process of finding enough angels to fund the array of early-stage ventures out there can be difficult and time consuming; however, with TCA's website there is a means for "easy communication and data storage for portfolio companies, potential investments, and investors" (Payne and Macarty 2002, 333). Those interested must apply through the website and complete a standard application. Those who pass this first round (roughly 20 percent) are scheduled for a screening meeting, in which entrepreneurs give a presentation before the network (May and O'Halloran 2003, 58). After the screening process, members of TCA discuss the deal opportunities presented to them and look for champion for each venture who will lead the due diligence team. After due diligence is completed, negotiations begin and a term sheet is made. If at least one member agrees to invest in the venture, the potential investment is presented to the network to solicit investors (Payne and Macarty 2002, 335). This entire process usually takes between four and six months (May and O'Halloran 2003, 60).

TCA has invested in over 170 companies in less than 14 years of existence (Tech Coast Angels). In 2010 alone, TCA funded 31 companies and invested $6.3 million (Tech Coast Angels). Additionally, 2010 marked a great year for TCA: four of their investments had exits, in which two went public. These companies are: Green Dot Corporation, Integrien, Trius Therapeutics, and Language Weaver.

Green Dot

Green Dot Corporation was founded in 1999 by Steven W. Streit. As per its 10-K filing, Green Dot is a prepaid financial services company that provides general purpose reloadable prepaid debit cards in the United States. These cards, as well as its cash reload and payment services are available at nearly 50,000 retail store locations nationwide (EDGAR Online). Their popularity comes from the fact that these prepaid debit cards resemble bank debit cards without actually pulling money from a checking account; rather, consumers load them with their own money using cash or direct deposit of paychecks. Furthermore, because of Green Dots strategic partnership, these prepaid debit cards can be used at any place that accepts MasterCard and Visa, making them very convenient.

Prior to working on this venture, Streit worked in the radio broadcasting industry. He was Vice President of Programming at AMFM, a publicly traded radio broadcast group (Forbes). This didn’t provide him with much of a background in the financial services industry. Nevertheless, he came up with an idea to sell prepaid debit cards at retail with the goal to “ultimately target millions of Americans who earn less than $50,000 a year and who are undeserved by the financial services industry” (CrunchBase). For those who do not have bank accounts, or cannot get a credit card, these cards provided convenience and became highly sought. Because of his passion regarding the unbanked and undeserved communities, Streit was very committed to the venture which ultimately led to its success. Risk was also minimized because the customer pays money upfront unlike with credit cards. Through most of the development and early-stage of the company, Streit was his own funder. This was because he truly believed in his concept and because he had made a decent amount of money in the radio business.

Green Dot received its first source of outside funding from TCA in January of 2001 and only nine years later had an IPO (CrunchBase). TCA initially invested in Green Dot because they believed in Streit and his venture. They also believed Green Dot could be a ground-breaking idea, given the number of people who have little or no relationship with a bank, and did not want to pass on the opportunity. In 2004, Green Dot launched the first retail cash-acceptance reload network (CrunchBase). Since then, Green Dot has become the leading reload network for "open-loops cards in terms of its national footprint, the number of card programs supported, and in terms of consumer and merchant reload brand awareness" (CrunchBase). By 2010, this venture was ready for an IPO. TCA's intuition about the demand for this new market proved to be right: Green Dot's IPO ranked among the most successful exits ever for Tech Coast Angels, yielding over 100 times return on their initial investment in the firm (socaltech). The firm was valued at $1.8 billion after its first day of being public (Tech Coast Angels). This was very significant because with the high return TCA was able to invest in more entrepreneurial ventures despite the economic recession.

Integrien

Integrien Corporation is an IT company that designs, develops, and markets integrity management solutions. These solutions "allow enterprise IT organizations to predict, prevent, and heal problems in technology-based business systems" (socaltech). Integrien takes a proactive approach to performance management by alerting their customer when an application problem is in its earliest stage with a Smart Alert that isolates the impact and likely root cause (BusinessWire). As a result, Integrien's customers achieve higher quality business operations

that are more efficient and continuously available (BusinessWire). In Additions, Integrien holds strategic partnerships with notable vendors such as IBM, HP, BMC, and VMware.

Integrien, based in Pasadena, CA, was co-founded in 2001 by Al Eisaian and Dr. Mazda Marvasti PhD. Prior to Integrien, Eisaian was a very successful business man with extensive experience that would later help him as an entrepreneur. He was Senior Vice President and General Manager at LowerMyBills. There he led the business strategy and growth of the company from startup to profitability in less than a year and a half (ChubbyBrain). Before working at LowerMyBills, Eisaian was a partner at USWeb—an internet marketing and web development provider—where he worked with companies such as Toshiba, Ingram Micro, and iGeneration (ChubbyBrain). And before this position, he was director of business development at LaunchPad where he helped grow sales from $15 million to $58 million in three years (ChubbyBrain). Eisaian was the type of entrepreneur TCA was looking for. He had both the technical background and cunningness of a business man, with both an MBA from Pepperdine University and a Bachelor of Science in Electrical Engineering degree from Oklahoma State University.

Marvasti also worked at LowerMyBills where he was its Chief Technology Officer (Bloomberg Businessweek). Prior to working there, he served as Executive Director of technology as USWeb (Bloomberg Businessweek). His technical background helps compliment the strengths and weaknesses of his business partner Eisaian which proved very useful in their development of Integrien. In addition, Marvasti has an extensive educational background in which he holds a Ph.D. in Engineering from Georgia Institute of Technology, an M.S.E. from the University of Michigan, and a BE from State University of New York (Bloomberg Businessweek).

In July of 2005 and then June of 2006, TCA provided Integrien with first-time financing and follow-on round of financing. This was before their product, Integrien Alive, first became available on the market (2003). Although they did not have a fully developed product by the time they needed financing, they had a strong customer base, strong management team with relevant experience, and technology that solved a pressing need. All of these were attributes of ventures that TCA sought to finance. Both the co-founders and TCA realized that this idea would prove to be highly marketable. In August 2010, only after five years of TCA's initial investment, Integrien was acquired by VMware for $100 million. This resulted in a huge internal rate of return (IRR) for TCA.

Trius Therapeutics

Trius Therapeutics is a biopharmaceutical company that focuses on discovering developing, and commercializing innovative antibiotics for life-threatening infections. The concept in itself would easily catch the attention of an investor: they are providing technology that solves pressing needs and if successful have high growth potential. The success of Trius Therapeutics would however depend on its management team. For this reason, before financing a new venture, TCA wants to see that the entrepreneurs have relevant experience as well as lots of passion.

Trius Therapeutics, headquartered in San Diego, was founded in 2004 by John Finn and John Schmid. Prior to working at Trius Therapeutics Finn had worked at three different biopharmaceutical companies. He was vice president of drug discovery at Elitra Pharmaceuticals Inc; senior director of lead discovery at Cubist Pharmaceuticals, Inc.; and associate director at Synaptic Pharmaceutical Corporation (Trius Therapeutics). By looking at

his resume, it can be seen that Finn was experienced, passionate and devoted to the biopharmaceutical industry. On the other hand, his co-founder Schmid had experience in several industries. Schmid had served as CFO and was the co-founder of GeneFormatics—a structural proteomics company (Trius Therapeutics). He had also worked at a venture capital firm, been vice president at Home Federal Bank, and served as an analyst for Manufacturers Hanover Trust Company (Trius Therapeutics). Although he did not have extensive experience in the biopharmaceutical industry, his background in finance as well as his prior success in starting a new venture made him an exceptional candidate in the eyes of TCA. Having a strong management team is always one of the dominant traits TCA looks for when screening new ventures.

In 2008, Trius Therapeutics received funding from TCA which was significant because by this time the economy was already in the midst of a downturn. Two years later Trius Therapeutics completed an IPO that left TCA members very pleased. The IPO raised $50 million through an offering of 10 million shares (Tech Coast Angels).

Language Weaver

Language Weaver, founded in 2002, develops and licenses automated translation solutions for multinationals, government organizations, and translation providers (ChubbyBrain). It also commercializes a statistical approach to automated language translation and natural language processing.

This company was co-founded by Daniel Marcu and Kevin Knight. Prior to developing Language Weaver, both held positions at the University of Southern California. Marcu was a Research Associate Professor in the Computer Science program as well as held multiple patents

and published an MIT press book (ChubbyBrain). On the other hand, Knight headed the machine translation group at the Information Sciences Institute of USC (ChubbyBrain). The research he conducted at USC played a vital role in developing Language Weaver.

For TCA to finance a new venture they want to see potential for high growth, a strong market position, and a sustainable advantage. When starting, most tech industries have a sustainable competitive advantage or some aspect that differentiates them from other companies. In the previous companies mentioned, co-founders had attributes that complimented each other. If one founder had extensive background knowledge and experience in the industry the other founder has the business and finance background. With Language Weaver, however, both founders have saturated knowledge and experience of the industry. Still, this did not worry TCA investors because Marcu and Knight had added several members to their management team including Mark Tapling who had held several executive roles including serving as CEO at Everypath and Serviceware Technologies (ChubbyBrain). This company became so successful that it attracted the attention of SDL, the world leader in Global Information Management. SDL then acquired them for a consideration of $42.5 million in cash (Tech Coast Angels). This became another great exit for TCA investors in 2010.

Conclusion

These four companies represent some of the most successful companies TCA has had the opportunity to invest in. It is not always common for start-up ventures to have IPOs or to produce such high returns to its investors. In analyzing these companies it can be seen that TCA has a standard set of requirements that they adhere to. This set of criteria includes: having a strong management team, technology that solves pressing needs, niche dominance, high growth

potential, and a sustainable competitive advantage. In addition, it is worthy to note that TCA members do not usually finance ventures based outside of Southern California. Particularly important were the backgrounds of the entrepreneurs. In each case, the founder or co-founders had a strong work ethic, lots of experience and knowledge in their industry, and were passionate and fully committed to their venture. This component remains vital to a ventures success and will continue to be highly regarded to angel investors.

Chapter 8: Conclusion

There are a lot of components that go into fully understanding early-stage equity investing. Although already large, the market has grown tremendously in size and influence. In the first half of 2010 alone, total investments were $8.5 billion (Sohl 2010, 1). This was used to help fund 25,200 entrepreneurial ventures (1). With over 125,100 active angel investors in the first half of 2010, angel investors are the largest and most influential group of financial supporters of early-stage ventures today (1). Because they are the main financers of entrepreneurs, they play a significant role in the economy.

In the past, little was known about this form of financial support for the entrepreneurial community, but because of the many success stories and spread through word of mouth, many entrepreneurs are now seeking the financial support of angel investors. Early stage equity financing may not happen for all small businesses but just because a business may not qualify for equity financing after several attempts does not mean that the business cannot be successful.

The entire process from start to finish can be grueling. Time is taken away from working solely on the venture in order to research, find, and prepare for meetings with angel investors. For those ventures fortunate enough to capture the attention of an angel or angel network much

value is added to their company both in capital and involvement contributed by each angel investor.

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