Best Practice Guidance for Angel Groups – Deal Screening

Shira Cohen, Columbia University

July, 2007

Screening new deals is an important part of maintaining the pipeline of equity investment opportunities for angel groups and their member angel investors. The logistical aspects that go into determining which investment opportunities would be most suitable to present to your investor forum are important in maintaining a good relationship with the entrepreneur and investor communities.

The screening process is already fairly consistent across angel groups. It is the first step in the journey toward finding appropriate investment opportunities. The following pages outline these currently observed and acknowledged practices.

Sourcing Deals

Participation in angel organizations has significantly grown over the past decade. This comes as a response to several factors, including a desire to attract better deals and generate higher returns than angels acting alone. To achieve this, access to high quality investment opportunities is crucial.

Deal Flow: Most angel groups have Web sites through which they accept applications for funding. These sites usually define the screening process and list the organization's investment criteria. This practice ensures transparency and provides the entrepreneur with an opportunity to self-select.

One angel we interviewed emphasized the distinction between quantity and quality of deals:

"As for quantity, we get enough deals – more than we need. As for quality, what this really means is that people that have access to the best deals forward it to you."

So it is not surprising that while the majority of angel organizations accept business plans via their Web sites, it is quite rare for a "cold" business plan (one that is not backed up by a trusted source) to advance beyond the pre-screening phase.

The following outlines the most commonly accepted sources of deal flow:

- **"Network of Trust":** Angels who have joined organized groups maintain that an angel's personal network of contacts – including trusted business associates – is a key source of deals. Because so much in early-stage investing relies on the management team, having a reliable and trusted source back the entrepreneur is essential.

- **Professional Sources:** Attorneys, accountants and consultants provide angel groups with access to a considerable number of entrepreneurs seeking funding. The professional source is considered more credible if he/she has a track record of successful investing and a preexisting relationship with the group. It is even more reassuring if the professional source wants to invest personal funds in the deal. Investment bankers are typically not good sources since they do not have sufficient experience in early-stage deals and angels are rarely willing to pay for deal flow.

- **Venture Capitalists:** One of the main differences between venture capitalists and angel investors is the latter's willingness to work directly with management to help develop the business. Angels typically have a disposition for entrepreneurship and enjoy the process of building a company. As such, there currently appears to be a growing trend for venture capitalists to collaborate with angel groups on early-stage deals which require such guidance.

- **Angel Groups:** Another trend that has emerged is syndication among angel groups. By combining their monetary investment potential, angel groups can attract the growing number of deals that require larger initial investment than any one group can provide. These angel groups can raise combined investments equivalent to a venture capital fund. The synergies from syndication extend beyond the screening phase, as the combined resources of these groups yield an overall more thorough investment process.

- **Entrepreneurs:** Deals received directly from entrepreneurs are deemed to be of poorer quality and some angels will not even consider deals sent directly by the entrepreneurs without a reference or recommendation from an associate they trust. However, an exception to this are previously funded entrepreneurs, as they have an already established relationship with the angel group.

- **Universities**: A number of angel groups source deals directly from universities (graduate schools, business schools, research centers, and technology licensing offices.) Here too, however, most groups rely on their private networks to source and pre-qualify deals. Many accept plans only through their university liaison.

- **Business Plan Competition**: Other sources of deal flow may include regional business plan competitions.

- **Brokers**: Angel groups vary in their response to deals brought them by brokers. Some find these deals to be more practiced and likely to address most of the basic investor questions. Other groups eschew all deals brought to them by brokers due to the fees involved and the sense that entrepreneurs relying on brokers may not be adequately aggressive or confident in their capital raising prowess (an obvious negative).

It should be noted, however, that if an angel receives a few poor quality deals from a particular source, that source is downgraded and other ventures will likely not be considered.

Knowing Your Investment Criteria

Knowing what you are not interested in is as important as knowing what you are interested in supporting. One angel group candidly listed on its Web site the following notice to entrepreneurs:

"Please note that we are not interested in "lifestyle companies" (i.e., companies that will not be sold to the M&A or IPO markets, since otherwise it becomes almost impossible to get our money back)."

Focus: A handful of angel groups fund specific groups of entrepreneurs, such as women and minorities. Golden Seeds, for example, is one group that invests only in women-led ventures. The majority of angel groups, however, invest in a variety of industries and products, and in companies that are located near them.

Criteria: Angel groups that have a screening process in place are likely to have a list of investment criteria which they look for immediately in a deal. While these requirements vary from one angel group to the next, there are a significant number of shared criteria among groups. The most prevalent are described below:

- **Geography**: Most angels invest in companies that are within a one to three hour driving range from their office. The reason for this requirement is that many angels, once they invest in a company, take an active role in the development of the company. Most angel groups will consider business plans from a variety of industries as long as the geography requirement is met.

- **Industry**: Angel groups that rank industry as a primary consideration will usually focus on high-growth industries, and specifically, those industries within the membership's expertise. Additional criteria may exist within particular industries, as one source notes "*some medical technology angels will not consider a deal if the venture does not own intellectual property rights. Many software and internet-focused angels do not consider patents an important factor, yet only consider deals with a working prototype*."

- **Growth Potential**: Angels often rate potential for market growth and expansion as a top factor when considering investing in any given company. For some groups this means the company should already be revenue generating (i.e. have at least one customer), while for others this means having a viable competitive advantage that will lead to market capture even if the company does not yet have revenues.

- **Management Team:** The management team's ability to come across as trustworthy cannot be overemphasized. Angels often base their decision to invest on their personal gut assessment of the entrepreneur. The personal attributes and track record of the management team is scrutinized. For a number of angels, the chemistry with the entrepreneur is the most important criteria. Angels often assess the entrepreneur's ability to be coached, which may indicate his/her ability to adapt to changing conditions. Most angels would agree that no matter how great the deal may appear to be, if they do not trust the management team, they will not consider the deal further.

One angel we interviewed explained,

"In early investing you can only invest in people. So you look for a team of people that is passionate, able to work together, and that gives you a reason to believe in them."

Mitigating Factors: Many angel groups rely on their social network to source deals and are willing to overlook some of their listed requirements, such as geography and industry, if the deal is supported by someone they already know. One interviewee remarked:

"Nothing is set in stone. All criteria are soft. Management is key."

Because so many risks and unknowns reside in early-stage angel investing, a business plan provided by a trusted source can make all the difference, and the group will most often consider the plan even if it does not meet all of its stated criteria.

Obtaining the Information from Entrepreneurs

To be considered by the angel group, an entrepreneur typically submits an application consisting of an executive summary and a business plan.

Angel organizations typically ask that applications be submitted either through their Web sites or via email. The "Angel Investing Group Best Practices" document from the Kauffman Foundation (April 2003) describes the need for fostering clear external communications:

Finding a fit between entrepreneurs and angel groups begins with helping the entrepreneurs self-select whether to contact or engage the angel group in the first place. A Web site that clearly and effectively communicates the group's investment criteria, processes, personality, interests and goals helps entrepreneurs decide whether to submit a business plan or not. It provides a window or visibility into the angel group. The site should be formatted so that it is easy for the entrepreneur to provide their business data, and should not require more information than is needed for an introductory contact.

A number of angel groups post application and/or executive summary templates on their Web sites. While some variations exist among groups in format or order, most require the same general information. These angel organizations argue that having a standardized form allows them to screen deals more easily.

There are exceptions. One angel investor we spoke with stated that his group considers it poor practice to ask entrepreneurs to *"fill out applications that look like bank forms…since they often make weak entrepreneurs look better and good entrepreneurs look worse…."*

Another angel interviewed stated that his group does not provide explicit guidance because *"what the entrepreneur leaves out of the executive summary is as revealing as what he/she puts in."*

Still, some angels prefer to review a one- to two-page executive summary to help them determine whether to pursue or pass on the deal.

- **Application and/or Executive Summary:** Some angel groups provide only general guidance as to what they wish to see in the summary, whereas others post specific questions for the entrepreneur to fill out. The format ranges from a Word document entrepreneurs email to an application submitted online.

  The summary document typically will include the following data:

  - Company Profile (name, URL, industry, number of employees, year founded)
  - Contact Information
  - Management Information (work history, education)
  - Advisors (law firm, bank)
  - Referral Source
  - Business Summary
  - Product/Services
  - Technology/Proprietary rights (if applicable)
  - Sales/Marketing Strategy
  - Target Market
  - Customers
  - Competitors
  - Competitive Advantage
  - Financial Projections
  - Type of Securities being sold
  - Exit Strategy

If the angel group finds the executive summary appealing they will then ask the entrepreneur to submit the full business plan.

- **Business Plan:** Angel groups recognize that investing in early-stage companies involves many moving variables – what is stated on paper will likely change as the company matures. Yet they also recognize that the failure of many early-stage businesses is often the result of inefficient planning by management. The business plan provides the group membership with a window into the management team's ability to plan and project. The business plan typically expands on the information provided in the executive summary, though more in depth detail and analysis is expected.

Again, as with the executive summary, some angel groups do not provide explicit guidance; what an entrepreneur leaves out of a business plan may be more telling than what the entrepreneur puts in.

Response Time: Most companies are contacted within two to -three weeks of submitting their documents for consideration (although some angel groups may take longer to respond.) If the company meets the group's criteria, management will be asked to provide additional information.

Application Fees: While the majority of angel groups do no require entrepreneurs to pay an application fee, some do. The reason for the fee in most cases is to defray administration costs associated with the application review process. However, several angels interviewed expressed concern about this practice, stating the need to be as accessible to the entrepreneurial community as possible and most recommend that any fee is minimal.

Managing the Process

Overview: Because angels work directly with entrepreneurs to help develop and grow the business, screening often involves searching for a good fit between the management team and the angel group. An efficiently designed screening process allows investors to cut through large number of deals and select those which warrant closer consideration.

According to surveys of angel groups by ACEF and the Angel Capital Association, only one in four deals that enter the pre-screening phase make it to the screening phase; and one in three deals that made it to the screening phase go on to the due diligence phase. As one angel interviewed described it:

> *"Finding the right deal is like finding a needle in a haystack"*

Screening Committee: The screening committee led by the committee chairman is responsible for selecting between two to three companies that will present to the entire membership. The number of members on the committee varies by group; groups typically rotate their members through the screening committee to allow everyone an opportunity to participate and provide input.

In a manager-led angel organization, the role of the committee chairman is often-times administered by the manager. In a member-run angel group, the chair position is rotated on a volunteer basis. When asked how the chairman is selected, one angel light-heartedly commented *"we often beg and plead until someone takes on the position!"*

Pre-Screening and Screening: Groups use processes to winnow the business plans they have received to the best one to three projects for the full angel membership at their next meeting. The number of applications received varies, but can easily reach upwards of thirty per month. Angel groups typically do a quick pre-screen that reviews the executive summaries (usually one to two pages in length) against specific investment criteria. Those that do not meet the group's investment criteria are removed from consideration immediately. Some angel groups assign this funneling responsibility to the chairman or an MBA intern. None of the angel groups we spoke with contact the entrepreneurs at this stage, as this is merely a process of elimination.

The committee (or chairman) then narrows the list down to approximately six to ten deals for more detailed screening. At this point the business plans are scrutinized for any underlying red flags that might surface later on; often times the entrepreneur will be contacted to answer questions or provide additional information. Some angel groups invite the entrepreneurs to present in front of the screening committee. This gives the committee an opportunity to meet face to face with the entrepreneur and ask questions.

One angel investor we interviewed explained that if the committee receives an interesting business plan but no one serving on the committee has the relevant expertise, they will forward it on to the appropriate angels in the membership. Angels enjoy this spirit of collaboration. William Payne, who served as Senior Project Consultant at the Kauffman Foundation, remarks:

"Screening and scrubbing deals with other knowledgeable angels is always a learning experience for me…By working with a group of angels I can find all the rewards of angel investing with much less of the pain."

Ultimately, the committee is responsible for selecting two or three companies which will present at the full membership meeting. Companies that have been declined are notified, but detailed feedback is usually not provided at this point.

Champions: Screening committees usually appoint a champion to assist firms that have been selected to present to the full group membership. The champion need not come from the screening committee. A particularly exciting deal usually draws a number of interested champions. Some angel groups maintain a database of membership skills, interests, and experiences, which helps expedite the selection of an appropriate champion, especially in larger groups.

Deal champions serve as the group's point of contact for the company, making any necessary introductions. Champions ensure the company is ready to present to the membership – they may help review and refine the presentation and provide feedback to the entrepreneur, and often will introduce the entrepreneur when they make their pitch presentation to the full group.

Presentations: Most angel groups organize monthly breakfast, lunch, or dinner meetings where two or three firms present. The format is remarkably consistent across groups. To present, a company has to be sponsored by a champion. Before the presentation, members usually receive a summary about the opportunity and some preliminary due diligence. After hearing the entrepreneur's short pitch (less than 30 minutes, and generally about 15 minutes), a question and answer period allowing members to further examine the opportunity (another 15-30 minutes). Because the Q&A session is usually a lively one, a well-run meeting is one where the champion provides structure for discussion.

Decision: At the conclusion of the presentation, the company is excused and the members privately discuss the proposal. This gives the angels an opportunity to discuss the venture and ask questions of the champion and other committee members. In considering whether to pursue a particular venture, the membership might assess the group's combined resources; the group needs to ensure that there is enough time and internal expertise to allocate to any potential portfolio company. In manager-led funds, members vote as one voice on whether to continue the process. In manager-led and member-led networks, individual investors make their own investment decision. Decisions at this point are whether to begin due diligence on the opportunity, which would be completed before final investment decisions.

Feedback: Companies that present to the membership are provided with detailed feedback on their presentation and the angel group's level of interest. Some groups ask each member in attendance to provide written feedback in order to accurately capture opinions; this also enables the membership to consolidate the information and provide the entrepreneur with one corporate voice.

Those companies that have been declined are notified. Referral sources are naturally made aware of the outcome. If several venture opportunities from a particular source fail to progress to the next stage, the value placed on that source will likely be downgraded and other recommendations not considered.

If membership shows interest and votes to continue pursing the opportunity, the champion and other volunteers from the membership start the due diligence process.

Conclusion

One angel investor interviewed vividly described the angel investing process as a mixture of hunting and farming. Investors hunt as they source and screen for deals; and they farm once investments are made.

The most important skill an investor can possess during this hunt is a strong sense for assessing people. Early-stage angel investors take on significant risk; there are often too many unknown variables. Angels must be confident that the management team will be able to adapt to new conditions without losing focus. Trust and confidence in the management team is usually the best way to mitigate these risks. And often, this confidence is the result of having the deal introduced to the group by a trusted source.

References:

www.angelcapitaleducation.org/dir_downloads/resources/BestPractices_Summit1.pdf

www.angelcapitaleducation.org/dir_downloads/resources/BestPractices_Summit2.pdf

www.angelcapitaleducation.org/dir_downloads/resources/StartGroup_Joining.pdf

www.pnl.gov/edo/documents/angel_investing_oct2004.ppt

Benjamin, Gerald A. The Angel Investor's Handbook: How to Profit from Early-Stage Investing. Princeton, NJ: Bloomberg Press, 2001.

Leaders interviewed for the guidance document:

- Catherine Mott of BlueTree AlliedAngels (Pittsburgh, PA)
- Tom Jones of BlueTree Allied Angels (Pittsburgh, PA)
- Stephanie Hanbury-Brown of Golden Seeds (New York, Connecticut)
- Carol Sands of The Angels' Forum (Palo Alto, CA)
- David S. Rose of New York Angels (New York, NY)
- Paul Sciabica of New York Angels (New York, NY)
- James Geshwiler of CommonAngels (Boston, MA)
- John May of New Vantage Group (Washington, DC)
- Bill Moore of LORE Associates (Philadelphia, PA)
- John Huston, Ohio Tech Angels Fund (Columbus, OH)