

Business Angel Investing Groups Growing in North America

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Angel investing has long been an important source of financial support and mentoring for new and growing businesses bridging the gap between individual (friends and family) and institutional venture capital rounds of financing. Over the past several years, this sector of the private capital market has been formalizing in response to both growing demands and complexity.

According to research conducted by Jeffrey E. Sohl at the University of New Hampshire's Center for Venture Research, there were approximately 50 formal business angel groups in the United States five years ago. He now estimates that there may be as many as 170 formal and informal organizations located throughout leading technology and business regions in the US and Canada. These groups have several characteristics: loosely to well-defined legal structures; part-time or full-time management; standardized investment processes; a public face usually with a Web site and public relations activities; and, occasionally a traditionally structured venture capital/angel investing fund.

The number of organized groups has grown in response to several factors:

- A desire to attract better deals and generate higher returns than angels acting alone;
- The growth of venture capital funds and the attraction of venture investing;
- A widening "capital gap" between individual and institutional venture capital investors that has created a need and an opportunity for pooled investments;
- The legal and economic complexity of these investments;
- A large increase in the number of self-made, high net worth individuals who want to be more involved in their alternative asset management;
- The volume of deal flow; and,
- Social camaraderie among investors.

As a result, investment screening is fairly consistent across groups. Specific organizational and legal structures, however, remain varied. Most groups developed their own organizational structures and processes independently and have recently begun to discuss and debate best practices, some of which are discussed in this paper.

For entrepreneurs and other investors, the net results of this change are mostly positive. Although the models of business angel groups continue to evolve, these groups are generally better financed than ad hoc groups of individual investors. These groups provide an extended network that benefits both funded companies and co-investors by providing greater due diligence,

operational support and domain expertise. Business angel groups can also provide a key source of qualified deal flow for venture firms; as well as provide intermediate capital for companies with financing requirement levels between individual investors and institutional venture capital.

This paper is the product of the first summit of organized angel groups, an April 2002 meeting focused on the best practices of angel investing. Thirty representatives from 18 groups across North America attended the meeting at the Massachusetts Institute of Technology. The Ewing Marion Kauffman Foundation coordinated the summit, working with a committee of angel organization leaders. The summit was initiated by the leader of CommonAngels, of Boston, who noted that organized angels need and are interested in opportunities to share information in order to enhance their practices. The participating angel organizations expressed a strong interest in continued sharing of information and best practices, and will hold additional summits in the future.

What Is An Angel?

From a purely legal standpoint, an “angel investor” (or “business angel investor”) is a “high net worth individual,” usually an accredited investor (as the term is defined in Regulation D under the Securities Act of 1933 or SEC Rule 501) who invests his or her own funds in private companies, typically at the seed and early stages. To most companies, though, angel investors are much more: they often bring expertise or affinity for that company’s product, market or management team, in addition to taking additional financial risks. Many serve as active advisors or mentors for entrepreneurs, provide additional relationships to aid the business’ growth, and supply industry and entrepreneurial experience.

Broadly, these individuals fall into four categories as defined by a study on angel investors by MIT’s Entrepreneurship Center:¹

- **Guardian Angels**, who bring both entrepreneurial and industry expertise. Many have been successful entrepreneurs in the same sector as the new companies they back.
- **Entrepreneur Angels**, who have experience starting companies but come from different industry sectors.
- **Operational Angels**, who bring industry experience and expertise, but generally from large, established companies, and may lack first-hand experience with the travails of a startup.
- **Financial Angels**, who typically invest purely for the financial return.

All are present within today’s angel organizations, but many groups form around similar types of investors. Some groups have arisen out of industry trade associations, while others have started from a cadre of professionals with shared interests.

Organizational Structure

Member surveys and anecdotal evidence indicate that a growing number of angels are joining organized groups to achieve competitive returns on early-stage investments. Members seem to

¹ “Venture Support Systems Project: Angel Investors,” MIT Entrepreneurship Center, Feb. 2000, p. 17.

believe an organized group can identify and attract better investments than can individual investors acting alone. However, that relationship is not usually an exclusive one. Many members of organized angel groups often stay active as individual angels. In addition, members have access to additional networks within and beyond their angel group – some may be financial (access to other deals) and some non-financial (social or philanthropic). Additional benefits to members include camaraderie with a stimulating peer group, working with start-ups, and staying connected to the local business community (for cashed-out entrepreneurs and retirees).

Most angel groups investigate opportunities in their local area and pull membership from a city centered, or “one-hour drive time from home,” region. Angel groups operate with different structures each suited for particular circumstances. As of yet, there is no leading candidate for the optimal model. However, there does appear to be a continuum from the most loosely organized to the most sophisticated of legal structures that has arisen from organizers’ personal experiences or the advice of close colleagues.

At the informal end, deals are done on a case-by-case basis, investors write checks directly to the company, and follow-up is assigned to individual angels.

At the other end of the spectrum are manager-led LLCs that aggregate angel funds into pools of capital to co-invest in early stage financings of private companies alongside institutional venture investors. In this case, angel investors participate in the selection, due diligence and voting process (generally a majority of members direct where club funds are placed).

In between these two ends lie several intermediate models:

- Umbrella LLCs with each angel as a member;
- Independent LLCs formed specifically for an investment;
- Non-profit organizations with individuals making independent investments;
- Some form of management company acting as a general partner; or
- A hybrid of some or all of the above.

While there appears to be no predominant model for either organization or funding, it is clear that each organized angel group evaluates its own requirements, alternatives, and preferences, and those sustainable groups have successfully refined their models to meet members’ needs over time.

Membership

While organized angels groups vary in size from a few members to many dozen, most agree on the importance of attracting the most suitable members for their specific strategy. Typically angel groups are not larger than 80 people. Above that size, group cohesion may begin to deteriorate, and groups have found it better to form a second group or subgroups. As a baseline, each member must be financially capable to make investments in early-stage ventures. Many organized groups require angels to complete legal documentation confirming their status as an “accredited investor” or “qualified investor” to meet regulatory requirements. Additionally, groups may seek members with industry or functional expertise, a willingness to be actively

involved with the angel group or its portfolio of investments, successful entrepreneurial experience, access to deals and networks, or some underlying shared beliefs or values. The most suitable members bring some combination of these attributes to the organized group.

Membership Dues

Typically groups charge their members dues ranging from a few hundred to a few thousand dollars a year to cover administrative costs. In addition to providing compensation for overall management and administration, organized angel groups may also support other general operating expenses (meetings, mailings, technology, legal, tax, and accounting at an organization level) and deal-specific expenses (due diligence, professional services). Payment of these expenses depends on the organizational structure and the financing model. For some groups, the organization covers both operating and deal-specific expenses, drawing fees from a fund, member dues or both. Other groups cover operating expenses, but levy specific charges on investors on a deal-by-deal basis. This may be either a fixed amount per deal or proportional to the capital raised. Many groups also have local sponsors such as a law or accounting firm. Typically the sponsors had some kind of strategic alliance with the group or its activities.

Investment Requirements and Expectations

Investment requirements and expectations are settled before a member joins the group. Generally members may be expected to invest a minimum amount each year in companies presented to the membership, on top of the yearly membership fee (typically a few thousand dollars). Often members invest \$25,000 to \$100,000 in each deal with the ability to utilize their network and contacts to raise additional financing if necessary. In manager-led LLC groups, members often commit a fixed amount, drawn down over time. Research finds that this amount has varied from \$50,000 to \$150,000 over several years.

New Members

Angel groups were found to have either open membership or a fixed closed, membership structure (i.e. the member-led or manager-led models). Most groups are networks or dues paying “pledge funds.”

Groups participating in the summit experience a turnover of approximately 10% to 20% per year for a variety of reasons including individual financial capabilities, time management/availability, and competing professional or personal responsibilities. “The main reason we lose people is that they are ‘recidivist entrepreneurs’,” one managing director said. “They cannot help themselves from starting another company. One day I get an email from them with a new address, and I know they are off on some new gig. They’ll come back – but it will be in a couple of years.”

The best source for new members is often referrals from the existing membership because of pre-existing relationships and shared interests. Regular communication within the group about candidates helps ensure a steady stream of new members and roles for them to play within the organization. Most groups surveyed highlighted the importance of attracting new members who have solid industry experience, networks and the willingness to attend meetings and invest.

Staffing

The two predominant approaches to management and administration of angel groups are: hired professionals or managing members selected by the membership (member-led). Many groups have hired a dedicated managing director who is in charge of the day-to-day operations of the fund. Typically the director has a full-time or part-time administrative assistant and/or an MBA student who may volunteer during an internship or work part-time during their second year of school. The director is usually compensated through salary, incentive fees, a carried percentage on investment gains, or a combination of these. Often, select members, possibly as board members or officers of the group, provide the necessary oversight and guidance to the professional staff.

Conversely, member-led groups tend to select and appoint managing members to lead the group with little or no additional compensation. These members may rotate their position or participate in a process-specific task such as meeting coordination, due diligence or deal closing. Some member-led groups are beginning to compensate members for taking on management roles through warrants in portfolio companies, a carry on investment gains, or a bonus. As the leader of one of these groups put it, “This isn’t just fun anymore – it’s too much like work!” Member-led groups may also request time from the members’ personal administrative staff to help with mailings and distributions.

Meetings

Most angel groups organize regular monthly breakfast or dinner meetings where members attend to hear two or three company presentations. The format is remarkably consistent across groups despite their varied legal structures. Presenting companies are often sponsored by a member, and prior to the meeting, members usually receive a summary about the company and some preliminary due diligence on the opportunity. After hearing the entrepreneur’s short pitch (less than 30 minutes), there is a question and answer period allowing members to ask questions of the management team (another 15 - 30 minutes).

In a manager-led organization, members put the decision to a vote after the companies leave. If the members voted to continue to pursue the opportunity, volunteers from the membership step-up to work with the managing director or other dedicated members to complete due diligence on the company. Frequently, the due diligence is presented and communicated at the beginning of the next meeting. In a member-led group, each individual investor may make his or her own investment decision, but often, interested members collaborate on due diligence and deal negotiation.

Deal Flow

Organized angel groups find entrepreneurs through both passive and active means. Because these organizations often have Web sites and otherwise advertise their existence with contact information, entrepreneurs have an easier time sending their business plans to angel groups than to individual investors. Similarly, a large percentage of deals come from traditional networking, such as attorneys working with new firms as well as events where entrepreneurs and prospective investors can meet. Most organized angel groups also actively take it upon themselves to find new investment opportunities, conducting “scouting operations” at conferences, among technical

contacts in laboratories and research centers, and soliciting partnerships with other investors. Because angel organizations have large numbers of members, many of whom are active in the business or technical communities, they have a wide reach and early knowledge of new companies' efforts.

Selection Process

Most angel groups have both a formal and informal selection process. The formal processes almost always involve a “steering” or “screening” committee composed of a subset of the group’s members and representative of the whole. These individuals review a brief summary of the business—ranging from one to a few pages—and vote either in person, by email, or on a private Web site to select which companies to meet in person. This committee seeks to balance members’ interests by market, sector, geography, stage or size of investment. There may also be a brief initial meeting with either a market expert or the screening subcommittee, to determine which companies best match the group’s investment criteria for making a presentation to the full membership. That meeting either results in an investment decision (invest or retire) or a series of questions that another subcommittee may address in due diligence. Depending on the angel group’s structure, members will provide money to a central fund/account to invest or make an investment directly in the company as individual shareholders. Investments can and occasionally do take the form of debt.

Equally important to these formal steps, however, are the underlying informal ones. Angel organizations need to have at least one member champion the investment opportunity not only to drive the formal processes but also to influence other members about the opportunities and risks involved in a particular case. This opinion leader brings technological or market expertise or already has a personal or professional relationship with the entrepreneurs and can vouch for their integrity and skill. They also often work with the entrepreneurs to package the deal most appropriately for the group, helping tailor the presentation, identify any particular issues to address up front, and otherwise coach them in both substance and style.

Due Diligence Process

Every organized angel group appears to conduct independent due diligence on their investment opportunities. The depth and extent of that due diligence varies both by group and by specific opportunity. Several common threads appear in the due diligence processes of many angel groups: a) conducting civil, criminal, credit, and state motor vehicle checks of key managers; b) verifying intellectual property ownership; c) intensely evaluating the management team; and d) understanding the potential market.

Most groups agreed that the due diligence process requires a leader or a champion. This leader may be appointed or assumed by the membership. The leader marshals the due diligence process and takes responsibility for circulating documents, scheduling conference calls, negotiating terms, collecting checks, etc. This process can be time-consuming. Often the due diligence leader will become the primary contact to the company after the investment is made, acting either as a board member/observer or advisor.

Most, but not all, groups provide written due diligence summaries to their membership from the members on the due diligence team. A few organizations make specific investment

recommendations to the membership, while others provide a summary of the data collected from the due diligence process and each member comes to his or her own investment conclusion.

Follow Up

After a funding decision, angel groups tend to follow up with a company in three ways:

1. Oversight and advice for the business;
2. Observer status or seat on the board of directors; and,
3. Assistance with additional fund raising.

Groups often appoint one or more of their members to a company's board of directors—at least one usually has been a champion for the investment. These and perhaps other individuals periodically report back to the group on the status of their investment either in person or in writing.

Angel groups also may syndicate the investment at the time funds are committed, or as part of a subsequent round, as a way to share due diligence and provide additional expertise and capital. These groups largely view themselves as complementary to, rather than competitive, with other individual angels, angel groups and venture capitalists. Other angels tend to have their own particular investment interests and most entrepreneurial companies either require or could use more capital than a single angel group can provide. Syndication with other organizations with additional funds helps strengthen the investment and share risk. Similarly, venture capitalists bring different skills or relationships, such as with investment bankers or strategic partners, further benefiting the company and the investment.

Deal Structure and Investment Model

Organized angel groups deal with a broad and varied range of decisions that may or may not include the entire membership. Administrative decisions may be handled by a small number of members or by the professional staff. Investment decisions most likely require a majority vote from members or a decision from a select subset of members, or by individual members. Given that the organizational models may differ, it is not surprising that the decision-making models appear varied as well.

In manager-led groups, the professional staff may be responsible for collecting and synthesizing data to support a decision and often, propose the “decision question” to the entire group. In member-led groups, members may be more actively involved in data collection and related activities contributing to the decision. All groups, however, appear to actively involve members in any formal proposals or recommendations that affect the entire group.

Investment Model

Again, variety appears to dominate. Organized angel groups have adopted a number of investment approaches that fit with their structure and funding models. Usually one approach is chosen and applied to all of a group's investments where possible. These include the following:

- Individually and directly writing checks to the investment entity;

- Individually writing a check into a single purpose LLC that is set up for each investment and the LLC invests into the entity;
- Individually through the group's umbrella membership organization;
- As part of a larger fund where monies have been raised prior to the investment (this may include outside limited partners or investors); and
- A combination of the above, including side-by-side investing in specific deals by members in the single investment entity models.

Often organized angel groups select an investment approach based on their desire for either increased visibility or anonymity; active member participation or passive involvement; negotiating clout or deference, etc. Anecdotal evidence indicates that groups prefer a specific investment approach but are willing and able to accommodate alternate approaches if the investment opportunity warrants it.

Deal Terms

Some organized angel groups prefer to lead the investment round, drafting the terms of the deal (valuation, security, rights and provisions) and negotiating the terms with the company and other investors. Other groups have chosen not to lead investments and instead prefer to co-invest on terms determined by other investors. Some choose to either lead or follow, depending on the amount of capital raised, the urgency of the investment, their relationship with the company, and their level of domain expertise.

Most groups have developed (either explicitly or implicitly) a set of standard and acceptable terms as a threshold for their investments. As many members of angel groups have been successful business entrepreneurs, they are most likely familiar with those terms that favor either investors or founders. They appear to understand the need for both investors and founders' incentives to be properly aligned.

At the first summit of organizations angel groups, participants identified several critical aspects of a suitable term sheet: a) crafting terms that are understandable and acceptable to subsequent investors; b) ensuring the original capital structure is clean and will remain so as a result of this financing; c) accounting for any future options pools; and d) if appropriate, including provisions for milestone payments, which creates a staged investment, releasing specified amounts following the completion of agreed upon milestones.

While most term sheets developed for seed and early-stage companies have a predetermined valuation, some organized angel groups instead choose to set the valuation as a discount to the valuation of the next financing. For example, there may be a set percentage, for example 75%, or it may be a sliding scale, increasing the discount and decreasing the valuation depending on the time elapsed to the next financing or the failure to achieve milestones. Most organized angel groups seek co-investors to share the risk of financing early-stage businesses. Often, the release of investment funds from the angel group requires the company to receive commitments from co-investors. Often members of the angel organization facilitate introductions to other investors for the company.

In general, organized angel groups seem more interested in the potential long-term success of an idea or a company rather than spending an inordinate amount of time and effort crafting terms. Many commented that “sophisticated, complicated terms will never make a bad company a good company.” Conversely, many groups believe that high potential companies will overcome any slight weaknesses in their term sheets.

Typically the lead member takes a seat on the board and is responsible for leading the terms and conditions discussions, with the support of the other members.

Learning Outcomes

The major learning outcomes to emerge from this white paper are that:

- Many successful business angel investor groups are manager-led, with a full time dedicated manager typically referred to as the Managing Director;
- Angel groups form in order to deal with the growing demands and complexity of angel investing, and seek to achieve higher returns on their investments;
- Institutional angel groups are better prepared to conduct thorough due diligence – a major variable in the pursuit of higher returns;
- Angels offer far more than financing. They add value by sharing expertise, contacts, coaching, mentoring and operationally; and,
- Angel investors themselves receive more than formal association with fellow investors from membership in an organized group – they get camaraderie, an opportunity to share experiences and a forum for socializing.

Conclusion

Over the years angel investing has become more prominent as a source for funding for the next generation of companies. The objective of the summit meeting was to discuss, challenge and influence the best practices for angel investing and then begin to communicate these best practices to both the internal and external communities. This report is the first step in this direction. We hope that the paper highlights the best practices of angel investing to other angel investors and organizations. Additionally, we hope this paper provides a window into the world of angel investing for both entrepreneurs looking for financing and for venture capitalists that typically get involved in follow on rounds of financing.

Angel Groups Represented in the April 2002 Summit

<u>Region</u>	<u>Group Name</u>	<u>Web Site</u>
<i>National (US)</i>	Investors' Circle	www.investorscircle.net
<i>California</i>	Pasadena Angels	www.pasadenaangels.com
	Tech Coast Angels	www.techcoastangels.org
	The Angels' Forum	www.angelsforum.com
<i>Mid-Atlantic</i>	Dinner Club LLC	www.thedinnerclub.com
	Loosely Organized Retired Executives	(none)
	New Vantage Group	www.newvantagegroup.com
	Pennsylvania Private Investors Group	www.ppig.com
	Tri-State Private Investors Network	www.angelinvestorfunding.com
<i>Midwest</i>	C-CAP/ Cincinnati Angels	www.c-cap.net/angels.html
<i>New England</i>	Angel Healthcare Investors	www.hcangels.com
	CommonAngels	www.commonangels.com
	Hub Angels	www.hubangels.com
	Launch Pad	www.launchpadventuregroup.com
	Walnut Venture Associates	www.walnutventures.com
<i>New York</i>	New York New Media Association	www.nynma.org
<i>Canada</i>	Mindfirst Angels	www.mindfirst.com
	Toronto Angel Group	www.tvg.org

Comments or Questions

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