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Creating an investment "bible" for Angels in Ontario is akin to herding lions naked. At best, it's a high-risk undertaking that leaves one exposed in a variety of vulnerable spots. Angels, active or passive, are by temperament rugged individuals, seasoned entrepreneurs who have forged businesses, commercialized innovation, and built enduring organizations. They are the last and perhaps best bastions of enlightened capitalism in Canada. As such, they are not lightly influenced nor easily persuaded by vague theories or unproven practices.

That is why this manual is meant to be strongly prescriptive rather than mildly descriptive. It is based on best practices, and written principally by Angels for Angels. This does not mean that it has everything right or that one size fits all. Formal group Angeling, after all, is a relatively new and evolving discipline, which has developed rapidly in Ontario over the past several years.

But from extensive research on successful Angel groups in North American and beyond, the authors of this manual have aggregated the principal processes that work in the best interests of investors and entrepreneurs. They have focused on the science of the probable rather than on the art of the possible. In doing so, the authors recognize that there are counterpoints to many of the assertions contained in this document and, given the personality of individual Angels and Angel group members, many of these differing views have a measure of validity. However, the authors of this handbook have chosen to side with the weight of empirical evidence and present a majority viewpoint.

The genesis for this work came from a meeting last year of the presidents of the western Canadian Angel groups who are affiliates of the National Angel Organization (NAO). They expressed the need for core standards for Angel investing in this country -- not as a control issue, but rather to ease the investment process when deals are syndicated from one Angel group to another within cities and across provinces. "It's vital that we have everyone singing off the same investment song sheet," asserted one Angel group president at the meeting, "there is comfort and confidence in knowing that all Angels are applying the same metrics to their investment decisions."

For Angel groups in Ontario, syndication of Angel deals is the key to commercialization of great ideas. Venture Capital firms seem to be moving downstream, so more money is required for start-ups to fill the funding gap between "love money" and later stages of financing. The number of VC players in early-stage investing, while never a major financing source for entrepreneurial companies, is dwindling, which is perhaps why informal investors, including Angels, today fund more SMEs than VCs do. As Dr. Alan Riding of the University of Ottawa revealed in a 2005 study, VCs invested a little more than $1.6 billion that year, while business owners alone provided some $11 billion in funding to SMEs.

We have entered the Age of the Angel, where high net-worth individuals have effectively become the commercialization engine for entrepreneurial companies. Availability of Angel investment money is not the principal problem hindering commercialization of start-ups.

The real challenge is channelling Angel investment capital into the most promising start-ups and mentoring those start-ups into sustainable, growing, and profitable enterprises

In order to aid this process, the first best-practice guideline in Canada was proposed to help mitigate Angel risk, encourage more Angel investing, provide win/win investment strategies for both investors and entrepreneurs, and encourage the formation of more formal Angel groups. For that we needed funding.

Armed with the urgency and the potential, the NAO went to the Ontario Government to help kick-start this publication, to seed the creation of more Angel groups within the province, and to help strengthen existing Angel organizations.

The response was both immediate (well almost) and enthusiastic. At last October's National Angel Summit in Toronto, Premier Dalton McGuinty -- who also serves as the Minister of Research and Innovation -- pledged $2.5 million to the NAO for Angel group facilitation and formation in the province.

This publication is an outcome of a small portion of that investment. It is also built on some of the pioneering work the NAO undertook several years ago with the financial and logistical support of the RBC Financial Group. Titled "The Primer for Angel Investment In Canada", that publication laid out some of the best practices for Angels, when the discipline was still in its infancy. In the introduction, Gordon M. Nixon, President and CEO, RBC Financial Group, noted that, "if Canadians are to sustain a high standard of living, they must become much better at turning innovation into profitable businesses, that is what the innovation debate is all about. It is here that Canadians are lagging – in research and development, in commercialization, and in growing new companies into viable enterprises with the scale and the scope for long-term success. And it is here that Angel investors across the country can and do make giant contributions to our collective prosperity."

This new text is an attempt to further the investigation undertaken in the "primer" to assist more Angels to make more and better investments in the commercialization of entrepreneurial companies.

It is initially offered as a spiral-bound text with an accompanying training manual, and is available online with the intention that it be updated from comments and observations from all qualified parties. Within a year, it will be published hardbound for further use in the creation and sustainability of provincial Angel groups.

I wish to thank the Premier for his vision and leadership, and his staff within the Ministry of Research and Innovation for their support and guidance. Most especially I want to recognize the immense contribution made by the Ministry's Bill Mantel, Brad Defoe, and Ruth Dorenfeld.

I also want to express my heartfelt thanks to Andrew Wilkes, National Angel Organization Chair, who applied his immense reservoir of practical and political talent in the creation of this text.

And I would be remiss, and surely hunted down because they know where I live, if I did not express my gratitude to my fellow contributing authors, whose bios you will find gracing the beginning of this manual: Frances Fast, Steven Gedeon, and Bryan Watson, as well as our line editor, Robin Sundstrom, who ensured that common sense did not read as nonsense, and that nonsense did not replace common sense – akin to our goal as Angel investors, surely.

W. Daniel Mothersill

President, National Angel Organization
Managing Editor & Contributing-author, *Age of the Angel: Best Practices for Angel Groups*
Angel Investor

W. Daniel Mothersill

Daniel Mothersill wrote the chapters on Sustainability, Deal Syndication, Due Diligence, and the final, supplemental chapter on Dilution, Down-round, Sidecar Funds, and Exits. Professionally, Dan is a serial entrepreneur and a serial Angel investor, keynote speaker, and lecturer with hands-on experience in industries ranging from telecommunications, to green technologies, to resources, to IT. In the last decade, he has founded and financed seven companies and spun off three of these as profitable enterprises.

He is founder and chair of the Ciris Group of Companies and president and founding member of the National Angel Organization (the national voice of Canadian Angels). He also serves as an advisor to a number of technology companies, and specializes in organizational and positioning strategy, financing methodologies, communications, and investor relations for emerging and early-stage North American companies.

At the same time, Daniel created and heads the Angel Network Program for Ontario's Ministry of Research and Innovation dedicated to developing core standards for Angel investments in the province and seeding the formation and expansion of formal Angel groups. Through the National Angel Organization, he received $2.5 million from the Premier to launch this initiative. He is also working with the Federal Government to roll out these standards and best practices across Canada, which will be unveiled in October during Alberta's Innovation Week. In addition, he is forming the first Canadian Angel trade mission in collaboration with UK Trade and Investment.

Daniel is chair of the Angel stream for the Canadian Venture Forum, strategic advisor to the Banff Venture Forum, advisor to the New Brunswick Securities Commission on the commercialization of innovation, guest lecturer to the MBA program at Ivey, founder of and facilitator to several angel groups, and board member of the CEO Fusion Centre. On behalf of the TSX Venture Exchange, he has presented the benefits of the CPC program to Angels and entrepreneurs in major Canadian cities. Prior to forming Ciris in 1991, Daniel was head of investor relations for Nortel.

Daniel also founded the go-to-market boot-camp paradigm for the Toronto Venture Group, which in the last seven years has proliferated across Canada to become a fixture at major Angel and venture forums. At more than 100 boot camps, Daniel has trained some 2,500 SME executives through his proprietary presentation preparation program. These entrepreneurs have gone on to capture more than $2.4 billion in seed and angel capital.

Daniel studied at York University (political science), The Wharton School, University of Pennsylvania (finance and accounting), Humber College (journalism), and the Royal Conservatory of Music (Toronto).

Bryan J. Watson

Throughout his career, both in Canada and the UK, Bryan J. Watson has been a champion of entrepreneurship as a vector for the commercialization of advanced technologies.

Upon his return to Canada in 2004, Bryan established his venture development consulting practice to help emerging-growth companies overcome the barriers to success they face in the Canadian commercialization ecosystem.

As demonstrated by his concurrent roles as Executive Director of a number of non-profit emerging-growth venture-fostering organizations including the National Angel Organization, CEO Fusion Centre and BioCEO Canada, Bryan takes an active roll in the entire entrepreneurial spectrum, from idea-generation to financing to liquidity event. Bryan is also a Director of Canada's largest technology association, CATA and the Strategic Liaison Officer for Young Inventors International."

Bringing youth and vigour to the commercialization sector, Bryan, as co-founder of the 4th Pillar Council, is actively engaged in turning the Ontario Commercialization Network into a globally competitive, efficient, commercialization engine capable of transforming advanced Canadian innovations into market-ready technologies and companies.

After concluding his BA (Hons.) in Economics at the University of Western Ontario, Bryan went on to complete his Masters in Management, Economics and International Relations at St. Andrews University, Scotland on the only full British Council Chevening Scholarship awarded in Canada. During this time he also worked with the Scottish Institute for Enterprise, fostering entrepreneurship and venture development on the local and national level.

Frances Fast

Frances Fast, author of the Formation of an Angel Group, Term Sheets, and Deal Screening chapters, is a founding Director of the Toronto Network of Angels and a recognized leader in the Angel investment community. Prior to entering the Angel field, Frances worked with the Canadian Industrial Innovation Centre and the Toronto Venture Group focusing on the unique capital needs of early-stage, high-growth potential technology companies.

Frances has spent the last 5 years managing Angel investment groups with a focus on high-technology, advanced manufacturing and life science companies. Her career has progressed from research analyst to Executive Director. Having written the preliminary business plan and grant application for the development of the Toronto Angel Group (TAG), she went on to manage that organization, tripling membership and overseeing 17 member investments which resulted in 13 technology companies raising over $10 million. In 2005, Frances co-founded the Toronto Network of Angels, a network of sector-focused angel investment groups with a primary mandate to get deals done by providing a more intelligent source of early stage risk capital: offering access to the right management talent; key strategic contacts; and access to follow-on capital. Within this role, Frances has focused on life science and industrial technology companies, resulting in an unusually high investor yield rate of 33%.

Over the past 15 years, she has analyzed and coached over 2,000 companies in the high-technology, advanced manufacturing and life science sectors. Frances has a strong reputation for delivering value to both companies and investors. She has brought relevant expertise, deep contact networks and an uncompromising approach to raising equity capital for technology companies across Canada.

Frances holds her Bachelor of Applied Science in Engineering from the University of British Columbia, and more years ago than she is willing to admit publicly, was a registered nurse specializing in neurosurgical intensive care.

Dr. Steven A. Gedeon

Dr. Steven A. Gedeon, author of the Negotiation and Deal Valuation chapters is a member of the NAO Education Committee, and is a serial entrepreneur and venture capitalist who has founded and/or led over a dozen private, public, venture capital and non-profit organizations. He has sat on over 30 boards and technical committees including the CEO Fusion Center, Academy for Tech CEOs (AceTech) and the Ontario Partnership for Innovation and Commercialization (OPIC).

Dr. Gedeon has his PhD from MIT, MBA from University of Toronto and is a licensed professional engineer in the US and Canada with over 100 publications and patents. Steve was recently CEO of 3DNA Corp., a new media technology company where he raised 5 rounds of financing and created the number one download in its product category with over 20 awards and 80 magazine articles, as well as many fan sites and over a million users.

Dr. Gedeon is a professor of entrepreneurship in the Ted Rogers School of Management at Ryerson University where he judges the $25,000 Standard Broadcasting Business Plan competition, is faculty advisor to Students in Free Enterprise and teaches the final capstone courses in entrepreneurship, strategy and eBusiness. His research interests include analyzing and modelling success factors related to performance of high-growth, technology-based companies, including:

- Sources of competitive advantage including information, technology, convergence, innovation, positioning and new market experimentation
- Financing entrepreneurial ventures including seed capital, angel investing, venture capital, private equity and merchant banking
- Improving personal and corporate performance including goal-setting, efficacy skills, motivation, networking and teamwork processes

Passionate about entrepreneurship, Steve is active in helping students start up over a dozen companies, working with entrepreneurs and lecturing on goal setting, motivation and personal greatness.

Steve also coaches and trains sailing crew at the National Yacht Club aboard his 40' sailboat – Progressive.

Executive Summary

In this chapter, we make the case for organized Angel investing, which has historically worked well for both Angels and their communities. In addition, we outline how to create and structure an Angel group, and discuss several procedural questions: Who should be invited to join? How should the group be structured? Who should run the group? What infrastructure is required? How should the meetings operate? How will the founders measure success?

1.0 Background

There are over 200 active Angel investment groups across North America. This is a huge rise from the late '90s when only about 50 such groups existed. Each functions under its own operational model, designed by its members to serve them and their local investment community.

The growth is understandable considering the appeal of the Angel model – people with money and expertise investing in upwardly mobile companies – and the creation of a new group often generates excitement among local media and business. Among businesses, suppliers, and entrepreneurs, there is heightened interest in the possibility of meeting with members of such a high-net-worth group. But while there is no clear best method for creating a successful Angel organization, the one defining characteristic across all Angel groups is that members and all those who attend investment meetings qualify as accredited investors:

Either:

> *an individual who beneficially owns, or who together with a spouse beneficially own, financial assets having an aggregate realizable value that, before taxes but net of any related liabilities, exceeds $1 million excluding their principal residence;*
>
> *Or;*
>
> *an individual whose net income before taxes exceeded $200,000 in each of the two most recent years and has a reasonable expectation of exceeding the same net income level in the current year;*
>
> *Or;*
>
> *whose net income before taxes combined with that of a spouse exceeded $300,000 in each of those years and has a reasonable expectation of exceeding the same net income level in the current year.*

Ontario Securities Commission Rule 45-501

This criterion is essential, as companies are restricted in their ability to present to, and raise capital from, investors who do not qualify as accredited investors. The government has implemented regulations concerning information disclosure requirements, reporting requirements, and funding limitations in order to protect investors whose circumstances render high-risk investments (such as most investment in early-stage companies) unwise.

Among Angel groups there has been a distinct move toward professional management. The past trend of creating informal groups as associations of Angels managed on a volunteer basis by the Angels themselves has declined precipitously since the end of the dotcom boom. Today, most Angel groups operate either in association with non-profit organizations that serve the early-stage, high-tech entrepreneurial or equity finance communities, or as stand-alone non-profit entities often having evolved from such an association. The vast majority of angel groups now:

- Employ professional part-time or full-time management;
- Maintain a public face with a website and public relations activities;
- Involve individual members making individual investment decisions;
- Pool their efforts towards due diligence; and
- Invest under a single set of terms.

1.1 A Strong Argument in Favour of Organized Angel Groups

It is obvious that Angel investment is an asset to the economic environment. However, it is critical to understand that while economic development is a clear outcome of Angel activity, it is not necessarily the focus of the Angel. Angels invest primarily to increase their own personal net worth. A professionally managed Angel group will increase the total amount of dollars invested into local technology companies, typically not by increasing in the investment activities of investors already active in the community, but by facilitating Angel investment activity among individuals who would otherwise invest their money in the stock market or other, lower-risk, alternatives. In fact, previously solo Angels who make the decision to invest only in association with their local Angel group tend to invest roughly the same amount of dollars on an annual basis but become able to spread that money across more deals. In this way they diversify their portfolio and reduce their individual risk. The only proven mechanism to increase the overall amount these investors devote to Angel activities, as shown across multiple countries and a growing majority of states in the US, is the implementation of tax credits.

The key economic development benefit of the organized Angel group is the promotion of Angel activity among those accredited investors who would not otherwise participate in Angel investing. Angel groups enable them to mitigate risk and participate in a credible community of investors.

Benefits of Angel Group Membership	
1	The structured Angel group provides a public face to attract deal flow while enabling individual members to maintain their privacy.
2	Community recognition of the Angel group and its particular investment focus leverages this public presence and creates a wide referral network to increase quality deal sourcing.
3	Professional management provides efficient deal-matching to investor's individual preferences.
4	Collaboration in due diligence provides multiple points of knowledge about market, management, and financial assumptions, ultimately resulting in better investment decisions.
5	Individuals new to the Angel investment community are able to learn from experienced Angel investors on all aspects of the investment process.
6	All participating Angels benefit from evolving best practices knowledge.
7	Regular meetings provide a social network to facilitate camaraderie and the sharing of common goals.
8	Structured investment processes and resources, along with the group position, enhance the investor's position in negotiating terms.
9	Collective investing typically results in companies raising higher dollar amounts. This provides not only greater economic power but also access to the mentoring capacity, contact networks, and the sector and management expertise of the investor group, which together increase the likelihood of overall success for the investee companies.

Unlike most other forms of investment, active participation in an organized Angel group provides members with an expectation of high financial return, the satisfaction of being involved in the entrepreneurial process, and the enjoyment of a peer network. Angel investing is a high-risk activity, but it brings great potential for financial and personal gain.

Professionally managed Angel groups serve to mitigate the individual investors' risk and provide other rewards, be they social or professional. At the end of the day, Angel groups promote entrepreneurship, provide for the greater good, and promote social responsibility.

1.2 Taking the First Step

Most operating Angel groups are first developed in association with non-profit organizations that serve the early-stage, high-tech entrepreneurial or equity finance communities. This assumes a community with an active entrepreneurial environment. Ontario has ample resources and services to support new businesses in most urban centres, so generally speaking, these local organizations will already have some level of informal relationship with at least a few active Angels in their communities. In this discussion, we are assuming that the initial steps are being taken by non-Angels in the entrepreneurial community, but Angels themselves can easily follow the same path, and will benefit from infrastructure already in place within their local business community.

As a first step, we recommend speaking with local professional service providers (attorneys, accountants, and investment bankers) who work with high-growth companies, in order to enlist their support. They can help to expand the list of potential Angel contacts, ensuring a representative group of investors. The next step is to hold an information session to explore the idea of starting an Angel group, permitting prospective group members to discuss their ideas on the subject. It is essential to structure any new Angel group to meet the needs of the investors in each local community. Key to this is enlisting the support of one or more local Angels to champion the organization and help get the new Angel group off the ground.

1.3 How to Start

Defining the mission and vision of the group with the champion Angels will set the tone for the entire organization. The first goal of every Angel investment organization is to make money, but beyond that there may be interest in creating an environment for learning and sharing experiences, placing members in management roles, focusing on a particular industry sector, or generating jobs for the community. Defining the common interests of the group with respect to the:

- Stage of investments;
- Industry or market focus;
- Geographic boundaries; and
- Expectation of financial return expectation,

will clarify the route to secure the "right" investors and investment opportunities, and will also serve to set the tone for all communications.

Traditionally, Angel groups recruit members by invitation through existing members or sponsors. To begin, solicit qualified referrals from the supporting professional service community. This can involve a manager-led or Angel champion-led phone campaign that permits both a warm introduction and some key questions to ensure all who are invited are accredited investors.

On an ongoing basis, best practices dictate that new members are referred by existing members. Prospective members without such referrals are often asked to attend a first meeting as a "guest" to ensure they know what they are getting into (and to ensure they fit into the existing group culture). Alternately, a lunch meeting or drinks with a representative from the Angel Membership Committee or Board prior to joining ensures prospective members understand the expectations and the process.

Operational Structure

With respect to organizational, management, and membership structure it is important to be responsive to and serve the needs of the local Angel community. Of the 200-plus Angel groups active across North America today, there are also 200-plus operational models. There is no clear best method for creating a successful Angel organization, but recent efforts toward defining trends has led to the identification of best practices in most aspects of group structure, operations, and investment activity.

It is becoming clear that groups led by a manager with experience in the investment process seem to provide an easier path for the Angel members. Depending on their professional skill set, the manager attends to much of the up-front work of sourcing and screening investment opportunities, coaching companies before they present, coordinating member events, and managing both member communications and public relations. In essence, the Angel group manager handles all of the details so the members can concentrate on making investment decisions and structuring the shape those investments will take.

Investment Structure

It is reasonable to expect that the local Angel community will weigh-in early on the group's investment structure, individual or pooled.

The most common structure for Angel groups is for members to make their own individual investment decisions, combining their efforts towards due diligence, and investing under a single set of terms. This investment structure reflects the typical investor's need for control over his or her investment capital.

The main alternative structure requires all members to contribute a set amount of capital into a pooled fund that is then triggered by a vote. In cases of small groups, under 10 members, a unanimous vote to invest is a reasonable goal. However, with larger groups and where members have more diverse backgrounds, achieving unanimity on any investment decision becomes increasingly difficult. Setting the trigger to invest at some percentage of the vote higher than a majority facilitates portfolio diversity but can leave some investors uncomfortable.

Corporate Structure

Many Angel groups start as operating business units of existing non-profit organizations, under the direction of an executive committee separate from the Board of Directors of the originating non-profit. This is a relatively inexpensive and efficient method to facilitate the start-up of a new Angel group with respect to staffing and capital expenditures. However, this approach can lead to frustration if the Angel group's executive committee find themselves unable to fully direct staff and operations. As well, the parent organization's Board is faced with new liability issues and competing priorities.

While there are a variety of legal structures in the US that are appropriate for various kinds of Angel groups, in Canada, a dedicated non-profit corporate structure is most appropriate. Incorporation must be in place to access bank accounts and structures for the employment of staff, as well as to ensure activities are fully in-line with Angel interests.

Membership

As a best practice, Angel groups should require that all members be accredited investors. Guests and new potential members are traditionally required to sign Accredited Investor Declaration Forms (attached) in order to gain entry to their first group event, and many groups require members to reaffirm their accredited investor status annually upon renewal of their membership. As discussed previously, the Ontario Securities Commission restricts companies in terms of information disclosure and raising capital from non-accredited investors. As a result, companies or their referral agents may choose to avoid groups that do not have the accredited investor requirement for their attendees.

Other frequently cited requirements for members of organized Angel groups are:

- Active participation through the investment of their own funds;
- Attendance commitments; and
- Recognition by the local business community as having reputable business ethics.

It is also a standard requirement to disclose any relationship with a presenting company, or any personal benefit relating from group investments and/or relationships with other members.

The creation of a "community of Angels" may seem like an appropriate goal. However, our experience in Ontario has shown that the number of members in an operating Angel group is not as significant as their investment activity. The camaraderie that comes with establishing an extensive peer network of high-net-worth individuals may seem to lead to sustainability with regard to membership fees, but does not contribute to the reputation of an Angel group within the larger business community. Ultimately all Angel groups are judged on the quality of their portfolio. Groups perceived not to be actively investing or who prove difficult to work with to close a financing round will quickly put off referral agents. Without community support, fewer quality companies will be available to present to the group for investment consideration and the process can quickly spiral downward.

In order to ensure member intentions are in line with the goal of creating a group of active Angels, many groups have included a clause stating some minimum investment participation in their membership agreement or code of conduct.

> *Angel Members are expected to invest a minimum of C$25,000 in the group's investee companies on an annual basis. Members' investment activity will be reviewed annually as a consideration for renewal….*
>
> *Extracted from the Toronto Network of Angels Code of Conduct*

Angel group codes of conduct generally also include the requirements to maintain confidentiality of member identities, company data, company due diligence discussions, and individual investment commitments.

Meeting Structure

The means by which different groups manage the meeting process varies widely, but we have found in our Ontario experience that maintaining a regular schedule of meetings through the September to May time-frame suits the work/play balance of most Ontario high-net-worth individuals.

As the primary focus of Angel groups is investing, it follows that the primary focus of Angel group meetings is company presentations. The number of companies that do present at each meeting should be limited for the following reasons:

- To reflect sustainable deal flow;
- To ensure companies are given sufficient time for their presentations plus a question and answer period;
- To ensure the investors are able to give each company their full attention; and
- To ensure consistency in meeting structure.

Typically, 2-to-4 companies present for 10-to-15 minutes followed by a Q&A period of approximately the same duration, though it is not uncommon for groups to feature only one or two companies, devoting 45 minutes to an hour to each.

Experience indicates that committing to a set number of companies at each event can sometimes compromise quality, so as a best practice, only the companies best qualified to present should be permitted to do so. Occasionally showing fewer companies provides the time for a member-led educational session, more networking, or perhaps for the manager or the Board Chair to "check-in" with the membership and hold an informal "show-of-hands" survey on member practices and initiatives.

The companies selected through the screening process should receive coaching in advance of the meeting to ensure they fully understand the process, are prepared for questions likely to arise during the Q&A, and make the best possible first impression. For them, their future path may depend on a 15-minute presentation – it makes sense to help them prepare, and it makes the process more enjoyable for Angel members.

Following the presentations, it is traditional to hold an Angels-only session to discuss members' impressions and solicit interest in pursuing due diligence. Audience enthusiasm and momentum play a huge role in Angel due diligence, so it is a best practice to maintain a schedule to ensure those interested in pursuing due diligence are actively engaged in the process within 24 hours and that the first meeting at the company's place of business occurs within a week. For presenting companies that do not receive interest, it is a best practice to get back to them with candid feedback on where their message went wrong so they are better able to approach other prospective investors outside the group.

Parameters of Success

The accomplishment of goals and member satisfaction can be difficult to measure quantitatively. Return on investment is not a practical measure for new Angel groups, since Angels typically invest at an early stage and returns may not be seen for several years. Instead, it is useful to measure member retention, number of companies invested, member referrals of new members, and member referrals of investable companies as tangible evidence of success. Strong quality deal flow provides ample incentive for members to remain actively engaged in the group and in the investment process.

Additional Resources for this chapter in Appendices:

Fig. 1 – Summary Accredited Investor Declaration
Fig. 2 – Sample Group Membership Applications
Fig. 3 – Summary of Administrative and Management Functions

Executive Summary

For Angel groups, longevity generally means superior deal flow, stronger reputation, and better process. Longevity amortizes the cost of both set-up and the learning curve all new Angels experience. Active, hands-on involvement in good deals is the single most important element in making an Angel group sustainable, but there are other tools and techniques, as well as mechanisms to protect the Angel group against external threats, such as deal competition.

2.0 Introduction

The challenge of making an Angel group sustainable begins on the day it is formed. From that point in time sustainability becomes a living process, not a one-off event. For Angel groups, this process requires a multi-disciplinary approach to funding, organization, deal-flow, investing, membership recruitment, deal exiting, and the care and feeding of member Angels.

Of course, Angel groups exist because they provide sophisticated investors with the opportunity to make superior ROIs, mitigate risk, mentor upcoming entrepreneurs, and collaborate with like-minded investors in a business/social setting. It's about doing some good, making some money, and having some fun in the process.

Within that context, the intent of forming an Angel group is to create an enduring entity based on common objectives. Unfortunately, reality has presented a variety of obstacles that have hobbled the effective functioning of some organizations in North America while forcing others to fold.

Some of these obstacles manifest quickly; others erode the stability of Angel groups more gradually. By examining the operations of mature groups, these issues can be seen more clearly in order to assess the structures and disciplines that can be put in place today to mitigate the challenges tomorrow.

2.1 A Sometimes Typical Scenario

Muddy York Angels (not a real group) has been operating for several years as a non-profit organization. It has a part-time facilitator and has attracted 40 members. Most are accredited investors, but over time a few suppliers and hangers-on have been allowed to attend the meetings.

The group is sustained by membership and was initiated with a small government grant that has run its course. Muddy York has a working committee that pre-screens deals and selects companies to present at member-paid dinner meetings held 10 times a year.

There is a formal due diligence process and the Angels invest about $3 million a year in start-up ventures. These investments have been topped up with syndication funds from other Angel groups and one seed

VC. However, the group has yet to exit any deal and membership attrition is starting to set in. Turnover rate is starting to exceed a normal 10%-to-20% annual fall-off and few new members are joining. There's modest tire kicking, but not many takers.

While mentoring of start-ups does take place, a few Angels are beginning to scare away some companies with an overly aggressive due diligence process. They have become masters of the universe in their own minds without significant cash to justify their behaviour.

At the same time, other Angel groups are recruiting some of Muddy York's members, the working committee is worn out, and membership dues are not meeting the expenses. In reaction, membership fees are unilaterally increased, resulting in even greater attrition.

Muddy York's Angels have hit, head on, the sustainability wall. They are faced with threats both internal and external and are undecided on workable remedies.

The following outlines some of the factors that can reinforce or threaten group sustainability and provides potential solutions to support sustainability within Angel groups:

Collegiality

An active membership is the key to sustainability. Investors join organized groups to achieve more than competitive returns on early stage investments. They want to belong to a group of their peers who share common interests, experiences, and insights on how to best grow companies and collectively can attract better investments than a sole practitioner.

When an Angel group functions optimally, it fosters a learning environment where Angels can draw on the been-there-done-that knowledge of their colleagues. Angels feel free to share horror stories on really bad investments and provide insights into lessons learned. Involvement is therefore critical.

Angel groups that enjoy strong participation by members in presentation meetings, pre-screening working committees, due diligence reviews, membership recruitment, networking and educational events and website and monthly newsletters tend to endure.

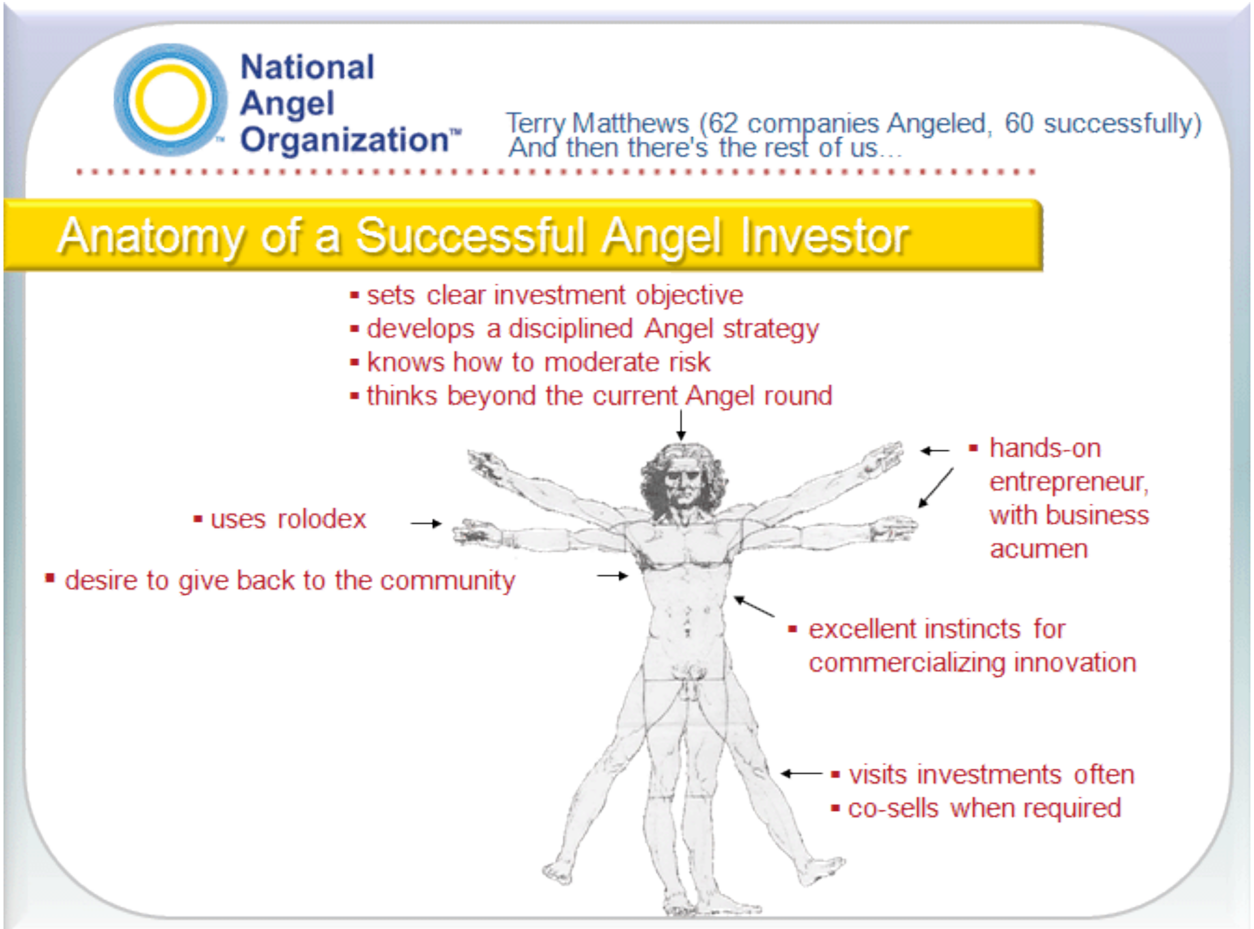
Mentoring

In the same way, strong relationships with investee companies will add to an Angel group's longevity, while significantly benefiting the companies and adding to their longevity too. Seasoned executives are Entrepreneurs-in-Residence (EIRs) without the title. They understand how to build businesses locally and graduate them globally. Properly encouraged, these Angels are the source of sustainable growth by providing three things:

1) a killer rolodex of potential customers and strategic partners;

2) the ability to mentor founders and senior management teams; and lastly,

3) cash.



Contrary to common wisdom, when it comes to start-ups, cash is not king. It is a lesser nobility and takes second place to industry introductions, business savvy, and operational expertise. Cash is necessary but not sufficient in propelling start-ups to profitability and exponential growth.

The secret sauce in sustaining an Angel group is in twinning investments with mentoring by as many members as is practical, especially in the new companies they back. These Angel entrepreneurs bring expertise or an affinity for the new company's product or technology, its market, its competition, and general industry trends.

Mentoring is one of the principal differentiators between Angels and VCs. VCs manage money; Angels mentor companies.

Mentoring is delivered in a variety of ways:

- Sitting as an advisory board member, where the Angel can temporarily plug some of the holes in a start-up's management team is such areas as sales & marketing, human resources, finance and accounting, and operational logistics;

- Claiming a position on the Board of Directors, providing advice on strategic direction while overseeing progress on milestone completion;
- Holding formal and informal team building and coaching sessions for management and staff;
- Introducing company executives to potential customers, suppliers, business partners, or strategic alliances; and
- Occasionally filling senior positions on the management team for a predetermined time, which can include the role of president or CEO.

Cultivating Member Involvement

Conversely, the more active Angels are in mentoring companies, the more attractive the group becomes to high-grade deal flow, because the entrepreneurial world is relatively small in any given community and the reputation spreads quickly. Which comes first, the good deals or the active mentoring? Who knows? But what is certain is that it's not a Big Bang event. Rather it's a process fuelled by several clearly defined initiatives that any Angel group can a should implement, including:

- Building a profile of all Angel members' business interests and experiences and twinning them with promising deal-flow companies from similar industry verticals for advice, counsel, and guidance. It's an Angel-group match-making initiative based on common backgrounds. This practice can kick start the formal mentoring of start-ups and strengthens dynamics and interaction among the membership;
- Using a member-only login on the group's website to promote discussion, suggestions, and observations on current and potential investee companies; and
- Pairing experienced Angel group members with new inductees and involving them in screening, due diligence, and term sheet negotiations, even if they are not funding any of the deals. To the uninitiated, Angel investing can be a bit daunting. Encouragement and tutoring from an Angel "coach" can quickly move new members up the learning curve, build confidence, clarify the options, and dispel misperceptions.

Good Deals

Good deals galvanize Angel involvement within the group. Good deals depend on good due diligence, which is covered elsewhere in this handbook.

National Angel Organization™

2.3 Threats (Internal & External)

2.4 Internal

Angel burnout

In Angel groups that don't have a manager to carry much of the logistical and promotional work, member burnout is inevitable. However, within facilitated Angel groups, it's vital that a balance be achieved between the Angel executives or working committee and the full- or part-time manager. When a group is first formed, Angels will at times undertake a disproportionate amount of the heavy lifting. Duties will include such things as incorporating the group, actively recruiting members, screening applications, coaching presenting companies, organizing meetings, conducting due diligence, handling term sheet negotiations, and the list goes on.

The goal is to achieve an equitable balance between the manager's duties and those of the members. The Angels will always retain primeship over such functions as deal syndication, due diligence, mentoring, and negotiation. They will also retain a significant role in networking and recruiting new members. Over time, greater responsibility should be placed on the manger, whose duties – spelled out clearly in writing -- will include:

Angel group manager's responsibilities checklist:

- Deal flow solicitation
- Company pre-screening
- Linking rejected companies with other resources (BMEP Initiative)
- Presentation coaching
- Meeting logistics and coordination
- Due diligence logistics
- Coordination with legal counsel
- Syndication logistics
- Member data base, profiles and communications
- Membership recruitment and logistics
- Website management
- Media relations

- Angel event (educational & other) coordination
- Sponsorship solicitation
- Budget, bookkeeping, office management
- Managing stakeholder relations

As a footnote, Angel managers can be recruited from a variety of sources – retired business executives, executive directors of non-profits with a background in event and business management, or MBA students who rotate work terms with an Angel group, for example.

Disruptive Angel Group Members

It only takes one rowdy person to ruin a party. In an Angel group, it only takes one disruptive member to hinder the effectiveness of a group. Allowed to continue, such behaviour can turn off existing members and discourage others from joining. It shouldn't happen, but it does.

The most effective way to prevent such behaviour having a real negative impact is to create a meaningful and well-observed code of conduct for the Angel group. All members should contribute and vote on the initial draft. Once ratified, every member must sign. However, there's an elderly joke that begins by asking the question: "How many psychologists does it take to change a light bulb? The answer: "Only one, but the light bulb has to want to change." If a group faces persistent infractions of its code and unaltered negative behaviour, these are cause for expulsion, with membership fees reimbursed on a pro rata basis. If the unruly member is otherwise a valued contributor, the group may decide on any of a range of lesser penalties, but these can run the risk of looking like "interventions" and serve to focus the group on the unruly member rather than the business at hand.

A Funding Crunch

As with any effective organization, the Angel group needs a business plan, a detailed sales & marketing plan, a detailed budget – and a contingency plan. Even with the most exacting planning, stuff happens. That's why the group requires a financial status review on a monthly basis. Once a problem is identified, the contingency plan provides a variety of options to increasing cash flow. These will include:

- Additional sponsors from both the public and private sector. (Since this topic deserves a greater discussion, it will be dealt with in more detail in the next section.);
- New member recruitment drive with hard targets. The group appoints Angel champions from its members to work their rolodexes for additional members;
- Hold paid educational and networking events and provide guest speakers to other groups presenting on relevant topics; and
- Charge fees for presenting companies – filing fees or presentation fees.

Obviously, increasing current membership fees should be avoided without open discussion with the committee of the whole.

Also to be considered is taking a percentage of the transactions – 3%-to-5%. This has worked for some active groups, but been highly problematic for others. Many companies view transaction fees as a form of double dipping, and experience indicates that it only truly works if the Angel investment is substantial. There are also legal issues involved -- most specifically, there needs to be a limited market dealer (LMD) within the group or a trusted source that the Angels can jitney the deal through.

More on Sponsorship – The Gateway to Angel Group Solvency

Cash-flow crunches for Angel groups are a truly avoidable embarrassment. Yet memberships fees, cash generating events, and charges to presenting companies are sometimes not enough to pay the bills of even the most modest Angel group. An adequate salary for the group manager, with the attending office, legal, insurance, and accounting expenses, can outstrip accounts receivable and place a venture in a deficit position. Paradoxically, a group run by sophisticated high net-worth individuals, who are recognized leaders in their industry verticals, can find themselves in the role of mendicants, begging the membership for more money. This really is not a good way to run a business.

To avoid insolvency, relationships with potential sponsors need to be forged as soon as the ink is dry on Angels group's articles of incorporation. It's a team sport, where Angel captains are appointed to meet personally with potential sponsors and begin the courting process.

Of course, the first and most logical question from would-be sponsors is WIIFM – "What's In It For Me?" That's where the Angel group captain rolls out a list of benefits. The overriding message is that it is in the best interest for the community to support Angel groups in the creation of commercially viable companies through a sustainable source of funding. The meta message is that the group will not exist without sponsorship support. More specifically, despite the fact that some will see a certain irony in high-net-worth individuals asking for sponsorship money, building sustainable companies enriches the community as a whole and the costs should not be borne disproportionately by the few.

The pitch to professional service suppliers and financial institutions:

As in the real estate sector, there is one major key to the Angel group's value to these groups:

1) Client acquisition;
2) Client acquisition;
3) Client acquisition;
4) Profile with the accredited investor community, many of whom own and run substantial businesses;

5) Exposure to entrepreneurs who in creating their business will rely on the services that many of the sponsors provide;

6) Trusted resources for entrepreneurs;

7) Brand awareness as the go-to firm in the commercialization of innovation space;

8) Recognition as company builders in key sectors of the economy, and leaders in the creation of wealth; and

9) Positioning as good corporate citizens and employers of note.

The pitch to federal and provincial governments:

For government, Angel groups provide value as:

1) A means of effective deployment of tax payers' dollars;

2) Generators of skilled employment;

3) Facilitators of commercialization of university generated innovation;

4) Partners in the creation of growth-oriented companies;

5) Adjuncts to existing educational and assistance programs for start-ups;

6) Promoters of wealth creation and exports;

7) Magnets for the repatriation of skilled executives and employees; and

8) Exemplars of good government.

And (soto voce) positioned properly, the incumbent governments will attract votes.

The pitch to venture capital firms:

1) Exposure to current seed and potential Series A deal flow;

2) Access to deal flow that is pre-screened by experts in the sectors;

3) Financing opportunities;

4) Syndication with Angel investor groups; and

5) Reduction in the expenditures of resources for due diligence undertakings.

VCs can be members as well as sponsors. However, they should be required to pay higher fees than Angel members, since Angels dip into their own pockets while VCs merely tap the resources of their respective firms.

For in-kind media sponsors (they never pay for sponsorships):

Angels are attractive to the media for a variety of reasons, but it is also worth appealing to their desire for:

1) Leads for business articles on fast-growing companies;
2) Profile potential on up-and-coming entrepreneurs;
3) Exposure to breakthrough technologies, products, and sciences; and
4) Coverage of Angel group activities and events.

That's the short list of selling points for potential sponsors. In more tangible terms, the Angel captains need to create various levels of sponsorship – Platinum, Gold, Silver, Bronze or whatever designation suits members' tastes – and provide a detailed sponsorship package. In the package, the Angel group should list the specific benefits under each category. These can range from the provision of client referrals, free participation in Angel events and workshops, logos on signage, marketing materials, website, newsletters, stationery, and Angel group offices to more active possibilities such as speaking opportunities, marketing handouts, event booths, Angel-led sponsor dinners, and networking forums. Creativity is the key to finding as many reasonable ways as possible to provide exposure to both Angels and entrepreneurs. The Angel group may well want to turn to professional marketing or media help, although most Angel groups will have considerable expertise in these areas among their members.

The one caveat is in allowing non-VC sponsors to attend regular deal-flow meetings. These sessions are about funding companies, not soliciting Angels and entrepreneurs. Special events can and should be created for service providers where they can meet with all participants in the Angel process without interfering in deal-flow matters.

Lack of Liquidity

While Angels tend to have a higher ROI than VCs, it is not uncommon for groups to be in numerous deals with no clear exit in sight. It is a huge detractor to new members if there is a perception that the group is involved in "Hotel California" investing -- where you can get your money into a company, but can never get it out. Angel members need to regularize liquidity events in order to take some profit and reinvest in other start-ups.

Once the money has been invested, it's difficult – but not impossible -- to force a liquidity event, unless exits have been baked into the term sheet and thoroughly negotiated with the founder. (For more details on the process and structure, go to the Term Sheet chapter.)

2.4 External

Seed VC Competition

Occasionally a seed VC will scoop an Angel deal. The best defence, of course, is a solid offence. A workable strategy is to turn the potential competition into an ally by building a solid relationship with the handful of seed VCs in Canada and partnering with them in Angel deals.

These VCs (BDC is a prime example) generally will come in on the same terms and conditions as Angels, which increases the amount of funding available and smoothes the path for a Series A round if one is required. Because of the high cost due diligence for VCs relative to the size of a seed investment, most will prefer to syndicate their deals with an Angel group that has already vetted the company and committed to a financing.

Angel Group Competition

The rise of deal syndication in Canada is leading to reduced competition among Angel groups. Increasingly the goal for many Angels is to provide sufficient funding to a start-up in order bring it to profitability within three-to-five years. Most often, the total investment required is beyond the appetite of one Angel group. Collaboration with other Angels is a solid and sensible solution.

At the same time, Angels in Canada can and do belong to one or more Angel groups, especially in larger centres where there are both general Angel groups and sector specific organizations. Encouraging multiple memberships is an effective strategy in reducing the threat of competition.

Lone Ranger Angel Competition

There will always be a significant role for individual Angels to play in the commercialization of start-ups. These Angels frequently play in a quasi-friends-and-family round or loosely band together with other Angel colleagues in an Angel deal. Of course, a solid sales and marketing campaign can draw lone rangers in by extolling the benefits of formal membership in an Angel group.

As with VCs, there is always the potential to syndicate deals with these Lone Ranger Angels if there is little affinity for a structured Angel investment climate.

Financial Model (Budget)

Sustainability depends on running the Angel group as a business. The same rules apply as for any new venture – create a business plan with a detailed financial model and budget. (It is sometimes surprising (at least to this writer) that serial entrepreneurs will band together, form an Angel group with no plan, process, or structure.) On a high level, the financial model must include a level of detail on both revenues and expenses.

Angel Group Sample Budget

Revenues	**Monthly**	**Quarterly**	**Annually**
Membership Fees			
Sponsorships			
Application Fees			
Presenter Fees			
Transaction Fees			
Events			
Total			
Expenses	**Monthly**	**Quarterly**	**Annually**
Manager's Salary			
Office Administration (including rent, computers, etc.)			
Members Meetings			
Legals			
Accounting			
Sales & Marketing (including membership recruitment)			
Media Relations			
Events			
Website Maintenance			
Total			

Promotion – Creating the Buzz

Successful Angel groups build brand equity within the local financial community. At the same time, Angel groups are no different from other organizations in needing to market that brand to the current and potential stakeholder base, potential new members, a wide sponsorship base, and founders of start-ups for continual high-quality deal flow. The Angel group's goal is to be perceived as the go-to organization in their region for early-stage investing on terms that reward both investors and entrepreneurs.

But in order to grab and keep the attention of potential stakeholders, Angel groups have to punch above their financial weight in their respective localities. That means promotion through media exposure, limited advertising, and e-marketing initiatives.

This process begins by interviewing at least three local public relations firms to assist in raising profile and effectively positioning the Angel group in the community. Examine the PR firms' track record and get references from past and current clients (very important). Go back to the budget to decide on a dollar figure for a monthly retainer. Engage the firm that has the strongest relationships with local media, both print and electronic.

The objective for the Angel group is to become seen as the leading source on Angel investing and on the commercialization of innovation in your region.

In order to facilitate this process, meet with the chosen public relations firm and work with them to execute the following tasks:

- Develop article ideas, press release themes, and event coverage for the next 12 months.
- Outline potential speaking opportunities for identified Angel members during the coming year that the media could cover. These venues include everything from Board of Trade presentations, Rotary Club talks, and university lectures to keynotes at industry conferences and regional or national Angel summits and forums.
- Since dealing with journalists is not an intuitive process, arrange to have designated Angels trained on handling media interviews.
- Decide what networking and educational events the Angel group will hold in the near and longer term.
- Target business, educational, and financial journalists and build a data base that the Angel group owns.
- Create a 12-month plan that encompasses all the potential activities and set realistic milestones for the Angel group and the public relations organization.
- Execute and monitor the progress. Note that the public relations firm should be paid for results. They are responsible for writing and distributing media releases with Angel group guidance,

gaining interviews, suggesting themes, and obtaining coverage. If nothing happens, the Angel group should have built into its contract the ability to revisit the arrangement.

At the same time, the Angel group should formally launch its website, based on the template that the NAO is providing through the Angel Network Program. This is a free CMS-driven Web solution that will allow qualified Angel groups to broadcast their upcoming events and presentations, profile their members, highlight their deals, and position their role in helping to create and funds emerging companies.

All media releases and presentations can be posted on the website, as well as newsletters and evolving investment success stories.

A Final Word About Culture

The most robust Angel groups have created a climate of inclusion, in which new members are informally mentored by experienced Angels and formally brought in to the investment process. There are few things more destructive to sustainability than when cliques are formed within an Angel group to the exclusion of others. Social interaction and compatibility are critical to the seamless functioning of the group, since membership is voluntary. No high-net-worth investor has to belong to an Angel group. They do so because they stand an excellent chance of getting a superior ROI. But the promise of above-average returns is not in itself sufficient glue to keep Angels interested, active, and socially involved within the organization.

For Angel groups to sustain, they must start with and retain a broad sense of ownership in the life and forward momentum of the "club", since investors join to have fun, network with their peers, improve their exposure to quality deal flow, and improve the terms under which they invest -- through collective negotiation and disciplined due diligence.

Angels want to improve their knowledge base, contribute to the successful outcome of their investments through mentoring and advising, and involve themselves in networking, educational, and angel-related social events.

But Angels don't want to do all the heavy lifting by themselves. Members look to full- or part-time managers to carry much of the logistical and administrative burden. This is why facilitated Angel groups tend to endure while member-led organizations staffed by volunteer Angels drift, fade, and fold.

Executive Summary

Screening is the first step in assessing companies for potential investment. Proper pre-screening provides quality deal-flow – which in turn has a strong positive impact on Angel returns on investment. Angel groups can hire a third party to do initial screening, leave screening in the hands of their administrators or selection committees, or undertake the screening process themselves. There are several standard tools that can assist with preliminary screening, including the mechanisms used for deal generation, the group website, carefully crafted application forms, and qualified referral sources. Best practices suggest taking an orderly approach to screening by establishing agreed criteria for a quick preliminary "yes/no" decision. This article outlines the seven basic questions for Angel groups to ask as they are screening investment opportunities.

3.0 Qualifying for Quality

The long-term success of an Angel group is based on the quality of its investment portfolio, which ultimately has a bearing on the financial return to its members. The key to building a quality portfolio is deal qualification. Screening is the first step.

Deal screening provides a mechanism to review applicant companies under consideration for presentation opportunities at Angel group events. The process ensures members are provided only qualified, quality deal flow and serves as one of the primary advantages offered by group membership.

As a best practice, initial deal screening is performed by the Angel group manager, and may be followed by a second screening session to include a small volunteer panel from the Angel membership. Individuals volunteering to review company applications should be experienced in the evaluation of early-stage companies and familiar with the membership. This approach is respectful of the Angel members, whose limited time could be better spent in the more complex follow-on due diligence and negotiation of terms with companies deemed to be worthy of investment consideration. Staff screening also prevents promising young companies from making negative first impressions among prospective investors if their initial submissions are not up to par.

Some North American Angel groups have employed MBA Interns for deal screening alongside members, but experience has shown that students are not sufficiently adept to perform the screening task on their own. Should your group wish to utilize students in the screening process, it is recommended that a well-developed evaluation matrix be developed, that they evaluate submissions in pairs or as a group, and that their observations are taken as recommendations as opposed to a final judgment on deal selection.

3.1 Mechanisms for Screening

A well-designed group website outlining investment criteria is useful for generating and qualifying investment leads, and an application form for prospective investees facilitates "apples-to-apples" comparisons, streamlining the screening process. The requirement of an accompanying executive summary limits the volume of material for review while providing the required insight into the company's ability to convey its message outside of the structure of the application form. Maintaining a standardized format for processing company applications also eases the referral process for local providers of deal flow, including venture capitalists, service providers, university technology transfer offices, and other points of contact for early-stage entrepreneurs.

Some Angel organizations require that at least one member agree to champion the investment opportunity prior to having the company present to the full Angel group. Typically, this member will be an opinion leader who brings technical or market expertise, or already has a professional or personal relationship with the entrepreneurs and can vouch for their integrity and skill. The champion serves not only to drive the formal processes but also to influence other Angel members about the relative risks and opportunities involved in the target venture. This approach has proven limiting among manager-led Angel groups due to the resultant decreases in deal-flow shown to the membership and large demand placed on the deal "champion."

The initial deal screening methodology generally involves the two-minute sort, the twenty-minute sort, and the two-hour screen. The process involves the same seven questions at each stage of the sort, with the best candidates progressing to the next stage. At the final stage of screening, phone calls to the lead entrepreneur and referring agent are recommended, as they will permit any corollary questions, add to the richness of information available, and further help the group to establish the credibility of the prospect.

3.2 Seven Key Questions to Screen Investment Opportunities for Angel Groups

Question 1: Is this a good deal for our Angel group?

Industry Sector: Angel investment groups generally focus on high-growth industry within the range of expertise offered within their Angel membership. With the exception of sector-specific groups, industry preferences are generally defined by industry exclusions. Sectors typically excluded from consideration include: partnerships, proprietorships, franchisees, investment funds, retail stores, publishing, professional or consulting services, real estate, entertainment (television/film/theatre production, restaurants, athletic & recreational facilities, etc.), natural resources (agriculture & agribusiness, mining & mineral exploration, energy generation & oil/gas production, etc.). As a best practice, the industry focus should be delineated at the formation stage of the Angel group to reflect the experience and comfort of the core Angel membership.

Stage of Product Development: Stage of development is a critical consideration. It is a fairly widely held myth that business Angels and Angel groups invest in ideas or concept-stage opportunities. Over the past decade there have been a few investments in very early stage deals but these have invariably been in management teams with a track record of growing companies that have provided exceptionally profitable exits for their investors.

Earlier-stage firms with clear protectable intellectual property are of interest but ideally companies should be in beta trials, have purchase orders, or an existing customer base. For many industries, including software and Web 2.0 models, completion of the product development is relatively inexpensive so "proof-of-concept" is reflected in actual revenue and client numbers.

It is also useful to note timelines regarding the products development – if it takes seven years to get through alpha, this does not reflect well on the team's ability to commercialize the product and execute the business plan.

Geographic Location of the Company (or Company's Head Office): As a general practice, Angels invest in companies within a one or two-hour driving radius of their homes. This enables ready access to the company founders during the due diligence effort and after the investment is made.

Angel groups often also consider more distant companies that have already raised Angel capital from a "known" Angel group in their own local community. A good deal is a good deal and shouldn't be discarded simply because of some arbitrary geographic boundary. Still, there are some clear red flags. Companies headquartered in Angel-capital-rich areas, such as California, Massachusetts, or British Columbia, should be able to raise plenty of capital locally unless something is "off" with their opportunity.

Referral Sources: Ideally, as an Angel group's investment portfolio develops, the professional service providers serving early-stage, high-growth potential companies will become the primary source for an ongoing supply of quality deal flow. As a best practice for deal screening, it is expedient to place a quick phone call to connect with the referring agent and verify their support for the company. Over time, with a strong network of referring agents, companies referred by those who consistently recommend quality deals can quickly be sorted to the top of the pile for the final screen.

Existing Investors: Any company that has already raised significant capital from friends, family, and other Angels deserves a closer look and should get promoted to the top of the pile for the final screen. In Ontario, it is expected that technology-based companies will have already raised $50k+ from friends and family and received funding through a third party such as IRAP.

Willingness to work with the Angel group process: As a best practice, it is important to send an immediate email communication upon the receipt of any incomplete submission, simply stating that in order to receive consideration a complete submission is required, along with an invitation to the applicant to reapply. Practically speaking, if the requirement of an application form and/or other specified materials is perceived as too onerous, the management team will likely not be a top target.

Question 2: Is this the right team to execute this business?

Ultimately, the investment decision hinges on the Angel's degree of confidence in the management team. A superior product and large market with the potential for a profitable exit are all required components of any Angel investment, but it is the management team that can make or break any deal. At the initial screening stage, when dealing primarily with documents, it is difficult to gauge the personal attributes of the lead entrepreneur. But the documents should reflect the track record of key team members.

There should be a balance of operational expertise (including financial), domain knowledge, and business acumen (including capital markets), though the team does not necessarily need to have all these capabilities from the outset. Angel investors can often be relied upon to help round out the team's management capabilities through their own efforts, or can help to source the right people through their business networks. Ideally, Angel groups look for experienced and passionate teams with relevant industry expertise, a clean reputation, technical capability, enthusiasm, and a willingness to seek out mentorship.

With respect to teams, it is worth noting that there are two primary categories of companies that are not appropriate for Angel groups:

1) **The "one-man-show"**: Any company that could be completely wiped out in the event the lone business or technology expert becomes ill or injured is simply too high-risk.

2) **The Family-based business**: Long experience in dealing with family-based businesses has led venture capitalists and Angels alike to avoid these opportunities under many circumstances.

Regarding complete submissions, note the entrepreneur's attention to detail. Are they able to clearly and concisely articulate what it is they are doing and how they intend to make money?

Question 3: Does this business have superior proprietary products?

Typically, Angel groups focus on technology opportunities, but Angels with strong marketing backgrounds (usually well-represented in Angel groups) will often consider the "right" services opportunity. The key question when it comes to screening is the ability of the company to scale.

Competitive Analysis: It is absolutely essential for any company to recognize not only that they have competition but to be able to clearly differentiate themselves from competitors. Angels are looking for incremental change in the order of 10X (better/faster/smaller/cheaper). They will also assess the nature of the competition (is there an 800-pound gorilla?), and the degree to which competition can be expected within the first two years. Note that products that represent a paradigm shift in the market, especially those opportunities that require an entirely new market be created, are better left to the deeper pockets of the formal venture capital industry.

Sustainable Competitive Advantage: Angels are looking for companies whose product or service has a strong intellectual property position or other significant barriers to entry that a competitor would have difficulty overcoming.

Freedom to Operate: Although this issue is usually dealt with in detail at the due diligence stage, care should be taken to note if the technology developers have recent employment histories with companies active in the same technology sector.

Product Line: Companies should have the technical ability to develop follow-on products. Applicants who have licensed or acquired technology and consequently do not control their technology pose a higher risk to investors.

Question 4: Do the products address a clear need in a large market?

Value Proposition: The submitted documentation should articulate a clear economic value proposition. It is useful to note whether the product is a painkiller (need to have) or a vitamin (nice to have).

Market Size: Is the market large enough to support the revenue projections? Angel groups do not necessarily require the venture capital industry's minimum $1 billion annual market. It is often prudent to consider companies that, while unlikely to capture follow-on venture capital financing, can reasonably capture a majority position in a $100 million market, if there exist reasonable exit opportunities.

Market Segment: Has the company identified one or more niche market(s) in which there is a reasonable chance of market acceptance for the product? As well, has the company correctly identified who will be making the purchasing decision on the product/service (as opposed to the end users)? Is this group targetable with a minimal marketing effort?

Sales: Does the company have paying customers or beta users as a reference?

Question 5: Is the requested investment sufficient for the company to achieve key milestones?

The capital being sought by the company should be sufficient to achieve a set of milestones that would either make them attractive for follow-on venture investment or bring them to cash flow break-even.

Sometimes, particularly in capital-intensive industry sectors such as life science or alternative power, relatively small capital injections are needed to achieve a specific milestone (usually a regulatory approval step). Once achieved, these companies are within reach of formal venture investing, after which a larger amount is required to bring the product to market. Angel groups that do not specialize in these sectors tend to prefer opportunities that show a reasonable ability to achieve revenue generation based on a single Angel round.

Question 6: Has this company made a compelling case for the overall attractiveness of the business opportunity?

Has the company clearly identified and analyzed its strengths and weaknesses relative to its likely competitors? Are the products or services to be offered being developed with the human and financial resources the company already has or can reasonably obtain?

Question 7: Is this an attractive investment opportunity?

Valuation Expectations: The company valuation must not be wildly unreasonable. It is unusual for any pre-revenue company to be able to justify a pre-money valuation over $3 million across most sectors, though exceptions do occur where there is substantial intellectual property protection in place. An expectation of twice or even three times higher than that baseline may prove justifiable on further due diligence, and if not, the difference falls within the reasonable range for negotiation. That said, any company with a pre-money valuation expectation over $10 million should be rejected outright. Even in the event that this valuation is justifiable, the equity available to an Angel syndicate is not sufficient to warrant the due diligence effort.

Potential for Lucrative Exit: When investing in a group, Angels typically seek returns of at least ten times their initial investment within three to seven years, so a clearly articulated exit strategy that would reasonably provide investors with those expected returns is essential.

The Deal: It is relatively unusual for investment opportunities to specify a set valuation and deal structure but this does occur on occasion, especially in the event of a deal syndicated across Angel groups. Concerns can, and frequently do, arise when the company has secured monies at unreasonably high valuations along with untenable deal structure terms from lone Angels.

3.3 Companies That Don't Make the Cut

Best practices dictate that the Angel group manager provide feedback to all applicants and follow-up with referring agents so that they not only understand why a company was not successful but are encouraged to continue to refer quality deal flow to the group.

In the case of potentially promising opportunities with substandard submissions, or companies that are simply too early-stage but show some potential for future interest, care should be taken to refer the company to appropriate local resources for assistance in moving the project forward. Clear milestones to be achieved prior to further consideration should be clearly laid out along with any invitation to reapply.

Executive Summary

Due diligence is a form of risk management. Best practices in due diligence, though sometimes variable, implement an ongoing process that enables Angels to assess the management team, industry setting, and growth potential of prospective investees. While the business plan is obviously a key element, there are other documents and criteria and require examination. This chapter provides a detailed due-diligence checklist and suggests how to weigh various criteria.

4.0 Due Diligence: An Evolving Discipline

Effective due diligence for Angel investors is more art than science. But from occasional bitter experiences over the years, most Angels can attest to a number of mistakes from which Angels can learn and best practices that can be catalogued for mutual benefit.

Indeed, the discipline of due diligence has evolved for Angel groups. There is no question that the sector has built on the experience of the past. Go back seven or eight years to the tech boom, when Angels arguably performed very little due diligence on the companies in which they were investing.

The results, of course, were predictable, and the tech wreck that Angels and VCs experienced was practically inevitable. Angels and their counterparts on the dark side – the venture capitalists – were doing deals on the backs of envelopes, entering into bidding wars over clever ideas that had little real chance of market success. Like lemmings, both groups of investors pushed each other over a cash chasm. It was elective blindness – eyes-wide-shut investing.

Indeed, they forgot the cardinal rule of investing: “The net sum value of a killer idea is zero unless it can be translated into a profitable business, within a respectable time frame.”

However, today we may find the pendulum has swung too far in the other direction. Dotting the informal investing landscape are Angels or groups of sophisticated investors who have adopted a quasi “masters of the universe” mentality, where they overwhelm start-ups with exhaustive due diligence in return for a five-figure check that may pay the lighting bill but won’t propel the company to successful commercialization.

Indeed, some of these Angels are undertaking vast amounts of due diligence backed by very little real cash. They see themselves as financial moguls rather than mentors with money and have lost their excitement and pleasure in the task. According to Andrew Waitman, Managing Partner of Celtic House in Ottawa, “Somebody writing a $50,000 cheque or a $25,000 cheque to a start-up really doesn’t help it…. You can’t go into a gunfight with a knife.”

But these are the extremes. Due diligence for successful informal investors involves a reasonable investigation conducted by an angel group, its advisors, legal counsel, or third-party experts to ensure that there is no significant false or misleading information in the business plan and that no material information has been omitted. In short, the purpose of the due diligence process is to ensure, as far as possible, that the company and its founders can do what they say they can do, that they own the product, science, technology, or service, and that they are solid individuals with whom to conduct business.

4.1 Best Practices Defined

In aggregate, the approach to due diligence conducted by Angels and Angel groups varies widely. On one end of the spectrum, lone ranger Angels tend to have less stringent screening criteria, rely on deal-flow from known referrals, invest on "gut feel", and fund start-ups that are close to home. Investments from these individuals tend to be passive. Investees get some oversight, perhaps. Day-to-day involvement – almost never.

By their very definition, active Angels, who are formally affiliated with a group, tend to take a proactive role in the company and typically have a well-structured due diligence process. This is based on models that have been derived through a lot of trials and errors, and synthesized into a core structure that works. While every Angel group has variations on the nature of the due diligence process, doing nothing or very little in this area is not an option if an Angel wishes to avoid costly mistakes. Dumbness is simply not a secret sauce.

> Q. What do you call Angels who don't undertake due diligence?
>
> A. Poor.

But it's important to recognize that Angels are not mini-VCs. Because Angels tend to mentor companies rather than just manage the money, they tend to be slightly more subjective in their evaluation and perhaps a shade less rigorous than venture capitalists. They also stay closer and are more hands-on. However, they will look to one or two lead Angels within a group to undertaken the heavy due diligence lifting on any given deal and will invest if the lead Angels invest.

4.2 Where Due Diligence Fits In the Investment Cycle

The due diligence process is not an isolated event within the life of an Angel group. First, of course, an application for funding is submitted by an entrepreneurial company. Then the Angels' selection committee pre-screens and evaluates the submission by reviewing the business plan and interviewing management. If the application is a go, suggestions are made for content changes to help the Angel group in its decision-making process. The entrepreneurs are also informed that the process will take, on average, three months to complete before an investment might be made. Next, the Angel group manager or designated Angel member or members will critique the presentation, and revisions and coaching are provided. Once the start-up has presented to the entire Angel group and sufficient interest is determined, the due diligence process begins.

4.3 Typical Criteria for Angel Due Diligence

Several years ago, the MIT Entrepreneurship Centre conducted a small survey of Angels on the criteria they use in determining what deals they should select for due diligence. While not exhaustive, the findings following widely accepted practices in initial deal-flow reviews.

The Due Diligence Process

While, as stated earlier, this is not an exact science, most successful Angel groups routinely follow the following process:

- From the committee of the whole, a due diligence (or lead Angel) team is selected. This team typically consists of between one-to-four members of the Angel group and often has at least one participant who is familiar with the technology or the industry sector.

- The company's business plan becomes the bedtime reading of the due diligence team.

- The DD team then meets with the founder(s) and senior management and interviews them to determine the kind of expertise and experience they bring to the company. Typically more than one meeting is required. The DD team is going to be a way of life for the Angels until they exit. If the entrepreneurs don't mesh with the Angels at this point, the relationship is unlikely to improve once the investment is made and milestones are inevitably missed. If the "gut check" tells the Angels to walk, they would be wise to follow their instincts.

- If the initial meeting with management took place away from the company's premises, then the DD team should visit the facilities at this point and meet the rest of the staff for brief interviews at the very least. A quick look at the order and atmosphere of the offices or plant says a great deal about how effectively the operations are run.

- Too often, technology reviews are omitted because of cost. However, unless there is a reasonable degree of certainty that the technology as proposed will work, the entire Angel investment is a gamble. A little money spent at this stage considerably lessens risk. Fortunately, the Ontario Centre of Excellence (OCE) provides funding to Angel groups to help with technology audits. Contacts for this assistance are located on the OCE website.

- Reference checks from former employers, customers, suppliers, credit bureaus, and educational institutions are required at this point.

- If everything is still positive, then a few calls to potential customers and industry experts can provide a useful read on the market appetite for the products, technology, science, or service, the trends in the industry, and the positioning and branding the company should adopt in sales and marketing.

- Finally, the due diligence team presents its findings to the group and the go / no-go decision is made by the interested Angels. Obviously, not all Angels in a group have an appetite for all deals. Some previously interested members often bow out at this stage, but not uncommonly others will join.

From a mile-high view, the lead due diligence Angels will focus on three specific areas:

1) The management team;

2) The industry segment; and

3) The growth potential for the company.

To a lesser extent, the due diligence team will also take into account the location of the company. Many deals are still done within a two-hour drive radius of the investor, although that is beginning to change and Angel groups will invest in good deals outside their province. This is especially true of syndication deals with other Angel groups or seed VCs. But more on that in another chapter.

4.4 Three Areas of Focus in Due Diligence

The Management Team

At least 60 percent of an Angel's decision to invest is based on the strength of management. Smart Angels know that the right management team can take a second-rate technology and build it into a market-leading company. The converse is equally true. A killer technology – no matter how potentially disruptive -- created by a couple of geeks with little business experience will die a death that is quick and costly (to the Angel).

While it's perhaps easy and somewhat obvious to posit that good management is the key to successful company creation, there are some universal elements that are less intuitive.

Several years ago, the accounting firm Ernst & Young undertook a survey of the principal characteristics that good companies share. From their extensive research, they determined that the management team must display excellence in three areas:

Domain Knowledge – the management team understand thoroughly their industry vertical. They know the players, their competitive positioning in the market, the verticals they can sell into, the current demands and trends, and where they fit into the maturity cycle with their product offering. There are few things more expensive to an Angel than to back a company that has, for example, a great browser technology, only to discover that the industry is dominated by an 800-pound gorilla that has an 80 percent market share.

Business Acumen – within the management team there is at least one senior person who has previously run or built a company with a modicum of success. Either on the management team directly or among the members of the board of advisors, there is resident experience on how an entrepreneurial business operates – the structures, disciplines, demands, and priorities. Start-ups rely on real-life experience, leavened with the appropriate educational background.

Operational Expertise – The management team has the practical and tactical skills to develop the product, science, service, or technology, patent-protect it (where possible), build and execute the sales and marketing plan, and get the product to the customer on time and on budget.

(As a side note: it is perhaps in the area of operational expertise that Canadian companies are the weakest. We are great engineers; we are awash with innovative ideas that fulfill specific market niches; we are easy people to do business with. But we too often fail in our ability to develop a customer base that will allow the company to compete on the world stage. That does not mean that Angels do not make money from Canadian start-ups. However, it does speak directly to the point that in term sheet negotiations, Angels must have a clearly defined exit strategy, executable within three-to-five years.)

Other important considerations with regards to the management team:

Ethics and Honesty: It may seem to be a given, but it bears not only saying but checking. Ethics and honesty are crucial. Is the management team comprised of high-integrity individuals or are they a bit loose in their business dealings? Most entrepreneurs are not outright crooks, although some certainly do exist. Reference checks can quickly determine their reputation. It's a very small world.

Recently, at a selection committee meeting for a Canadian venture fair, a company was presented for consideration that looked at first glance like a solid business proposition. Technology was sound, the management team looked like it had the credentials – it all sounded very promising. But just before the final vote, a selection committee member, who had past business dealings with the president, noted that this individual had burned a number of suppliers in his previous enterprise. The group instantly turned thumbs down, the company was not allowed to present, and word spread throughout both Angel and VC communities. That company never did raise the money it needed.

Passion: Does the management team have a passion to do whatever it takes to drive their venture through to significant revenues and profitability? Since every enterprise has setbacks, the founder and his team have got to have the ability to work 24/7 against what will seem at times impossible odds. A great idea is one thing; the ability to translate it into a sustainable enterprise is another. It requires an unparalleled will and ability to overcome the adversities and make it work. In truth, few people posses this talent. Many can talk the talk; few are prepared walk it through to completion. An entrepreneur that has enduring passion (coupled with a great idea and solid business model) deserves an Angel investment.

Track Record: It is imperative to determine what relevant experience and successes the entrepreneurial team brings to the new business venture. Past accomplishments determine the potential for forward trajectory. The term "relevant" is key. If, for example, the founder has only worked for Fortune 1000 companies with all the support mechanisms those organizations provide, he or she is unlikely bring the skills necessary to launch a hands-on enterprise. There are always exceptions, but these are rare. Many enterprises fail when the founder discovers that she or he has to be secretary, shipper, accounts payable, and washroom attendant during the critical first few months of the enterprise. Little support, long hours, tight deliverables, and a healthy injection of personal money, soon turn off many would-be SME presidents.

The Industry Segment (An Angel's Comfort Zone)

The field of entrepreneurial investing is littered with the remnants of financial investments that died in agony because the investees resided outside the Angel's field of expertise or interest. They all looked like reasonable propositions and were all "guaranteed" to realized huge returns on investment. Greed overcame common sense. Passion prevailed over reason.

The trap for Angels is that it is possible to fall in love with a technology for which they have little understanding, a product for which there is no real market demand, or a service for which there are thousands of competing offerings. To make matters worse, these deals are often referred by business colleagues, friends, or relatives who are putting their own cash into the venture.

It's imperative at the beginning of the due diligence process that passion be stripped out of the equation. The Angel is making an investment decision based solely on the business merits of the business proposition.

To aid in that decision, the Angel needs to rely on past experience or knowledge of the market sector that the business addresses. If, for example, the Angel knows little about nanotechnology or has no desire to investigate, then perhaps this is an area that should be avoided. Angels contribute more than cash to the success of businesses in which they invest. Mentoring too is often as important, if not more important, than the dollars provided. To invest most successfully, the Angel needs to advise from a position of experience.

The exception to this rule is investing by Angel groups. Here the individual investor can call on the knowledge of other Angels who have had experience and/or successes in the same market that the investee company is addressing. A recent example from the Toronto Angel Group illustrates the point.

The business plan dealt with programmable memory for semiconductors. One of the members had extensive background in the industry and had launched several very successful companies in this field. He invested his own money in Newco and then agreed to act as president for at least two years.

Given his credentials and past investment success, a number of Angels wrote sizeable checks, even though they knew nothing about the semiconductor industry. They bet on the record of the serial Angel entrepreneur, and as at the writing of this article, they have not been disappointed.

Angel money is easily invested. You just write the cheque. But getting that money out of the enterprise, even one that is doing well, can be a difficult task, unless a realistic strategy and rules of engagement are contractually set out before the money is invested.

It is also important when considering an investment in any industry sector that the Angel has a clear understanding with management on the most appropriate exit strategy for the enterprise:

- Going public;
- Buying out or merging with a competitor or acquirer from the same industry; or
- Implementing a management buy-out, where the company is refinanced out of cash flow.

Angel investments ideally have a three-to-five year time horizon. But without an exit strategy the money can get stuck.

The Growth Potential for the Company

All successful start-ups must address a big pain (or demand) in the market. They have developed something for which they can substantiate their claim of solid market appetite that is currently not being met. Few start-ups have truly disruptive technology, but most have a solid niche that will let them build a real business.

They are offering something that is unique, which will fill the demand better than the existing competition or status quo. That's why it is vital that whenever possible and practical, they have a proprietary product or platform technology that is at least patent pending. If it can't be patented then there are likely to be few barriers to entry. If the innovation has merit in the marketplace, the competition will quickly grab the idea, lock up the technology, and put the enterprise out of business before it truly gets started.

In addition, the Angel investor must be satisfied that the entrepreneur knows how to address the status quo inertia. Since the world has been going along quite nicely without this proposed innovation, what are the compelling reasons why the market would make a move and buy the company's offerings? It's a tough question to answer, but answered it must be. Otherwise, there is the real danger that the Angel is being presented with technology push and not market pull.

With all the numbers that are presented, any Angel must understand how to make between 500 and 1000 percent ROI -- within a reasonable period of time. 100 percent over 10 years is not worth the effort. For that reason, the company's revenue or profit projections must be examined with great care and questioned exhaustively.

The Angel must be satisfied that the company will be worth what the numbers predict in three-to-seven years. If it's a nice little business that will plod along and make some money, that's good for the founder. But it is not an Angel deal. Successful Angels invest in companies that have the potential for a high growth rate within a set timeframe. An essential part of the due diligence process is to determine what that timing will be.

The milestones the enterprise has achieved with founder and love money are a good indication of the care with which management will treat an infusion of Angel cash. Therefore, financials need to be presented to the Angel investor in a complete, current, and comprehensive fashion. Financials are not historical documents. They are living entities that demand to be kept up-to-date with present reality. A founder who is presenting a business proposition with spread sheets that are a year old doesn't begin to understand the rules of the game and certainly doesn't deserve a fresh infusion of cash.

Once the Angel is satisfied re the currency of the present numbers, the five-year pro forma numbers can be examined. Critical to the due diligence process are the post-money projections over the next 12-to-18 months. It is during this time period that the Angel can expect the enterprise will begin to post profitable revenues. If not, some hard questioning needs to take place. Too often Angels see pro formas that state revenues will be $1 million in the first year, $2 million in the second, and then will jump to $20 million in the third, $40 million in the fourth, and $60 million in the fifth – or variations on that theme. What is going to bring about that huge increase from year two to year three? What cataclysmic event will make this happen? Even if it were real, how could any start-up manage this kind of growth in a single year? In reality, these are not pro forma financials, they are wish lists.

4.5 The Business Plan: Truth or Consequences

All the entrepreneur's hopes and dreams should be summed up in a comprehensive business plan. These are always, on some level, fiction, as they deal with planned outcomes rather than current reality, but they nonetheless should contain some constant elements.

After reading the first page, the Angel should be able to say what the company does and why it thinks it can succeed. Business plans that flow for pages about industry trends and technology innovations can cover both fuzzy thinking and actual obfuscation. The business plan should:

- Quickly and concisely describe the market pain the company will solve;
- Outline what the company thinks it can do and why (its vision);
- Draw a picture of market realities and the size of the opportunity;
- Summarize the business strategy;
- Describe the product/technology/service – briefly;
- Provide bios of the management and advisors;
- Go into more detail about the go-to-market strategy, sales approach, competitive analysis, industry and business risks;
- Provide detailed financials with break-downs of the numbers and a description of the assumptions being made; and
- Give a solid exit strategy.

4.6 A Detailed Due Diligence Checklist

Gleaned from a variety of sources, the documents and materials itemized below form the basis of a comprehensive due diligence checklist. While no Angel group should feel confined to just these items, they are intended to cover the some of the most important elements of an Angel investor checklist.

General Background

- A simple declarative statement outlining the pain or problem in the market and the company's solution that addresses the need;
- The company's unique advantage;
- A brief history of the company;
- An outline of the company's financial needs;
- What are the issues that keep the management team awake at night?

People

- Organizational chart;
- Complete resume of each member of the management team that concentrates on accomplishments rather than just titles;
- Significant gaps in the senior management team;
- Bios of the advisory board with responsibilities in Newco outlined. Note: most start-ups don't have formal board of directors, but there are exceptions;
- Professional advisors – lawyers, accountants, bankers, etc.;
- References: current and prior customers of the management team, former employers, suppliers, former business partners, bank references;
- Reps, warrants, and disclosures (legal issues (pending law suits or threats of same), conflict of interest, etc. -- anything that might hinder or impair the functioning of the company, management, or employees;
- Compensation for all officers, key personnel, and founders, including options which include an overview of the vesting periods;
- Employment contracts, partnership agreements, non-competes and assignments such as founders assigning IP rights to the company.

Market

- Market Opportunity - size of the mega market, addressable market niche, and expected market penetration within the next three-to-five years;
- Competition;
- Market geography and industry trends;
- Barriers to entry;
- Market maturity and where the product fits into the business maturity cycle;
- Potential acquirers (particularly among the 800-pound gorillas);
- M&A activity within the market vertical – with industry multiples.

Product

- Product description – in detail, focusing on what it does, not how it does it;
- Stage of development – Alpha, Beta, etc.;
- Pricing structure and unit sales forecast per year;
- Unique features. What is the product advantage over the competition?

Sales and Marketing

- The sales and marketing strategy in some detail. (Note: many start-ups have focused on technology and bookmark the sales and marketing planning until they get Angel funding. S&M is often not well thought out.);
- The sales pipeline-- direct and channel sales model and distribution plans;
- Price and price history
- Product description
- Brand positioning;
- Sales force required;
- Target market;
- Promotion plans – hard launch, marketing, media relations, product literature, etc.

IP ownership

- Chain of title – legal documents that prove ownership;
- Copies of all patents and status of filings, especially patents pending; Trademarks and copyrights;
- Clearance to operate – releases from prior agreements, past employee contract, non-competes, etc.;
- Regulatory issues identified;
- Licensing agreements for IP and their financial impact;
- Other IP activity;
- Status of filings, including ensuring payments are current;
- Copies of material contracts (including license agreements, if any);
- Employment agreements.

Competition

- Details on the major competitors – especially the 800-pound gorillas;
- Advantages of the competitions -- their product branding and position in the market (what market share do they own);
- Competition's strengths and weakness and how Newco can counter the former and take advantage of the latter;
- How are the major competitors growing – organically, through consolidation, through aggressive marketing?
- Plan and strategies to deal with direct, indirect, and alternative competitors, including how Newco will deal with the status quo in encouraging customers to buy its products rather than maintaining traditional solutions;
- Assessment of how competitors will react to the entry of Newco;
- List of major customers who are buying from the competition and the major reasons they are purchasing the products.

Financials

- Historical financials - Five-year financial pro formas (in detail). These financials must include cash flow projections to the next round of financing, breakeven timing, and profitability forecast;

- Balance sheet and P&L;
- Historical financials;
- Current fiscal year versus plan;
- ARs & APs;
- DSOs if applicable;
- Debts outstanding;
- Cap Table – fully diluted, variations in terms, preference;
- Monies raised to date – 3Fs, founders, management, employees, directors, advisors, SH&RD, IRAP grants, loans, etc.;
- Proposed use of proceeds;
- Current and projected burn rate;
- Staffing requirements – compensation and options;
- Pre-money valuation.

Other Legal

- Any claims, threatened or pending claims or litigation;
- Notification of lawsuits.

All this may seem onerous, but one of the advantages of being in an Angel group is that there is nearly always someone who enjoys the process, and someone who is expert in the field in question. Due diligence is the closest Angel investors come to protecting their investments in the early stages.

Executive Summary

Early-stage and pre-revenue company valuation can be a vexed question. The management of a prospective investee will almost always have a higher initial notion of the company's worth than the investing Angel group is willing to pay. This chapter deals with valuation fundamentals and some of the technical terminology associated with evaluating Angel investments, which can be a bit daunting for the Angel without a finance background. Key to valuation are negotiating power and the many mechanisms for examining potential rate of return, as well as the external influences, from market trends to sector shifts, that can have a dramatic impact on the final price paid for shares of the company.

5.0 Valuing Angel Investments in Early-Stage Companies

Valuation is perhaps the most potentially controversial deal term in an Angel investment agreement. Many otherwise strong deals fall through over this issue, and the long-term relationship between investor and entrepreneur can be damaged by disagreement over valuation. It is critical to protect the future relationship by ensuring that both sides understand the following points:

- There is no single "correct" valuation. There is merely the negotiated market price paid for shares and this market price varies with time and outside forces.
- Future-round valuations by other investors will affect today's potential valuation range. Some sectors are hotter than others and this affects valuation too.
- Valuation is inherently linked to perceived risk. Any deal term that reduces perceived risk (such as a seat on the board, anti-dilution, milestone tranche financing, liquidity preference, discount to future rounds…) will increase valuation.
- The two sides will disagree over valuation. It is natural and expected that the entrepreneur always anticipate higher profits, lower investment requirements, shorter time to liquidity, and lower risk.
- There are valuation methods and rules-of-thumb that may be applied to obtain a range of valuations to help frame the final negotiated price.
- Angel groups and syndication can both reduce risk, increasing the chances of success and providing benchmark valuations and terms applicable to other, similar deals.

5.1 Valuation Fundamentals

Rate of Return Fundamentals

Angel investors commit cash today in order to gain a future financial return on investment. A company's valuation is fundamentally based on today's expectation for the magnitude, timing, and riskiness of future cash flows arising from the company being invested in.

Risk-taking lies at the heart of capitalism and is responsible for a large part of the growth of an economy. Investors are willing to be exposed to increased risks only if, on average, they can expect to earn higher returns than if they had less exposure to risk.1 Figure 1 shows a schematic of how the expected rate of return increases for different investment classes.

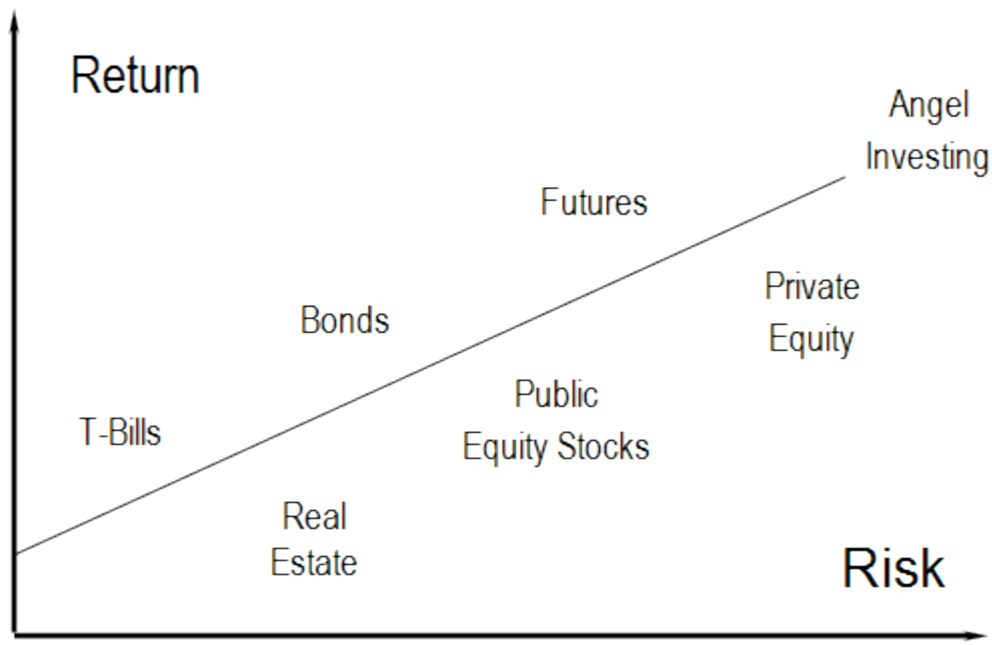


Figure 1: Rate of Return vs. Risk for Various Investment Classes

Many references and valuation methods refer to an investor's "required" rate of return. An Angel investor will invest his or her cash into a portfolio of investment categories such as real estate, stocks, bonds, money market, or treasury bills in addition to investing a small portion into Angel investments in early-stage companies. As the risk and market volatility increase, the anticipated return on investment is "required" to be higher (or the investor would instead put his or her money into a less risky investment).

Investing in bonds with a 7.2% rate of return for 10 years will double a person's money, which is referred to as obtaining a 2X multiple. An investment at 11.6% for 10 years will provide a 3X multiple. Most valuation methods refer to the required multiple, combining an estimate of not only the rate of return, but also the duration of the investment. As the riskiness or anticipated duration of investment increases, the "required" multiple increases.

Various sources suggest that early-stage investors require multiples of 5X to 20X. To put this in context, a 20X multiple would be a 35% compounded rate of return every year for 10 years, or an 82% rate of return every year for 5 years. Only very few companies will be able to achieve these stellar performances. This is one reason why many successful Angel investors manage their risk by investing in a portfolio of Angel deals rather than just one or two.

Pre-Money and Post-Money Valuation

Prior to meeting the Angel investor, the founders will have worked hard to create value in the company, among other things by generating business plans, producing prototypes, building revenues, and filing for patents, as well as by investing their own money. The value of their creation is termed the Pre-Money Valuation. Once the Angel invests money, the Angel will own a percent of the post-money shares and the company will now be worth the Pre-Money Valuation plus the amount of money invested.

The Post-Money Valuation equals the Pre-Money Valuation plus the amount of money invested. The percent of shares owned by the Angel is equal to the amount of money invested, divided by the Post-Money Valuation.

Post-Money Value = Pre-Money Value + Investment

% Investor owns = Investment / Post-Money Value

Pre-Money Valuation	$2 million	$3 million
Investment Amount	$1 million	$1 million
Post-Money Valuation	$3 million	$4 million
Investor Equity Ownership	33%	25%

Effect of Successive Rounds of Financing

Every additional round of financing will dilute all prior investors (unless certain types of anti-dilution provisions are in the shareholder agreement). This additional dilution, and the later-stage valuations on which they are based, will affect the eventual return on investment of the Angel investor. In essence, these later-stage valuations and valuation methods will cap the total returns available to the Angel.

An example of how successive rounds of financing may affect the valuation of a company and dilute the Angel's ownership share is shown in Figure 2. In this example, an Angel invests $1M in a company with a pre-money valuation of $2M for 33% ownership. The next round, a VC may invest $3M at a pre-money valuation of $7M for 30% of the company, thus diluting the Angel from 33% to 23%. Successive VCs invest at increasing valuations that dilute the eventual Angel share to 13%. If the company is acquired for $100M and there are no liquidity preferences in place, the Angel will receive $13M or a 13X multiple return on investment. If the liquidity event takes place in 7 years, this would equate to a 44%

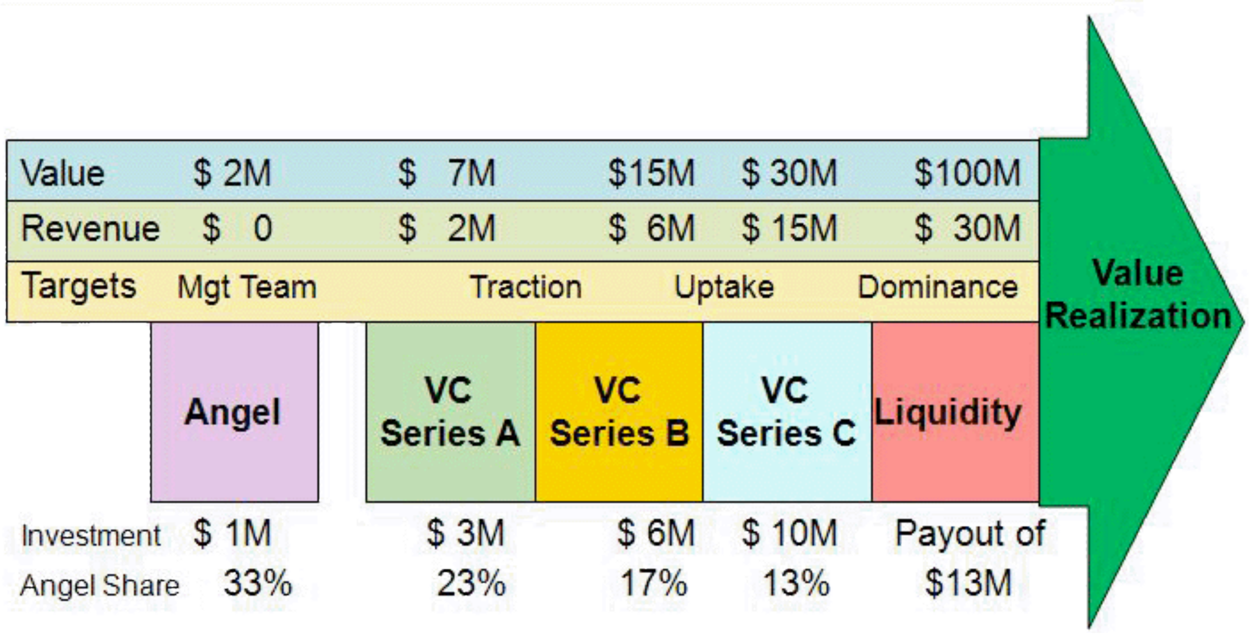


Figure 2: Effect of Successive Rounds of Financing

In theory, as the company grows and risk is reduced, the valuation will increase. However, it is important to realize that future-round investors will want to see certain milestone targets achieved, and the Angel investor must invest enough money to ensure that these future milestones are met. If these milestones are not achieved, there may be a "down round" (where valuation decreases) – or no round at all.

In essence, the Angel is providing bridge financing to help the company get from its current state to a state where it will be able to:

- Obtain the next round of financing;
- Achieve an exit transaction; or
- Become cash flow positive and potentially throw off dividends.

One major source of Angel investment risk is that there is often a “funding gap” between an Angel investment round and a VC round, as can be demonstrated in the following example.

If an Angel invests $500K in an “average” company with a pre-revenue valuation of $2M, the company will need to grow to the point where it can raise a VC round. An “average” VC may only be interested in companies that need at least $3M in financing with pre-money valuations of at least $7M (that is, for example, if they want to own at least 20%, but don’t want more than 40%). Using a traction-based target and revenue multiple valuation methodology of 2-3X, they may only be interested in companies that are generating at least $2M per year in revenue.

Is $500K enough money to grow the company from zero revenue to $2M per year in revenue? How long will it take to complete product development? How long will it take to close key reference accounts, deliver, and then grow sales? What happens if there are snags that slow things down? The company may need an extra year and an extra $500K or $1.5M, and there may not be any VCs interested in investing such small amounts at such small valuations.

Think of it as a required valuation growth hurdle. The Angel investor is investing $500K for a company now worth $2.5M. This investment must obtain almost a 3X valuation increase before being large enough to interest a VC (it must grow from a value of $2.5M to $7M). If the $500K will only last 2 years, then the company must “grow” by 73% each year. If the money lasts only 18 months, that’s over 100% rate of return being demanded – not much room for error!

When VCs make an investment disbursement, they normally reserve at least an equal amount of money from that same fund to ensure they are able to continue financing that company and/or participate in future rounds. This risk-reduction strategy makes sense for Angel investors too and this is one major reason for NAO’s syndication initiative to increase the number and size of Angel groups throughout Canada.

In fact, many of NAO’s Best Practices are designed specifically with the likelihood of successive financing in mind. The Angel must not only consider his or her deal terms with the entrepreneurs, but also with future VCs as well. Terms such as anti-dilution and liquidity preferences make Angel-round financing terms look more like VC financing, and may provide stronger negotiating power during future transactions.

Effect of Deal Terms on Valuation

If risk is reduced, then value increases. There are many investment deal terms that, at least in theory, reduce perceived risk. For example, if the Angel sits on the board, then the Angel will have more insight into the company and will be able to intervene if required. This should help to decrease risk. Having a second Angel on the board, a formal mentor, and/or an advisory board will also decrease risk. Although having the Angels take control of the board may appear to further reduce risk, it is generally felt that the change of control valuation premium required is not worth the extra cost.

Similarly, clauses such as anti-dilution, milestone tranche financing, liquidity preferences, and/or security over the assets of the company (such as structuring the deal as a loan or convertible debenture) will also reduce risk and affect the valuation. Thus it is impossible to divorce the idea of valuation from these other deal terms.

NAO has developed a number of Best Practice deal terms that are believed to minimize risk without the need to pay an excessive valuation premium. (Please also see the following chapter.)

Market Fundamentals

Valuation is based on the expectation of future cash flows. Since the future is inherently uncertain, all valuation methodologies and/or rules-of-thumb are imperfect. Because different individuals' perceptions and expectations of the future are different, it should be expected that everyone would have a different opinion of a company's valuation.

As a result of these realities, there is no single "correct" valuation. There is merely the price paid for shares, and this negotiated price will be some compromise between the perceived valuations calculated by buyer and seller. In the regulated "public markets", large numbers of participants provide information, price stability, and a sense of fairness. However, in "private markets", the limited number of buyers and sellers means that negotiating power often affects the price more than any macroeconomic, microeconomic, or valuation methodology.

Public Bond Market

If there were such a thing as a "correct" valuation method, it would be the Discounted Cash Flow (DCF) method. In this method, the Present Value of future cash flows is discounted back to the present time using a Discount Rate. Money today is worth more than the promise of money in the future. If there is very little risk associated with the future payments, then the discount rate is low. As risk increases, so too does the discount rate (or required rate of return on investment) as shown in Figure 1.

The simplest application of valuation fundamentals is the public bond market. In this market, it is easier to calculate the present value of a bond because the magnitude and timing of future cash flows are fixed and the market only needs to assess the riskiness of payment failure and adjust for external macroeconomic factors, such as interest rates and inflation (this sets the discount rate used in the present value calculation).

No individual sets the bond price. The market sets the price and any individual merely decides whether to buy or sell at the market price depending on his or her own expectations of future value. Microeconomic factors such as number of sellers (supply) and buyers (demand) directly affect the price, but no individual can wield their negotiating power to force a higher or lower price.

Public Equity Market

In the public equity markets, there is the additional complication that the magnitude and timing of future cash flows is uncertain. Even though these are established businesses with positive cash flow, stable

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capital structures, and consistent historical performance, the DCF model is extremely difficult even for the experts to apply. As a result of this additional uncertainty, a wide range of alternative valuation methodologies has been created. Many of these methods are based on multiples such as multiples of earnings, revenue, or book value.

> *"Investors must recognize the simple fact that multiples are not valuation, multiples are a shorthand for the valuation process… Shorthands are also, by definition, more crude than the reality they seek to represent… The simplicity of multiples is a sign of inaccuracy, not accuracy."*(2)

All of these valuation methods merely provide a range of potential valuations, often incorporating comparables and rules-of-thumb. For example, a relatively simple rule-of-thumb is the Price-to-Earnings Multiple, or P/E. If most companies in a certain sector have a P/E ratio of 20 and the company being valued has a smaller ratio, then a potential buyer may assume that the company is "undervalued" at that stock price and decide to buy more shares at that price. A big flaw in this method, of course, is that the company may have huge debt, no cash, and poor management, and these factors are not figured into the P/E ratio multiple method.

Despite significant valuation method shortcomings, the public markets are regulated and generally have large numbers of buyers and sellers, as well as sophisticated analysts, using a range of valuation methodologies issuing buy, sell, and hold ratings. It is well known that the "collective wisdom" of a group of individuals using diverse decision rules will consistently make better valuation decisions than the average individual.(2)

All of these factors decrease risk and thus increase the value of public companies. In general, private companies suffer a 20-50% valuation discount to public companies as a result of the increased risk and uncertainty associated with being private.

Private M&A Equity Market

The private equity market for mergers and acquisitions also uses sophisticated analysts with well-validated valuation methodologies and demonstrates that in some cases, certain private buyers will pay a strategic acquisition premium above the value normally paid in the public markets. A takeover announcement will almost always increase the share price of a public company being acquired. Not all buyers are equal; a strategic buyer is willing to pay a premium above the floor price set by the public buyers.

The liquidity event for the vast majority of early-stage private companies is acquisition rather than going public. This is, at least in part, because most companies get a superior valuation from a strategic buyer and the transaction cost of being acquired is significantly lower than the cost of going public.

Despite the range of valuation methods used by the acquiring buyer, the valuation method most often quoted is a multiple of revenues, with an expected range of 2-4X revenues.

Private Equity Market

The private equity market for early-stage companies lacks all of these risk-reduction and value-enhancing features, as demonstrated in Table 1. Future cash flows are even more uncertain and are usually dependent on the occurrence of a terminal liquidity event. There are fewer comparables, no historical data, and more risk of business failure. Finally, individual negotiating power heavily influences negotiations over price.

	Public Stock Market	**Private Angel Investment**
Data	Good data, publicly available, analyzed by experts, consensus estimates, GAAP, audited	Weak data, difficult to validate, requires extensive due diligence
Future Expectations	Historical data, track record, industry comparables	Uncertain pro-forma projections, often non-validated idea/product
Valuation Methodologies	Many well-formulated methods, scientifically based, certified professionals	Few rules-of-thumb
Comparables	Many available	Few available
Price	Set by group consensus and expert opinions	Subject to individual negotiation
Terms and Conditions	Set by regulatory authorities	Subject to individual negotiation
Liquidity	Liquid	Illiquid – often must wait 5-10 years to exit
Risk	Short-term volatility but good average portfolio risk	Highest risk

Table 1: Comparison of Public and Private Equity Investment

As a result, the valuation methodologies used for Angel-round, early-stage valuation are more subjective than the methodologies used for later-stage companies. Despite these limitations, a number of Angel-round early-stage valuation methodologies have been developed, some of which take into consideration the terminal valuation expected from the public equity market or private mergers and acquisition market. Thus, it is important to understand how these future financing valuations affect the potential Angel investment valuation.

5.2 Valuation Trends

Effect of Later-Stage Valuation Trends on Angel-Round Valuations

Like all markets, the price Angels pay for shares of early-stage companies goes up and down for both microeconomic reasons (for instance, the number of buyers and sellers) and macroeconomic reasons (for example, the strength of the economy and shifts in interest rates). Angels need to be aware of trends in early-stage valuations as well as later-stage and terminal valuations. If VCs are no longer investing in your investee company's industrial sector and the IPO market and acquisition market for firms in your sector are drying up, then this will affect your valuations too. Smart Angels network and keep their fingers on the pulse of valuation trends.

For example, leading up to 1999-2000, there was a robust IPO market for technology and Internet companies, as shown in Figure 3.5 This drove up later-stage valuations and pumped extra cash into VCs' funds. Many new investment funds started up, thus increasing the number of buyers and further driving up valuations. As competition for deals heated up, investors moved forward into earlier and earlier deals with higher valuations. When the IPO market quite suddenly dried up, VCs started to conserve cash for their current portfolios' future investment needs, and there was less cash available for early-stage deals. As the number of early-stage investors diminished, valuations also decreased.

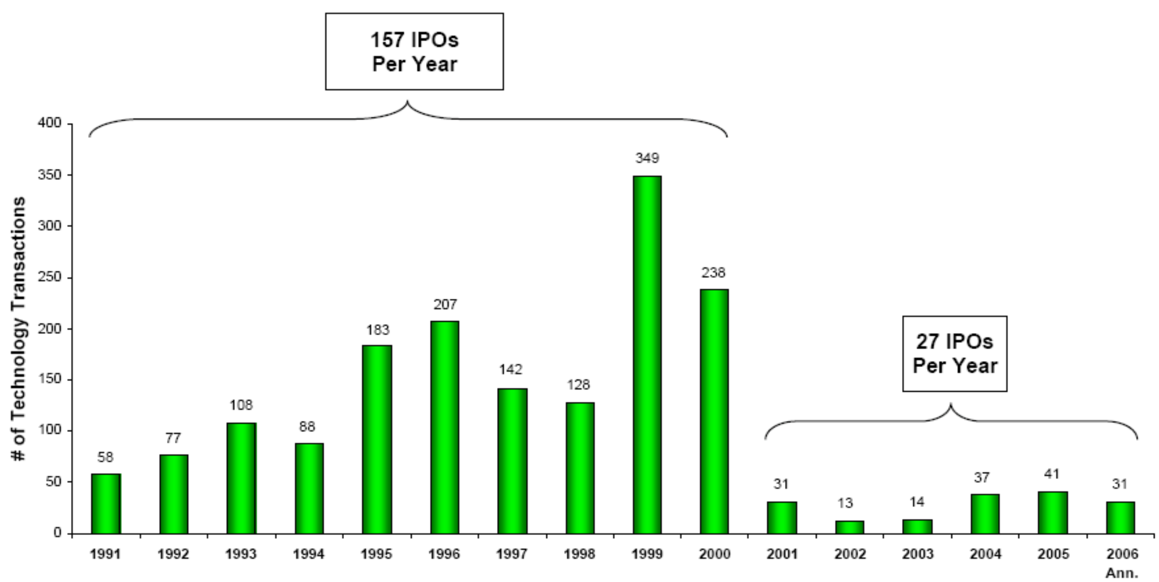


Figure 3: The IPO Market for Technology Firms (1991-2006) 5

After a "nuclear winter" where even excellent companies could not find financing or were acquired for a fraction of their break-up cash value, we appear to be in a relatively stable investment climate. Although the IPO market for technology companies has not completely recovered, there is now a hot M&A market and these valuations are currently driving terminal valuation estimates for investee companies that meet their appetites (see, for example, the DealMaker Newsletter from Grant Thornton). Figure 4 demonstrates that the vast majority of exit transactions (when Angels "cash out") are now due to acquisition.(6)(7)

Angel investors can clearly benefit from understanding what acquiring company appetites will be in several years since these transactions may drive their exit valuations.

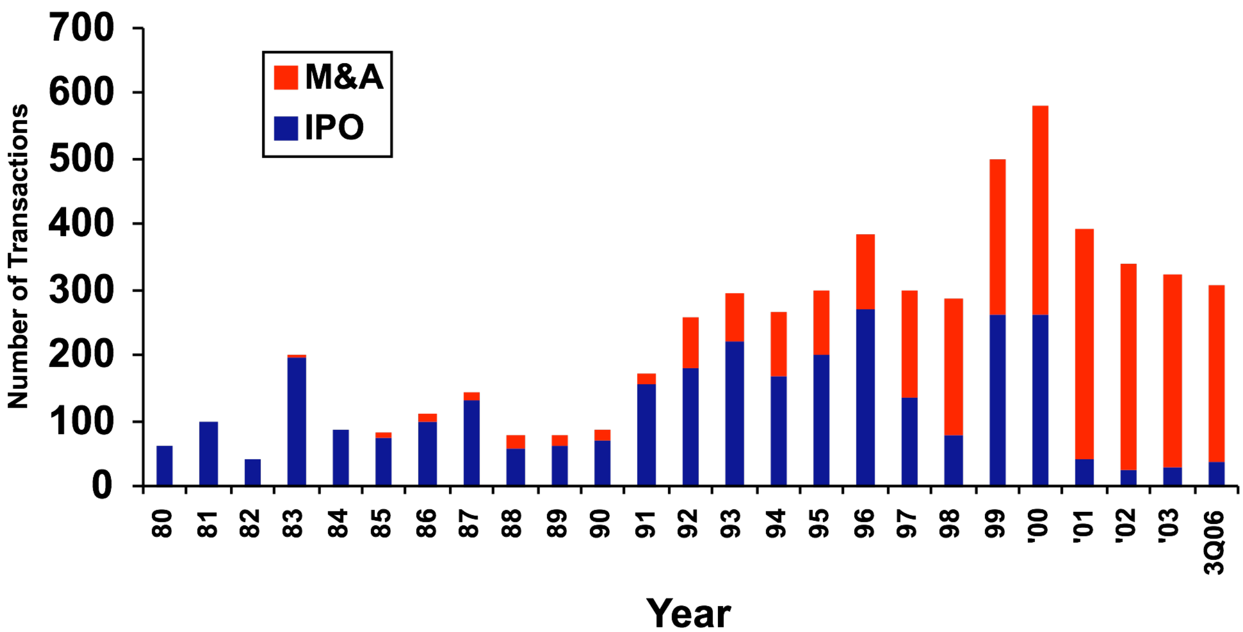


Figure 4: M&A and IPO Market for Technology Firms (1980-2006) 6,7

There is virtually no market valuation data for Angel investments, but companies such as PWC (MoneyTreeTM), VentureOne, and Thompson Financial (that includes the prior MacDonald & Associates Canadian data) track the venture capital industry and deals they consider being "seed round". Figure 5, shows that seed-round valuations increased significantly between 1990 and 2000 before dropping by two-thirds in 2001.(4)

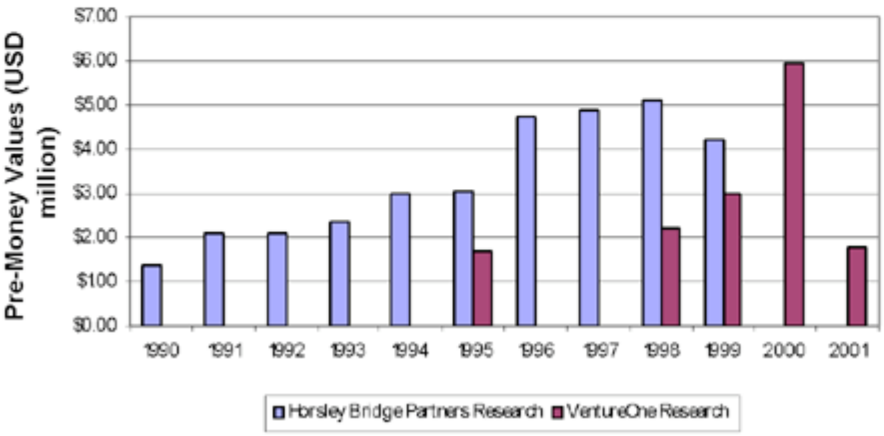


Figure 5: Seed Stage Pre-Money Valuations (unadjusted for inflation)

Figures 6(4) and 7(3)(6)(7) compare seed-round valuations to the valuation escalation that the IPO and later-round markets saw during the same time. As can be seen, later-round valuations clearly affect other, earlier-round valuations, although the price escalation is not nearly as pronounced.

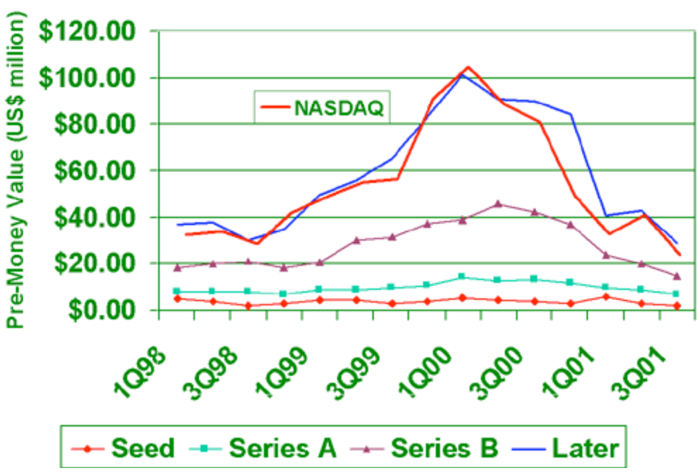
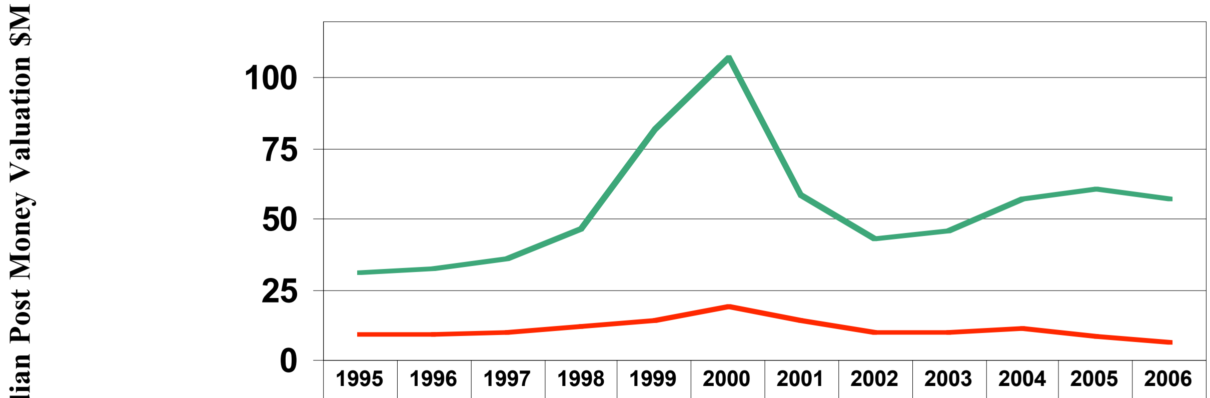


Figure 6: Effect of Later Stage Valuation Trends on Early Rounds4



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Seed/Startup/Early	9.4	9.5	9.7	11.7	14.0	19.4	14.0	10.1	10.1	11.3	8.6	6.7
Later	30.9	32.8	36.1	46.6	82.0	107.3	58.4	43.3	45.6	56.9	61.0	57.3

Figure 7: Effect of Later Stage Valuation Trends on Early Rounds3,6,7

Because early-stage valuations fluctuate over time and can be heavily influenced by what is happening in the IPO market, M&A market, and VC industry, rule-of-thumb valuation metrics change with time (see, for example, the 1993 and 2002 Berkus Method metrics) and so-called “average” seed valuations can change over quite short periods of time.

Valuation Variation Between Sectors

What is hot one day may be old news the next. As a result, the overall average seed-stage valuation trends described in the previous section can only provide general direction, but cannot be used to fully understand how valuations may fluctuate for a given deal in a specific market sector.

The most common graphical description of this phenomenon is the Gartner Hype Curve, shown in Figure 8. The vertical axis can represent company valuation, expected market size, and/or company revenue projections. The horizontal axis normally represents time. As can be seen, when a new technology is first introduced, the perceived value increases dramatically until it may become over-hyped with inflated expectations. Eventually, reality sets in, the technology’s shortcomings become apparent, the world has not been transformed as promised, the market is not as large, sales cycles are longer… and investors despair that the technology/company will fail. Eventually, the technology finds its market niche, the company achieves operational excellence, and stable realistic growth occurs.

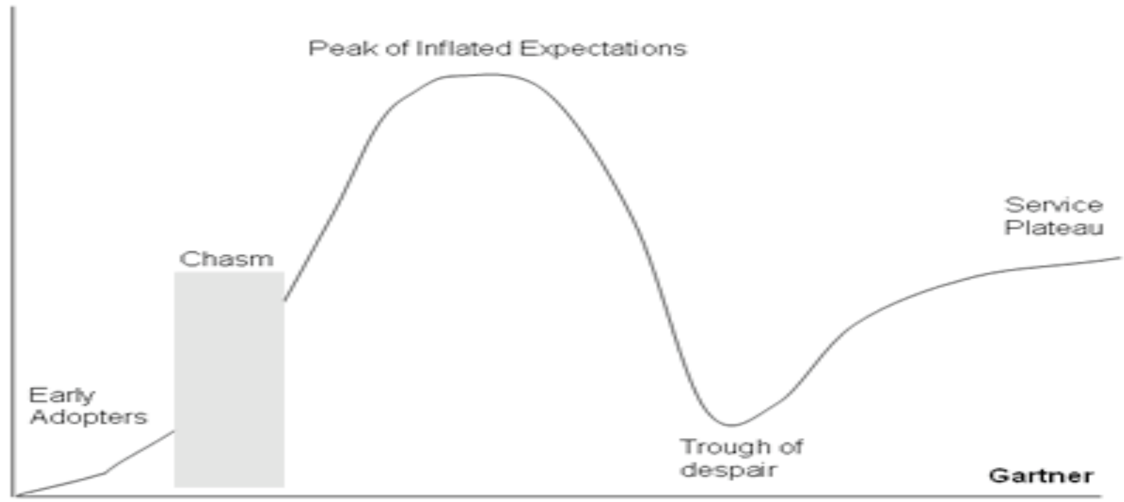


Figure 8: The Gartner Hype Curve

At any given snapshot in time, different technologies, sectors, and companies will be at a different place along this curve. Although opinions may vary widely, one might say that in 2007, for example, Web 2.0 is at the peak, nanotechnology is in the trough, RFID and VoIP are climbing the Plateau, and eCommerce is well along on the Plateau.

Depending on which futurist, visionary, CEO, or analyst you are reading you may feel differently, but the key is that different sectors are at different stages. If VCs think your sector is hot, then the next round of financing will be easier and valuations will be higher. If your investee company is selling services into a market that is coming down off the hype, then it will have a more difficult time than a company selling into a market that has climbed out of the trough.

5.3 Pre-Revenue Angel-Round Valuation Methods

Dozens of different valuation methodologies have been developed over the years, and all the experts recommend that several methods be applied to determine a range of valuations. Once this range has been established, the starting point for discussion is set and the parties negotiate to arrive at the final, agreed, investment terms. These may include various risk-mitigation covenants (deal terms such as anti-dilution and board seats) and the price paid for shares or the "market valuation".

Most traditional valuation methods, such as Discounted Cash Flow, Asset Value, Book Value, Liquidation Value, Price-Earnings Multiple, Revenue Multiple, and Dividend Capitalization methods, may be easily researched, but do not generally apply to pre-revenue Angel-round valuations. Early-stage company assets primarily consist of things not found in financial statements -- like intellectual property, sound management team, and solid strategic partnerships. Revenues and revenue projections, if they exist at all, are so uncertain and changing so fast, that it is difficult to arrive at any meaningful valuation calculations.

Of all these methods, the Revenue Multiple method (company value equals 1 to 4 times revenue) may be the most highly referenced method, perhaps due to the ease with which it can be calculated and reported. Caution should be used, however, when attempting to use this method for companies with very low revenues (under $2M per year) or with high anticipated growth rates (i.e. most Angel investments).

The following pre-revenue Angel-round valuation methods, metrics, and rules-of-thumb may be used to frame the range of potential valuations as a starting point in the negotiations. Because future cash flows are so uncertain and often so far in the future, Angel-round valuation methods are extremely subjective and rarely based on the more mathematically intensive methods (why argue over whether the profits in 7 years will be $1M or $10M if we cannot agree on a discount rate?).

It is important to remember that these Pre-Money Valuation Methods were developed for the so-called "average" Angel investment. Overall valuation trends, variation between sectors, and deal terms will significantly affect the final negotiated market price. It is also important to remember that Canadian valuations are normally lower (based on anecdotal evidence) than the US valuations upon which many of these metrics are based.

Similar-Company Transaction

Perhaps the least controversial method is to pay whatever someone else is willing to pay if the comparable market price for a similar company is known. Unfortunately, this is seldom possible in the case of Angel investments. Potential sources of information may include the 10-Q and 10-K forms filed when a public company acquires a private company. If a comparable public company sale can be found, then a private company discount of 20-50% would be applied to the company seeking Angel investment.

NAO is currently working in collaboration with the Entrepreneurs' Benchmarking and Thought Leadership Forum (www.thoughtleadership.info) to collect data related to early-stage company valuations. This is the largest database of its kind available free to Angel investors, and provides a source of high quality valuation benchmarking tools.

Replacement Method or All-In Method

This method looks at the opportunity cost involved in re-creating the company. It includes the amount of cash and time invested to get the company to its current state. If five high-quality individuals capable of making $100k per year have invested two years of their lives developing the product, then the company should be worth a pre-money value of at least $1M. The value of any current assets, as well as out-of-pocket expenses paid by the founders or prior investors, would be added to this amount. This method may be used to set the floor price of the valuation negotiations.

Modified Berkus Method

This method was originally proposed by Dave Berkus, a full-time Angel and founder of Berkus Technology Ventures LLC in Los Angeles. It has since been modified several times and/or quoted differently by various sources. This method essentially recognizes various non-revenue components of valuation, according to the following table:

Valuation Metric – if you have this…	Add to Company's Value
Attractive Idea	$500k - $1M
Good Management in Place	$500k - $2M
Strategic Alliances and Barriers to Entry Erected	Up to $500k
Prototype Completed	$500k - $1M
Quality Board in Place	Up to $1M
Product Sales	Up to $1M
Total Potential Pre-Money Value of $2.5M to $6M USD depending on Author	

One virtue of this method is that it specifically recognizes various components of value that the founders have been able to achieve and acknowledges that companies with these things in place are worth more than companies without. There is obviously some room in this method for personal or group weightings of the different factors.

Rule of Thirds

This "rule" states that 1/3 of the shares should go to the founders, 1/3 to management, and 1/3 to the capital providers. Thus, if $100k is raised, the post-money valuation is $300K. If $500K is raised, the post-money valuation is $1.5M and if $1M is raised, the post-money valuation is $3M.

A modification to this "rule" is the rule-of-thumb that any investor will want around 20%-to-40% ownership regardless of the amount of money invested.

Very often in Angel investments, the founders and management are the same. However, in many cases, one use-of-proceeds is to hire additional management and provide enough financial security to entice high quality individuals to leave their jobs to join the company. In these cases, a portion of the equity is carved out and provided to the new managers as part of the deal terms.

One obvious outcome of this "rule" is that it motivates entrepreneurs to raise as much money as possible, even if they don't need it (since every additional dollar invested triples the valuation and does not cost any additional shares – "OK, I'll give you a third of the company, but put in twice as much money."). One way to reduce risk associated with this investment escalation is to use milestone tranche financing.

This "method" may be viewed more as a Valuation Screen than as a Valuation Method. If the deal only needs $100k and the entrepreneur will not accept such a low valuation ($300k), then the deal is too small. If the entrepreneur needs $2M and the Angels will not accept such a high valuation, then the deal is too large. Somewhere in between (at the "Standard Value" – the deal is just right.

Standard Value

This method simply states that all early-stage companies should have a certain standard pre-money valuation (such as $2.5M or $3M). This standard is based on the experience of successful Angel investors who have said that this is the "sweet spot" and/or maximum valuation for start-up companies that have a reasonable chance of providing acceptable rates of return.

This “method” may be viewed more as a preference. Most Angel groups claim to prefer investments with pre-money valuations of between $500K and $4M and this is generally posted on their website. Valuations in excess of $5M are reserved for particularly advanced companies and rare exceptions (note that these maximum valuations are significantly lower than the “average” seed/start-up valuations tracked in Figures 6 and 7).

Discount to Terminal Exit Value (aka Rate of Return or Venture Capital Method)

This method calculates today’s value based on the anticipated future exit value discounted back to the present. This method is flexible and can incorporate various methods to arrive at the exit valuation and various methods to discount back to the present. If the discount method used is the based on the required rate of return, then this method is sometimes called the Rate of Return Method.

For example Newco may claim to be similar to RecentlyBoughtCo (RBCo) and anticipates that it will be acquired within five years with a valuation of $50M (based on 3x future annual revenues of $16M). If the investor has a “required” multiple of 10X, then the current (post-money) value would be $5M. If $2M is required in order to achieve the stated 10X return and $50M valuation, then the pre-money valuation is $3M and the investor will obtain 40% for the $2M investment.

Although this method has the desirable feature of providing some amount of mathematical rigour, it is extremely difficult to agree on what future revenues may be, what multiple of revenues may be fair, what kind of a company would be comparable, and what the multiple and/or discount rate should be. As the company gets closer to achieving a terminal exit, these calculations become easier. There are many VC firms that invest in companies on the verge of such an exit (such as Series B and C financing or mezzanine debt) and so this method is sometimes referred to as the Venture Capital Method.

Value Later – Discount to Next Round

One way to avoid the need to value the company today is for the Angel to invest on the same terms and valuation as a future VC round, but at a discount to that round of 10%-to-40%. This would typically be structured as a convertible debenture and convertible into shares at the agreed upon discounted price. This method does not actually avoid the valuation debate – but it does effectively push it off into the future.

5.4 Effect of Angel Groups on Valuation

Working with a local Angel group improves the chances of success and reduces risk in many ways. Local Angel groups help provide better deal flow, deal syndication, increased negotiating power, and better access to financial capital, human capital, relationship capital and information capital. Through the NAO, local Angel groups and individual Angels have a conduit to government and can affect the macro-environmental conditions by lobbying for reduced taxes and improved monetary policies in order to improve rates of return and opportunities for investee companies to succeed.

Local Angel groups help screen deals and educate entrepreneurs in order to make the Angel's use of time more effective. They help manage expectations so that deals happen more smoothly without damaging the long-term relationship between investors and the companies they are seeking to support. By improving the quality of deal flow, Angels can broaden their portfolio of investments – the basic risk management technique of diversification.

Syndication provides deeper pockets and the ability to provide follow-on financing (more financial capital). By co-investing with other Angels, the company is also able to access a wider array of talents (human capital) and contacts (relationship capital). Furthermore, negotiating power is improved since the entrepreneur cannot shop around to get a better deal from another Angel if the Angels are all working in collaboration.

NAO and the Entrepreneurs' Benchmarking and Thought Leadership Forum (www.thoughtleadership.info) are working to improve the ability for Angels to benchmark their deal terms, valuations, and executive compensation packages. This collaboration will help provide access to the only known free source of market information about early-stage financing. This information will help both Angels and entrepreneurs establish a "fair market price" for their deal as well as help them to improve their ability to increase value as the company grows.

Executive Summary

In this chapter, we provide basic definitions and templates outlining a best-practice term sheet and voting trust as well as samples of subscription and shareholders agreements. Of these, the term sheet is where the Angel group's investment lives or dies, where protection against untoward dilution is cemented, where valuation is laid out. Essentially we recommend that every Angel group employ a good corporate lawyer to ensure that its documents are constructed properly – but remember, the group's desires should guide the lawyer, not the other way around. Also, budget should be discussed prior to engagement, so that the lawyer understands the group's terms of reference. Angel investment is still not perfectly grasped by many law firms, despite their wealth of experience, and, all other things being equal, the Angels' understanding of both the deal and the desired outcome should inform the document.

6.0 The Term Sheet

The term sheet outlines the terms and conditions of the investment deal. In Canada, Angel terms sheets rarely existed five years ago. Today they are a must for any informed investor.

The term sheet document serves as a letter of intent, created by the Angel or the Angel group and presented to the company. It spells out the proposed terms under which an investment will be made. This is not, obviously, a legally binding document, but rather a mechanism that summarizes the key financial and legal conditions under which a deal could be done. Most importantly, it serves as the base document for negotiations and focuses both parties on the major items that must be resolved before a deal is consummated.

Terms sheets lay the basis for the legal documents in the investment package. When executed in an efficient and timely manner, they can and do drive down the legal costs of papering the transaction. In addition, they also establish the relationship between the company and the Angel group.

Generally, the following topics need to be covered in the term sheet:

- The financial structure of the investment: debt or equity; common shares, preferred shares, convertible debentures, etc.
- The valuation and / or the mechanism by which the valuation will be set, either during the current-round negotiations or at the next round of financing. (Note: Angels should deal with the valuation during term-sheet negotiation rather than postponing it to some later date and leaving the decision in the hands of subsequent investors. Postponing the valuation only leaves the Angel group vulnerable to the decisions of others who will not necessarily have the best interest of the Angel in mind

- Amount/parties investing: what is the size of the deal; what is the price per share; and who will participate in the Angel round? Will the Angels invest individually or in a voting trust?
- Use of funds: what will the investment be used for? Without this provision an entrepreneur could use the proceeds for his own salary exclusively or to retire old debts. In this scenario, there would be little or no money available to drive the Company to revenues and profitability.
- Downside protection: terms and conditions under which a measure of protection is provided to the Angel in future rounds of financing or in the case of the liquidation or sale of the Company.
- Expenses: what are the acceptable expenses in negotiating and closing a deal and who will absorb these expenses?
- Exclusivity/no shop/closing date: Angels need assurance that this deal is not being shopped, that they are not in some kind of a beauty contest, and that the Company is not trying to create a bidding war for this round of investment. Also, since investment negotiations are a process and not a career, a firm end date for the deal needs to be set early.
- Milestone and tranches: Angels are advised not to invest in one lump sum. Rather, milestones are created up front, usually tied to such things as completion of software development; signing customers; gaining significant revenues; or achieving some form of positive cash flow. The funds are tranched out upon the completion of each milestone at a pre-determined percentage of the deal.
- Short vs. long form: most Angel term sheets err on the side of brevity. As long as the basics are covered, few Angels have the need for term sheets that go on for 25-plus pages. The purpose of an Angel term sheet is to lay out a framework that helps protect the Angel investment. A VC term sheet is much more about control. Since the VC is investing other people's money, he or she must be able to provide evidence to funders that as many control mechanism as possible are in place.

6.1 Term Sheet Specifics

This section-by-section look at a standard term sheet helps outline the associated challenges and discussion points. Some of these terms vary from the term sheet best-practices template following this chapter in order to give readers an idea of the range and variation of term sheets and their individual elements.

Basic Information

Company name:

Term sheet date:

Statement:

The XYZ Angel Group is prepared to invest $x00,000 in ABCCo under the terms and conditions contained in this document. This term sheet is non-binding and is prepared for discussion purposes only. The proposed investment is subject to due diligence, stock purchase agreements, and other conditions contained herein, which must be satisfactory to XYZ Angels.

Again, at the risk of repeating points made earlier, the term sheet is a non-binding document and serves primarily as the basis for negotiation. Once these negotiations have been completed and the points agreed to, it is difficult to come back to the Company with a formal Purchase Agreement that has material changes in it. Deal with all outstanding issues at the term-sheet stage. Resist the temptation to add in other conditions when your lawyer is papering the deal. If there is something important that has been omitted, go back to the term sheet, sit down with the company, and talk it through.

Proposed Investment Details

Amount of Investment:

Investors:

Amount should include minimum and maximum possible investment.

Investors' name should also include note as to investors' accreditation.

Type of Security

The investment can be structured in a variety of ways, based on the Angels' needs and the company's requirements and ability to repay. While convertible debentures are often used, they are debt instruments. Since most start-ups are strapped for cash, they don't have the financial ability to make interest payments on a predictable basis, regardless of intentions. As a result, interest is often converted to common shares with possible "bad blood" resulting between founders and investors as founders see their share ownership eroding. It is better to start off with preferred shares that provide Angels with a measure of investment protection, more control over decisions, and result in better economic terms.

Debt: Private debt financing involving the loan of capital at a fixed or variable rate of interest is a suitable mechanism for raising capital from friends and family but is not typically utilized by Angels. When traditional debt is employed, Angels typically will co-sign a bank loan rather than providing capital directly.

Convertible Debt: This is basically a debt instrument (secured or unsecured) that may be converted into equity under specified terms and conditions. Until converted, it offers the investor a fixed rate of return and provides tax advantages to the company (for example, deductibility of interest payments). Convertible debt is also suitable for friends and family. Some venture capitalists and industry specialists have positioned convertible debt as particularly useful for Angel investment in pre-revenue companies as a way to avoid valuation issues. But this structure has largely fallen out of favour among Angel groups as a result of past experience with venture investors who do not accept the return premium set by the Angels.

Except in cases of bridge financing, where the next round is imminent, convertible debt is considered to provide unacceptable limitations to the potential for higher returns.

Equity: The type of securities ultimately selected and the structure of the transaction will usually fall into one of the following categories:

- **Preferred Shares**: This is the most typical form of security issued in connection with an Angel group financing of an emerging growth company. This is because of the many advantages that preferred shares offer an investor - they can be converted into common shares, and they have dividend and liquidation preference over common shares. They can also provide anti-dilution protection, mandatory or optional redemption schedules, and special voting rights and preferences. Properly structured, a preferred equity term sheet will provide incentives for the management team to achieve high rates of return while limiting the returns to founders only in the event of modest outcomes.

- **Common Shares**: While common shares are suitable for friends and family, they offer the Angel investor no special rights or preferences, no fixed return on investment, no special ability to exercise control over management, and no liquidity to protect against downside risks. It has frequently been argued that common shares provide a share structure that is "fair" to all stockholders, and the basis for best practices tends to favour the option that is considered to be the most fair to all parties. However, we strongly believe that the efficiencies provided to the entrepreneur through an organized Angel group structure, including accessing multiple investors and negotiating a single set of terms, can merit preferential terms.

Pre-Investment Valuation

You can read more about valuation in Chapter 5. But at the risk of repetition, valuation is the most important issue that Angels face when negotiating a term sheet with company founders. While the founders often have a strong notion as to what their company is worth, they can put too much emphasis on their sweat equity, unrealized ideas, or wishful thinking into the mix. The reality is that hours employed do not really enter into the equation when it comes to determination of value.

The other issue that Angels often run into is the false notion by founders that they, as the sellers, set the price. In reality, it's the "Golden Rule" that comes into play. He who has the gold makes the rules. Of course, this is a negotiated process but it's the Angel who lays down the opening price.

It's important to remember that the purpose of the negotiation is to create a win/win scenario: the Angel gets a sufficient equity interest in the company to reward his investment; the Founder retains enough of the shares to keep him motivated to get the company to the next performance level.

Of course, the reality is that everyone – from Angels to VCs to corporate financiers – makes up how much they think the pre-money value of a company should be and then runs the numbers to help validate their gut sense. Not very scientific, but for the most part it works.

Capital Structure Following Private Placement:

Existing holders of Common Stock:	xx%
Option pool:	yy%
Holders of Preferred Shares:	zz%
Total:	100%

Generally, depending on the size of the investment, for a first Angel round the goal is to have founders retaining 51% and up. Also, establish the size of the option pool in the agreement. Setting limits prevents the percentage of options getting out of control and diluting all investors. The prefs will be equivalent to the Angels' investment divided by post-money evaluation (the exact formulas are discussed elsewhere in this volume).

Use of Proceeds

This outlines the Angels' understanding of the company's needs – working capital for ongoing operations, a sales and marketing program, technical support for expanded operations, a full-time CFO, and so on. If the Angels are to be involved in any part of this, such as in interviews and hiring of additional management, it should be stated here.

Takedowns

Angels must reach milestones. Once the overall size of the investment has been determined, the Angels need to set specific tasks that the Company must accomplish before all the money is handed over. While there is an initial cash infusion, the rest is doled out in sizeable allotments on a milestone basis. These milestones can relate to sales, R&D goals, staffing, or any element that the Angels see as key to the company's growth. Terms should be laid out clearly, with dates specified as appropriate.

Anticipated Closing Date

The closing date should be clearly stated, but may stipulate that there are requirements that must be fulfilled before closing.

Closing Conditions

Closing conditions include such elements as the provision of legal documents, chain of title on IP ownership, the completion of due diligence, the signing by company employees of non-compete / non-disclosure agreements (vetted by legal counsel), the negotiation of employee agreements with key management, the arrangement of "key person" insurance for the management team, the hiring of an acceptable accounting firm.

Please note that the non-compete agreement is particularly important. Without this agreement, employees could develop IP while they are in the Company employ, leave or be terminated, and take the

IP with them to start a new business that is in competition with the Company. An Angel must make sure that current and potential IP is fully and legally protected.

Conversion Features

Preferred stock always has the right to convert to common shares at any time and will convert into common stock automatically at the time of an IPO or at the time of agreed events – a takeover bid, or various financial targets. However, if the agreed dollar thresholds are not achieved, any IPO must be approved by the holders of preferred shares.

Note: The special rights that are given to prefs could create problems for a public company.   Multiple classes of voting shares in a public company discourage institutional investment and confuse the average retail investor. It is more difficult for brokers to attract a following in a company that gives preference to some shareholders and not others.

Stock Option Plan

Options are a useful tool for start-ups in attracting key management and employees. They serve as a key incentive in driving Company milestones and rewarding employees for extraordinary efforts. However, the size of the pool needs to be limited to prevent dilution creep and to provide discipline around this key recruitment and reward asset.

Right of First Refusal

This clause give holders of preferred shares the pro rata right to participate in subsequent stock issuances. They can also have the first right to buy any founder and management stock being sold, on substantially the same terms as the proposed sale. These rights terminate immediately prior to the closing of a qualified public offering.

VCs often put this in the terms sheets as a mechanism for keeping their options open regarding further participation in equity of a Company. While they are not required to invest, many have found it to be a useful trigger in reviewing their ongoing commitment to the Company. For that same reason, many Angel deals are now beginning employ a ROFR clause in their agreements since it allows them to maintain their pro rata interest. However, this provision can cause some concern on the part of common shareholders, and especially founders, because limits their ability to bring in funding from other sources.

Anti-Dilution

This provision is a must for an Angel deal. As discussed elsewhere, the Company issues new shares at a price below the conversion price of the preferred stock, the conversion price is adjusted to eliminate the dilutive effects of the new stock. This results in more shares for the Angel on conversion. There are basically two kinds of antidilution provisions: a full ratchet and a weighted average provision. Angels tend to favour the weighted average since they are less dilutive to Founders. VCs generally go for the full ratchet.

Voting and Veto Rights

In some respects, the voting rights provisions are at least as important in providing a measure of control as the percentage of the Company the Angel owns. In essence, the Angel investor could "control" the company with one share depending on what is included in Voting Rights. While the intent of an Angel investment is to make money and not to micro-manage the Company, it's critical that the Angel investor have a role to play in material decisions. Provisions to protect Angel voting rights can range from limitations on the amount of money the company can spend, to control in a dissolution situation, to control over share re-purchasing. Depending on the type of company and the management team, these provisions can and should be tailored to each Angel deal.

Redemption

This simply gives the right to the Angel to achieve liquidity in the event that the Company is not sold, or does not goes public through an IPO within a stated period of time. Since the Angel investment is made on the understanding that there will be a liquidity event, a timeframe should be clearly stated. Typically the time period stipulated for redemption is between three-and-six years.

Liquidation Preference

One of the principal reasons for an Angel to chose preferred shares over common is to receive preferential treatment, since by all standards Angel money is a high-risk investment. The liquidation preference can enable the Angel group to head the list of debtors in the event of dissolution, thereby protecting the investment.

Board of Directors

Boards are critical to the success of a start-up. Since most Angels invest not only their money but their business, domain, or operational expertise, they need a "seat at the table" in order to help guide the ongoing operations of the Company. Two Angel seats at this stage of the organization's development are appropriate.

Founding Options and Vesting

Vesting periods are always included to encourage key players in the Company to stay. If a Founder or others who may own options elect to leave, they lose the unvested shares.

Expenses

It's prudent to get an estimate from the lawyer as to how much it will cost to paper the deal. Cap it in writing and built it into the term sheet.

6.2 Key Deal Terms

Many of the phrases used in discussing investment terms may be familiar, and in fact the authors have included a glossary for readers, but for convenience we include some deal-term definitions here:

- **Anti-dilution**: Angel investors can be "washed out" of their stock positions if there is no anti-dilution provision. If, for example, the Founders control more than 50% of the voting shares and there is no anti-dilution clause they could oust the Angel investors by offering shares to a third party at a few pennies when the Angels came into the deal at $2.00 stock. Management could grant itself new options that would gross up the Founders and return them to a dominant position.

  Among the most important anti-dilution provisions requires the Company to give the Angel free stock if it sells shares to a later investor at a lower price. The two main anti-dilution instruments are:

  - **Full Ratchet**: when the Angel investor receives enough free shares to reduce his average cost per share to the price paid by the new investor;
  - **Weighted Average**: when the investor receives fewer free shares and is subject to partial dilution of his holdings.

- **Assignment of technology**: key employees are required to assign to the Company all rights, titles, and interest in all technology and proprietary information owned by them relation to the Company's business.

- **Conversion**: This provision allows for preferred stock to be converted into common shares at a certain price, usually whenever the shareholder chooses. Note that conversion can also take place automatically for a variety or reasons, most importantly if the company goes public.

- **Dividends**: In some cases, Preferred Shareholders are entitled to receive cumulative dividends in preference to the holders of Common Stock at a predetermined annual rate of the purchase price per share. This requires Board approval.

- **Drag-along right**: This requires all shareholders to vote for and participate in any sales transaction approved by a specified percentage of the preferred stockholders. Since this allows the preferreds to force the sale of the Company, this can be of particular concern to the Founders since this forced sale may be on terms that provide little, if any, return to the Founders and others who hold common shares.

- **ESOPs**: Angels want to ensure the Company attracts the best talent possible. Since cash for start-ups is always tight, employee stock option plans can entice key employees at lower salaries that are offset by a stock-option plan. However, the Angel should stipulate the number of options in the pool and that these cannot be increased at some future date without prior approval.

- **Information rights**: In Angel terms this obliges the Company to produce such documents as quarterly financial statements, an annual budget, a monthly report on the events, and an outlook for operations. A stipulation is often made here that a member of senior management presents these reports in person no more than four times a year.

- **IP ownership**: ensure that the Company can produce the "chain of title" for the IP and that a percentage of ownership is determined – usually in line with the overall percentage ownership of the Company that the Angel investment buys.

- **Liquidation preferences**: in the event of any liquidation, sale, or dissolution of the company, the holders of preferred shares will receive a certain amount of the fixed assets before any assets are distributed to the holders of common stock. If there are more than one series of preferreds then the assets will be distributed on a pro rata basis.

- **Milestone (takedown) investing**: funds will be tranched out in pre-determined amounts upon the successful completion of milestones that have been agreed upon.

- **Pay-to-play**: this provision gives the Angel a measure of protection against price dilution if the Company subsequently sells shares to other parties at the price below is issue price. The Angel must, however, invest in these shares when offered in order to protect this provision.

- **Purchase agreement**: this legal document acceptable to all parties, should contain such things as the appropriate representations and warranties of the Company and the Angel Investors, covenants of the Company that reflect the terms sheet provisions, and appropriate conditions to closings that include qualification of the shares to be sold under the appropriate securities laws.

  Other documentation under this section includes such things as:

  1) Board and Shareholder resolutions approving the transaction

  2) Investor Rights Agreement

  3) Registration Rights Agreement

  4) Stock certificates.

- **Redemption rights**: this provision treats preferred stock like debt, which needs to be paid back with interest. For example, if the preferred stock has not been converted within five years, the Angel can oblige the issuer to redeem these shares at some premium over the initial purchase price of the stock.

- **Restrictions on founders and employees**: Angels have the right to buy shares that are offered by Founders or employees.

- **ROFR**: Angels holding preferred shares can have the right to purchase additional shares when issued by the Company, up to their current aggregate ownership percentage. In other words, if the founder receives a third-party offer for his shares, the Angel has the right to purchase shares on the same terms as the third party.

- **Tag alongs**: Founders agree not to sell stock without providing the Angel investors the right to pro rata participation in the sale.

- **Vesting of Founder's shares**: since the Angel usually wants to keep the Founder in place until the Company has revenues, cash flow, and even profits, restrictions can be placed on when the Founder receives his shares. Often these are tranched out yearly over a set period of time.

- **Vesting periods**: Often Founders shares are vested over a three-to-five years period from the time of issued at one year increments. Note that a percentage of the Founder's shares (decreasing over time) can be purchased by the Angel investor if a Founder leaves the company.

- **Veto rights**: Angels can elect to have veto rights (usually financial) over such material matters as large Capex purchases, significant expenses, issuance of debt over a predetermined amount, increase in the size of the board, etc.

6.3 Papering the Deal: The Investment Package

Many of the phrases used in discussing investment terms may be familiar, but it makes sense to ensure that clarity prevails by providing the definitions forthwith.

Components of the Investment Package

Term Sheet: The term sheet sets forth the key financial and legal terms of the transaction, which will then serve as a basis for negotiation between the lead investor and the company.

Shareholder's Agreement: The shareholders' agreement (sometimes referred to in the US as a stockholders' agreement) is an agreement based on the successfully negotiated terms set out in the term sheet regarding the ownership and voting rights of the shares in the company, as well as the control and management of the Board.

Subscription Agreement: The subscription agreement (also referred to as a Share Purchase Agreement) is based on the successfully negotiated terms set out in the term sheet regarding the material terms of the financing. It also serves as a form of disclosure document because the Representations and Warranties portion of the Subscription Agreement covers the relevant financial and historical information made available to the investor. The Representations and Warranties (sometimes issued as a separate agreement) provide a basis for evaluating the risk of the investment and structure of the transaction.

Stock Options Agreement: This agreement specifies who will receive stock options, how many, and how they will be distributed. The options agreement can include the employee share option program (ESOP), and details the strike prices, vesting issues, timing issues, and mechanisms to claw company stock options back.

Voting Trust: As a best practice for Angel group investment, especially when investing in a company likely to attract venture capital in the future, a voting trust should be formed by the Angels who contributed the capital. Under a voting trust, one Angel member assumes a seat on the company's Board of Directors and is responsible for voting the proxies of the investor group. The "Voting Trustee" is usually the person with the most sector knowledge, or in some cases, the largest individual contributor to the financing round.

A voting trust also has the benefit of being able to provide a proxy signature for the investor group. One recent venture capital financing round in Toronto was derailed, and ultimately abandoned, because the company was unable to chase down the signatures of all the shareholders.

Legals and Lawyers

In an effort to ensure the Angels' investment dollars are used to grow the investee company, organized Angel investment groups typically arrange for low-cost (typically in the range of $5,000 - $15,000 per investee company) investment packages with members who happen to be lawyers or with sponsoring legal firms. However, experience has shown that prospective investee companies in Ontario have sometimes received literally boxes of legal documents that must be interpreted by their legal counsel before closing, escalating legal expenses exponentially. As a best practice, therefore, it is considered prudent to invest in the development of a standard investment package that is clear, concise, and easy to read and understand. Once a standard package is in place then legal counsel only needs to have input on the peculiarities on each specific investee company.

Additional Resources for this chapter in Appendices:

Fig. 4 – Sample Term Sheet
Fig. 5 – Sample Shareholder's Agreement
Fig. 6 – Sample Subscription Agreement
Fig. 7 – Sample Voting Trust

Executive Summary

Term sheets are the linchpin of the Angel deal. Successful term sheet negotiations are based on good faith, and will not work in its absence. In this chapter, we examine effective negotiation. Most of this chapter is based on finding positions of mutual benefit. Taking a win-lose approach will erode good faith. The win-win tack will net more for everyone. Strategies, tools, and tactics are outlined, including such elements as position assessment, identification of issues, negotiating table approaches, and advancing your position. Finally, specific deal terms are discussed.

7.0 Introduction

Negotiating investment term sheets is a bit like negotiating a pre-nuptial agreement prior to marriage. You want to protect the long-term relationship, but you want to clearly document certain details related to ownership, governance and exit payouts. If either party negotiates in bad faith or demands unrealistic terms, then the marriage never takes place or breaks down soon after the agreement is signed. If properly executed, the negotiations can help build respect, understanding, and the lasting foundation for a successful long-term relationship.

Angel financing can range from a couple thousand dollars to several million and the term sheet conditions should reflect this. Complicated deal structures and legal agreements make no sense for small financings, but larger financings with multiple syndicate partners start to look a lot like VC terms, and in fact these Angel syndicates are increasingly circumventing VC involvement completely.

In the smaller agreements, a single Angel is often acting more like a founder or friend and family and the deal terms should reflect this closer relationship. In these cases the Angel may want common shares so they are treated more like partners with no special rights beyond what the founders may have. For larger syndicated deals, the Angels expect to be treated as professional investors and can expect terms that start to look like what a VC would expect (for example, preference shares with liquidation preferences and anti-dilution clauses).

Angels want CEOs who can get what they want when negotiating with employees, vendors, customers and future investors. Angels want CEOs who can do this without damaging their relationships. Negotiating term sheet conditions can be a way to coach the CEO, demonstrate proper behaviours and reinforce key character traits (such as honesty, integrity and ability to be objective).

7.1 Negotiation Fundamentals

All successful negotiations share certain fundamental characteristics. It is helpful to review these prior to discussing the issues specific to Angel investing. There are many excellent references available that an

Angel may benefit from reading. “Getting to Yes” by Fisher and Ury is particularly easy to read and full of helpful insights and suggestions.

Separate the People from the Deal Terms

It is vital to ensure that the negotiations do not damage the long-term relationship. To ensure the success of the company, it is important that the management team fully utilize the talents and contacts of the Angel investors. The management team should involve the Angels as trusted advisors and bring strategy deliberations, sticky HR problems, and other issues to their attention outside of the formal board meetings that may be required under the terms of the actual agreement. If management feels that the Angels have acted in bad faith, are self-serving, or are interested only in their own personal financial gain, then these informal consultations – so vital to the company’s success – will not occur.

There is no point in fighting hard to “win” on a certain point when “winning” causes lasting harm to the relationship. Using “hardball” negotiating tactics seldom works and often leads one party to try to later subvert the agreement and/or myopically follow the letter of the agreement, but not the spirit.

Negotiators are people first and people can be sensitive. This may be especially true of entrepreneurs who have poured their heart and soul into the company that they view as their baby. Saying that the baby will probably fail to achieve its targets, the value is less than proposed, the team is not as good as they think, and the product not as astounding as they believe can be painful and damaging to the relationship.

By separating the people from the problems, issues and terms you can help maintain a professional relationship without making it personal. A slight change in the wording can make all the difference in the world.

When negotiating for a specific clause (like anti-dilution or liquidation preferences), the Angel would be advised not to couch the rationale in terms like “you might fail to hit your targets and so I need protection”. Instead, a more positive approach could be “I think you and your team will hit your targets which is why we want to do this deal. However, we all know that statistically, even excellent companies can suffer a down round if the market changes. An anti-dilution clause reduces risk and this is what allows us to agree on valuation.”

Focus on Interests, Not Positions

The traditional way to view negotiations is for each side to start with a range of conflicting positions and then haggle back and forth to arrive at some compromise between those two positions. Each side increasingly strives to justify their position while undermining the other side’s position. Position based negotiation is generally considered to be an inferior technique that drags out the negotiation, damages the relationship and results in poor outcomes.

Position-based negotiators often find themselves locked into their positions. The more they try to justify their position, the harder it is later to change it. Stating something like “I’ll never pay more than a $2M valuation.” makes it hard to later trade-off a slightly better valuation for other deal terms (like anti-dilution and liquidation preference) that may actually be far more important. Furthermore, the negotiator's ego often becomes identified with the position and they would be humiliated and/or feel like a liar if they later concede on that particular point.

The classic example is two sisters negotiating over an orange. The starting point position is that both sisters want the orange. They engage in various tactics, but eventually end up compromising and each getting half the orange, which seems fair enough. However, if they had gotten behind the positions and addressed their interests, they would have discovered that one sister wanted to bake a cake and wanted to zest the peel and the other wanted to eat the orange. If they had understood these interests, then each sister could have gotten everything she wanted (that is, all the peel and all the fruit).

Negotiation is not a battle of wills. It is a process by which each party seeks to understand the other person's point of view and interests behind their positions. Simply asking "why" and listening, can provide not only a way to strike a better win-win deal, but may also provide deep insights into what problems management expects to face in the future and how they plan to deal with them.

The ability to see the other person's point of view is perhaps the greatest strength a negotiator can have. Solving the other person's problem is your problem. By understanding the reasons and interests behind any given position, you can uncover which deal terms are most important to the other side. This becomes critical information when exploring options for mutual gain.

Invent Options for Mutual Gain

In virtually all complex negotiations involving multiple issues, there are ample opportunities for give-and-take that benefit both parties. This ability to uncover interests and discover which issues are most important to each party is key to achieving win-win outcomes where both sides feel they have negotiated a good deal. If one party gets their way on a term that is particularly important to them, then the other party should also get what they want on the issues that are most important to them.

Negotiations should go through a diagnosis phase where both sides brainstorm potential ideas and options for ways to improve the deal. The idea is to assume that the two sides can increase the size of the pie and broaden the number of options while withholding judgement on any single idea. The two sides search for mutual gain through this process.

There are essentially three types of issues to discover: mutual agreement, integrative and distributive. Some issues will be mutually agreeable to both sides (such as number of board seats, whose lawyer drafts the agreement and amount of financing raised). Other issues will be integrative, meaning that one side cares more about this term than the other side. For example, the investor may care deeply about anti-dilution and liquidation preferences whereas the entrepreneur may care more about the size and distribution of the option pool. Discovering these issues is key to creating win-win scenarios where one side gets something they care deeply about and so does the other side. Distributive issues are issues that both sides find equally important, there is no room for win-win on this term, and negotiation must distribute the benefits between the parties.

By engaging in the diagnosis phase, differences of opinion may be used to discover integrative issues. For example, the entrepreneur's forecast will normally be more optimistic and their opinion will be that the investment is less risky. The Angel may thus trade off upside terms like option pool, salary and valuation for downside risk-mitigation terms like anti-dilution, liquidation preference, dividends and redemption rights. It is precisely the entrepreneur's confidence and optimism and the Angel's risk aversion that creates these integrative opportunities.

This information-seeking and discovery process may involve putting out multiple offers and trial balloons such as "how about a higher valuation if we increase the liquidation preference?" or "How about if we increase the size of the option pool and give you another 100,000 options in exchange for using a preference share structure?"

In practise, this phase may affect both the structure of the investment and the deal terms themselves. For example, if there are significant friends and family investors involved prior to the Angels, the idea of giving pref shares to the Angels may be a major sticking point. Shifting to a convertible debt structure or using common shares with a lower valuation may be the solution to resolving this impasse.

Use Objective Criteria and Fair Procedures

Whenever possible, base your positions on objective criteria. This works particularly well for buying a car or house when the buyer or seller can point to a blue book value or price of the house down the street. This is one major reason why NAO has compiled this document on best practices and is working with the Entrepreneurs Benchmarking and Thought Leadership Forum (www.thoughtleadership.info) as a source of fair market standards and objective criteria.

Rather than arguing over valuation and engaging in a battle of wills, one may point to objective data related to the average valuation of early stage VC rounds or early stage valuation methods as described in the previous chapter on valuation. Instead of negotiating each term in the term sheet separately, one may instead offer one of NAO's best practice term sheets as a starting point in the negotiations.

Because there are currently so few objective standards related to Angel investments, it becomes particularly important to engage in fair procedures. For example, the two sides should agree on principles and procedures very early on in the negotiations such as:

- Each side should have only a single negotiator. It would be unfair for one investor to negotiate terms, gain all the concessions they can, and then turn the deal over to another investor to push for additional concessions after the fact. Similarly the CEO should not negotiate the best deal possible and then have someone from the board or a prior investor push for additional concessions. As well, one side should not go behind the other side's lead negotiator to try to lobby amongst their colleagues (such as calling the investee company's board or management team to try to convince them that the current terms are fair, or to ascertain how much support the CEO has).

- Neither side's lawyers should be involved in the term sheet negotiations. This can add cost and disrupt the relationship. Each side should have excellent high-quality counsel with appropriate expertise to advise them outside of the negotiations and explain the implications of the terms, but third parties should not be directly involved until after the basic term sheet conditions have been agreed upon. Once the lawyers get involved, it is their job to negotiate the legal details, but NOT re-negotiate the deal terms themselves. Obtaining a not-to-exceed quote from your lawyer will help reduce frustration all around.

- The two sides should agree that the health of the company takes priority over the deal negotiations. The deal negotiations should not be so onerous that management has to divert its attention and harm the company. Similarly it would be unfair for the investors to drag out the negotiations while carefully tracking the bank account in order to get better deal terms once the company is in danger of missing payroll.

The timing and location of meetings should be agreed upon in advance and the meetings should always be face-to-face and never by phone. It is unfair to just "drop by" the office, thus leaving one party unprepared for the meeting. It is also unfair to always make the other party come to your office (or sit facing the sun, or sit in a lower chair…).

7.1 Negotiation Strategy

The basic strategy in all negotiations is to first create gains and then capture gains. First the negotiator seeks to increase the size of the pie by understanding the other side's interests, positions, and range of acceptable conditions. The negotiator seeks to find which terms are mutually agreeable, integrative and distributive. Next the negotiator seeks to capture his or her share of the larger pie through innovative deal structure, trading off integrative terms and capturing share of the distributive terms.

There are five basic analysis points to any negotiation:

1) Determine your BATNA (Best Alternative to a Negotiated Agreement). What is your "walk away" position if no deal takes place? In most cases the Angel investor has a pretty good BATNA – they simply continue to hold onto their cash and wait until another deal comes along. This excellent BATNA generally gives the Angel investor the upper hand and greater negotiating power.

   However, Angels often find it exciting to be involved in working with excellent young companies and taking part in their success. Great companies are relatively few and far between and Angels don't want to let the good ones get away. The promise of spectacular rates of return can make greed a powerful factor in the negotiations.

   A key rule may be taken from the housing market – never fall in love with a house or you will overpay for it. Fall in love with a number of houses and be prepared to walk away from any single house. Don't get "caught up in the deal."

2) Determine their BATNA. If the company is burning through their cash and there are no other offers on the table, then the entrepreneur is highly motivated to close a deal and compromise on terms. If their BATNA is firing staff, bankruptcy or a second mortgage on their home, then your negotiating power is dramatically improved. On the other hand, if the company is cash flow positive or has other offers for investment, then they have a stronger hand and will be less inclined to accept terms. Entrepreneurs with multiple offers will always get higher valuations with better terms.

3) Assess the True Issues in the Negotiation. Understand the interests and not just the positions. Is the deal just about raising money, or is there additional prestige and legitimacy associated with being involved in the deal? Is there a face-saving issue that must be resolved to close the deal? Does someone on the board have a particularly strong opinion that may shape the deal?

4) Determine Important Issues to You. Which integrative issues are you going to negotiate hard to achieve? Which terms are you willing to compromise on or give away easily? The Angel syndicate members should specifically articulate any of these issues to the lead negotiator.

5) Determine Important Issues to Them. Which integrative issues are they going to fight for? Which issues are equally important to both parties and are distributive?

7.2 Negotiation Tactics

There are many references on negotiating tactics and this is largely outside the scope of this chapter. However a few important tactics to highlight are appropriate here:

Anchors: The anchor is the first offer to be put on the table. If the anchor is a good one, then the other side will naturally gravitate to these points and negotiate relatively minor modifications around these terms. If the anchor is a poor one, then credibility is diminished and the deal is potentially lost. For example, if the entrepreneur throws out an anchor of a $20M valuation, then many Angels will consider this to be a deal-killer and lose interest. Similarly an Angel asking for a 3X liquidation preference may be a deal-killer. The primary tactic is to drop the anchor (make the first offer) if you think you are close to a deal they will accept. Try to get them to drop the anchor if you are uncertain.

In practise, the Angel will normally expect the entrepreneur to drop the first anchor around valuation and money raised (e.g. "What percent of the company are you expecting to sell us for the money you are asking for?" is a standard question to ask during the screening presentation). Many negotiations break down over valuation long before the other deal terms are even raised.

Once the valuation range is within reason, discussions over deal structure often make sense. These can be broad-based informal discussions to determine whether convertible debenture, pref shares, or common shares make the most sense. Various deal terms associated with these different structures should be discussed to prevent any unpleasant surprises that may occur when the entrepreneur sees these terms in writing for the first time.

Again, you want to drop the anchor only once you feel the other side will accept it as a legitimate anchor and the negotiations will involve relatively minor modifications around these terms. Once you have a feel for the type of investment structure and term conditions that will be agreeable, the normal process is for the Angel to drop the biggest anchor and issue a draft term sheet. Putting forward a term sheet clearly demonstrates that the Angels are serious about coming to a deal and is normally considered to be a major milestone in coming to an agreement.

(NAO has created a best practice term sheet for relatively large Angel group syndicated investments using a pref share structure. This is an excellent anchor to use to structure the negotiations for investments that fit this profile).

Time: The Angel would be wise to understand the importance of time. In some cases, it is important to strike a deal quickly while valuation may be low and the entrepreneur has no other deals on the table. In other cases, it may be the entrepreneur who is in a hurry and concerned about cash flow. In such a case, the Angel may be tempted to obtain better terms and last minute concessions if they drag their feet. However, care must be taken to not damage the company with this tactic if key employees must be terminated or sales contracts are signed on poor terms due to lack of cash.

Don't Proceed Issue by Issue: Negotiating each issue individually almost always results in reversion back to position-based negotiation tactics. Both sides feel compelled to push for concessions on each issue even if it is not particularly important to them. This wastes time, results in poor outcomes, and damages the relationship. A better approach is to brainstorm trade-off scenarios (e.g. "how about a $200k increase in valuation in exchange for anti-dilution and 1X liquidation pref?). Think in terms of trading off integrative terms and using distributive terms to make up the difference if one side trades off more integrative terms than the other.

Be Firm on Interests and Flexible on Position: People resist take-it-or-leave-it tactics. Issuing a term sheet and then refusing to budge on positions will often kill a deal. Instead, consider putting the term sheet out as a starting point position and offer to be flexible as long as your underlying interests are met. Offer to adjust the terms if the other side can come up with a solution for meeting your underlying interests. You may end up back at your starting position, but the other side may find solutions to better meet your interest. The key is to allow the other side to feel that they had a hand in negotiating a win-win agreement.

Advance Your Interests Outside of Negotiation: You are building the foundation for a long-term relationship. In many cases trust and understanding are the bridges required for the other side to see the deal from your point of view. Investing a bit of time in dinner or helping the company with an issue it is currently facing may be all that is required to help make a deal happen on positive terms without the other side feeling that it caved into your demands.

Be Predictable and Explicit: Position based negotiation tactics often include things like walking away in a huff, faking anger, showing disbelief, and asking for far more than you expect. Being unpredictable or lying about your interests damages the relationship and seldom results in

Positive Outcomes: While concealing your bottom line and/or BATNA is a fair negotiating tactic, lying is not. Angels provide more than investment to their investee companies, they also provide mentorship and coaching – including how to get what you want fairly and predictably during negotiations.

7.3 Negotiating Specific Deal Terms

Deal Structure

Angel investments come in all shapes and sizes. For smaller deals or deals where a single Angel is acting more like a partner than an investor, the Angel may want to be treated like a founder or mentor/coach. In many cases, a common share structure makes the most sense and is the most economical means of investing. A common share structure is also very flexible and normally allows many of the same deal terms for the investor as a preferred share structure.

For larger investments, involving multiple Angels and/or Angel groups in a syndicate, the best practice is to use a Preferred Share structure or Convertible Debenture. The following specific deal terms are all based on NAO's best practice term sheet shown in an earlier chapter.

Amount of Money Invested

The more money invested and the more significant this money is to the success of the venture, the greater the negotiating power and the more the Angel group should insist on obtaining VC-like market terms using a preferred share structure. If the Angel group is investing a small amount of money and the financing does not get the venture to a terminal event, then it is less reasonable to push for terms like liquidation preferences or redemption rights.

Working with an Angel group and being involved in syndications allows Angels to participate in larger deals. Very often, the amount of money raised becomes an important integrative issue – the entrepreneur will trade off terms like anti-dilution in exchange for raising more money (for example, more Angels will participate in the deal and invest more money if the deal terms are more favourable).

Valuation

Valuation is probably the most controversial deal term. You should make sure that both sides are at least within the same ballpark prior to the start of negotiations over the other term sheet conditions. Most entrepreneurs (mistakenly) view valuation as one of the most important points and this gives valuation a good potential for being an integrative issue. Valuation is also potentially the most flexible term for the Angel to trade off in order to obtain concessions on the other terms.

Proposing adjustments to valuation in exchange for other deal terms helps put a specific price on the value of the other deal terms. Brainstorming trade-off scenarios such as "we'll eliminate the dividend premium if we reduce the value by $500k." shows flexibility on position, but firmness on interest.

Dividends

As Angel groups start to make larger investments with shorter anticipated terminal exit durations, the market is starting to see more of these clauses inserted into preferred share term sheets.

Nobody really wants or expects a high growth company to pay dividends. This clause is used to apply pressure on the company to seek a liquidity event by adding a liquidation preference premium for each year the company delays in getting to a liquidity event. For example if the agreement calls for a 7% annual dividend (payable upon liquidity) and the liquidity event takes place in 10 years, then this essentially results in an additional 1X liquidation premium above and beyond the stated liquidation premium clause.

If no liquidity event ever takes place, this term also applies pressure on the founders to pay dividends to the Angels before they pay dividends to themselves.

There are many potential negotiation points around this term including the dividend percent, when the amount becomes payable, and when such dividends begin to accrue (for example, they can start to accrue immediately or after 5 years…). The interests behind any position related to this term are clearly the Angels' desire for a liquidity event and concerns about lack of control over cash distributions should such a liquidity event fail to take place.

Liquidation Preference

While this term has been virtually unheard of for Canadian Angels, it has become more common in the US, partially as a result of their larger investments with shorter anticipated terminal exit durations. As Canadian Angels begin to syndicate more and craft larger deals, this clause will increasingly be viewed as a best practise in Canada too.

The liquidation preference multiple changes with market conditions and negotiating power. In 2007, market conditions seem to indicate that 1X is reasonable and that anything over 2X is unreasonable. Asking for a 3X multiple would be considered a sign of bad faith negotiating.

Keep in mind that a Dividend clause essentially buries an additional liquidation preference multiple over time and so negotiators may consider trading off the liquidation pref multiple against the dividend payment terms.

Anti-Dilution

No longer just for VCs, this term has also become more frequent in both common share and pref share Angel investments. The standard clause uses a weighted average calculation and often excludes from the calculation below-market strike price options granted to management or consultants. Asking for full ratchet anti-dilution is normally considered to be bad faith negotiation.

Board Seats

The right to appoint at least one director to the board of directors is a very common term. Except in rare cases, any deviation from this should be viewed with suspicion.

The normal rule-of-thumb is for the Angel group's board percentage to reflect the percentage ownership. Thus a 20% equity stake would merit 1 of 5 board seats and a 40% stake would merit 2 of 5 seats. If a 30% equity stake were obtained, then a reasonable term would be 1 board seat plus the requirement for 1 of the seats to be held by an independent person. If the investee company already has a fantastic board, then it may be reasonable to merely seek observer status.

There will always be a significant Change of Control Valuation Premium if the Angel group wants more than 50% of the company or voting control of the board. This valuation premium is seldom worth it.

Redemption

This term demands the right for the Angels to get their money back or replace the board and seize control of the company if the company does not have a liquidity event within a specified time period. This VC-like term might be considered if the Angels are making a large and significant investment into a company that does not require more funds to achieve their terminal exit event. This term also makes more sense if the company's board and management team are less experienced. Most entrepreneurs will resist this clause, thus giving this term high integrative potential.

Information Rights

These clauses are very standard and should not elicit much discussion. If the Angel investor has a board seat and a good relationship with the company then this clause is superfluous. If the relationship is damaged, then this clause is hard to enforce. There is a high likelihood of this term being a mutually agreeable issue.

Negotiations may revolve around whether Angels should require audited financial statements. It really depends on the stage of the company and whether the company should be spending its money this way or spending it on other things. If the management team is competent and honest (and you should have already determined this!) then auditing may just be a waste of money for early stage investments. Similarly quarterly reports are pretty standard and the company shouldn't be spending its time issuing more frequent reports.

Option Pool

The size of the option pool and number of options issued to management is normally one of the issues of most interest to the entrepreneur. It thus provides a high potential for integrative bargaining. The normal range would be around 15% of the total number of issued and outstanding shares, but negotiations could bring this number as high as 20%.

Closing Date

This term is also often of tremendous interest to the entrepreneur, thus providing excellent integrative bargaining potential. If the entrepreneur is feeling time pressure, then trading off a shorter due diligence period and closing date for other concessions may make sense ("We can reduce the due diligence period and meet an earlier closing date, if we have risk mitigating provisions in place like anti-dilution and…").

Other Terms

Many of the other terms are considered standard in both common and preferred share structures. While there is ample room for negotiations around minor issues and specific wording, there is normally relatively little disagreement overall.

7.4 Conclusions

How the two sides conduct themselves during the term sheet negotiations will set the stage for the remainder of their relationship. Dirty tricks, hardball tactics, take-it-or-leave-it offers, unpredictable behaviour, unrealistic expectations, excessive negotiation over minor details, and general disagreeability are signals that these are not people you want to work with. Life is short – move on!

The negotiations should be conducted in a spirit of fairness and respect for each other's legitimate interests and values. Remember that you want your CEOs to be good negotiators and get what they want. You want the company to be successful and start your future relationship on a foundation of trust and cooperation. Upon conclusion of the agreement and making the investment, it never hurts to send a thank you gift or card and/or perhaps hold a celebration event with the entire team.

Executive Summary

As Angel groups become more sophisticated, the natural inclination is to mitigate risk by expanding the portfolio. Given that most Angels have a finite amount to invest, syndication is key to spreading the risk more broadly. Syndication has become quite well established in the U.S., but Canada has only recently reached the necessary mass.

Advantages of syndication, beyond risk management, include enabling Angels to finance complete deals without the dilution often associated with a venture capital round, helping form stronger bonds among and within Angel groups, and giving Angel investment generally a higher profile. To further these goals, and to support Angel investment, standardized approaches to the Angel investment process – from deal screening to valuation to term sheets to exits – have become increasingly important.

8.0 Introduction

Individual Angels have always syndicated deals with other sophisticated investors as a way of spreading the risk inherent in funding entrepreneurial companies. But as Angels began to band together in formal groups, deal syndication among these entities became a well-established form of financing, predominately in the U.S.

However, deal syndication is more than just spreading the risk. It also allows Angels to provide companies with sufficient capital to take them to sustainable revenues and profits, avoiding the necessity of a Series A venture capital round and the potential dilution that often applies. At the same time, VCs in Canada are increasingly favouring later-stage rounds, thus creating a widening financing gap for start-ups.

Normally, a $5 million or $10 million a deal could not be contemplated by a single Angel group. But by syndicating the deal among other Angel associations and individuals, that size of raise can be realized.

Based on the success of this activity in the U.S., syndication is beginning to take hold in Canada. But Canadian Angels should not feel they are the only ones slow to adopt this trend. As a recent report by the British Business Angels Association (BBAA) states: “In terms of syndication, the UK is five years behind the U.S. market.“

The Enterprise Directorate General of the European Commission comments in a paper entitled Benchmarking Business Angels: “As the Angel market matures in Europe, Angel networks might need to pay more attention to benefits of, and support needed for, syndication. Business Angel networks need to take this complexity of the marketplace into account when devising strategies to activate Angels, and the same holds for policy makers when designing policies favouring Angel investment.“

Borrowing again from the BBAA report: "Syndication is attractive because Angels have access to a pool of experience across sectors and access to more opportunities. They have more bargaining power and new investors get the opportunity to learn from more experienced ones."

Syndication also has the added benefit for individual Angels in quickly building a portfolio of emerging companies is a relatively short period of time. As one industry observer says: "unless an Angel has the money and the time to invest in 10-or-12 companies in under two years, it is better to join a syndicate. With a syndicate, you can invest in a dozen companies relatively quickly and take advantage of the portfolio approach. You prosper by playing the numbers."

While Canada has been slower to adopt the syndication model, Angel groups in this country have syndicated deals in recent years: within provinces (Toronto Angel Group and the Ottawa Angel Alliance), between provinces (BC's Okanagan Angels & Alberta's Deal Generator), and across the border (where Ed Alfke, for example, a veteran Angel investor and NAO board member, has raised some $5 million, principally from a number of U.S. Angel groups).

With the growing number of syndication deals in Canada, the NAO realized that in order to smooth the process and avoid unnecessary complexity that core standards in such areas as due diligence, valuation, term sheets, and exits needed to be developed. It is one of the prime reasons this manual was developed. It is intended to outline current best practices and standardized processes that Angel groups in Ontario and elsewhere can apply for their own individual and syndicated deals.

As more data on Canadian syndication deals, processes, pitfalls, and successes are gathered in the coming year, this section will be updated. However, for now, the NAO will borrow heavily from some of the pioneering work undertaken by the Angel Capital Association (ACA) in the U.S. It should be noted that the NAO is an affiliate member of the ACA as they are an affiliate of the NAO. Therefore, without apologies, and as members of the same Angel family, we are going to offer some of their documents as a starting point, specifically:

1) Draft process for a syndicated deal
2) A sample two-pager for syndicating deals
3) An agreement of cooperation for due diligence sharing – the Treaty

8.1 The Draft Syndication Process

Goal: 60-day process

Week 0

- Lead Group confirms due diligence minimum standards in place
- Lead Group sets expectations with company

- Lead Group prepares opportunities and risks document together with a deal summary and key challenges to success ("Two-Pager")

Week 1

- Company presents to Syndication Summit
- Mini DD meeting held at Syndication Summit
- Soft circle numbers

Week 2

- Schedule presentations with other Angel groups

Weeks 2 – 4

- Make presentations to other groups (Lead Group should be present)
- Commence follow up due diligence meetings
- Each group designates a deal lead
- Provide Lead Group's due diligence with summary

Weeks 5 – 6

- Lead Group provide due diligence (DD) to other groups in syndicate.
- Determine if additional DD needs to be done
- Hard circle numbers
- Consider negotiating leverage

Weeks 6 – 7

- Present/Renegotiate Term Sheet with company if applicable
- Complete DD
- Lead Group writes up summary of additional DD completed

Week 8

- Documentation and closing

8.2 A Sample Four-Pager for Syndicating Deals

Purpose

The following template is intended for use by all Angel groups in the National Angel Association so as to facilitate deal syndication.

Disclaimer

Reference is made to the Agreement of Cooperation (the "Treaty") entered into between various Angel groups in the National Angel Organization. This Two-Pager is provided conditional on and subject to the provisions of the Treaty. By their acceptance hereof, the persons receiving this Two-Pager hereby signify their accession to the provisions of the Treaty.

Name of Company: ____

Lead Angel Group: ____

Name of Lead Investor: ____

Email address of Lead Investor: ____

Phone number Lead Investor: ____

1. Overview

Provide company's date of formation, location, why formed, key milestones in its history.

2. Deal

Describe the structure (including closing date) of the current deal and whether prior investors are participating. List names and amounts of significant investors in the current round. Detail any investors who will be providing specific active involvement in the company.

3. Investment Thesis

Provide a summary of why this is an attractive investment.

4. Investment Considerations

List (a) positives and (b) negatives to this deal.

5. People

Describe and provide assessment of the management team, Board, Advisory Board, and employees.

6. Product

Describe the product, current customers and pipeline, sales cycle. Include your assessment of the product.

7. Market

Estimate market size and your assessment of it.

8. Competition

List actual and potential competitors and provide your evaluation of where they stand relative to the company. Include barriers to entry.

9. Financials

Provide your assessment of the company's financial presented in due diligence, including cash flow and when next financing is likely to be required.

10. Milestones to exit

List the company's next several milestones and including the key ones that will get it to Exit.

11. Exit

Describe the company's exit strategy as well as your assessment of it.

12. Due Diligence List

Provide full list of Due Diligence completed and advise of availability for viewing by other groups. Refer to Minimum Standards of Due Diligence Checklist provided by the NAO. (Note: for Canadian Angel groups, the due diligence checklist provided earlier in the next section should apply.)

Agreement of Cooperation for Due Diligence Sharing

Preamble

The Angel group Parties to this agreement ("Treaty"),

Having in mind the purpose of fostering cooperation in investments by each other in privately held companies ("Companies");

Considering the sharing of due diligence documents that report upon Parties' investigations of Companies ("Materials") to be necessary to enable the co-investment by two or more Parties in Companies (a "Syndication");

Believing that it is in the best interests of the Parties to establish arrangements where each Party may freely share its Materials with other potential Parties to a Syndication;

Wishing to establish a model for other Angel groups to follow, so as to increase Syndication opportunities amongst all Angel groups;

Treaty

Hereby agree as follows:

Article 1. Due Diligence Materials. Unless otherwise represented in writing by a Party providing a particular set of Materials, it shall be understood by any Party receiving Materials from another for the purposes of a Syndication that such Materials are provided "as is," without warranty, implied or otherwise, of accuracy, consistency or thoroughness about a given Company or its investment prospects. It shall be further understood that each Party shall be responsible to conduct its own due diligence independently, and that any reliance by one Party upon the Materials of another shall be at such Party's own risk.

Article 2. Promulgation within Groups. The designated leader, or managing group, of each Party shall communicate this Treaty and its terms to each respective member of such Party, and shall use his or her best efforts to endeavour to obtain the agreement of each member, and new member, to adhere to the provisions hereof.

Article 3. Disputes. Any dispute between two or more Parties concerning the subject matter herein or its application, shall first be subjected to informal negotiation and mediation between the leaders of the Parties involved. A single arbitrator acting under the rules of the appropriate Canadian arbitration association shall submit any such dispute that is not settled thereby, to binding arbitration. The arbitrator shall first be picked from a pool consisting of the leaders of Angel groups that are not involved in the syndication. The parties may agree upon the arbitrator or, if not so agreed, the arbitrator shall be jointly chosen by the parties' respective choices.

Article 4. Notices. Any notice to a Party hereunder shall be effective three days after its mailing, postage prepaid, certified mail, return receipt request via the Canada Post or overnight if by overnight traceable delivery service if sent to the address listed on such party's Web site or, if none, through contact information provided by such party to the National Angel Organization

Article 5. Amendments.

Section 5.01 Any amendments hereto shall be made in the form of a

Protocol, which shall be set forth a preamble explaining the intentions thereof, and stating each proposed amendment in full within an article. The effectiveness of any Protocol with respect to a given Party shall occur immediately upon the signature of such Party, and notice thereof to the other Parties hereto. Those Parties that do not sign the Protocol shall remain bound by the original articles of this Treaty and any Protocols that they have signed.

Section 5.02 Suggestions for Protocols should be directed to the National Angel Organization, Attn Executive Director

Article 6. Effectiveness. This Treaty shall be effective on a given Party upon its signature hereon.

In Witness Whereof, the undersigned, being duly authorized by their respective Angel Groups, have executed the Treaty effective as of the date stated below his or her name.

Maple Leaf Angels

By:______________________________

Name:____________________________

Its:______________________________

Dated:___________________________

Toronto Life Science Angels

By:______________________________

Name:____________________________

Its:______________________________

Dated:___________________________

Deal Generator

By:______________________________

Name:____________________________

Its:______________________________

Dated:___________________________

8.3 Due Diligence Checklist for Deal Syndication

Due Diligence Guidelines for
Angel Capital Association (ACA) / National Angel Organization (NAO) Co-Investment

Financials

- [ ] Historical financials (audited is preferred, but not required for minimum standards)
- [ ] Current year plan v. actual
- [ ] Forecasted financials (including cash flow to next round or breakeven)
- [ ] Additional cash investments required and where cash is going to come from
- [ ] Financial model
- [ ] Balance Sheet
- [ ] Accounts Payable
- [ ] Cap Table – fully diluted, variations in terms, preferences
- [ ] Debt outstanding

Market

- [ ] Market Opportunity
- [ ] Newco's solution for the market
- [ ] Competition
- [ ] Market Share
- [ ] Who are the likely M&A players (potential acquirers)
- [ ] M&A activity in the sector (with multiples)

Sales and Marketing

- [ ] Strategy
- [ ] Pipeline (need for confidentiality might limit who in any group sees this)
- [ ] Price and price history
- [ ] Product description
- [ ] Positioning
- [ ] Placement (channels)

People

- [ ] Full resume of each member of management team
- [ ] Bios of board members and Advisory Board if applicable
- [ ] References: prior customers (pre Newco), 360 degree, business partners, plus independent checks
- [ ] Reps, warranties & disclosures (any legal issues; conflicts of interest etc)
- [ ] Employment status at Newco
- [ ] Employment contract
- [ ] Non-compete and assignment (example: founders assigning IP rights to the company)
- [ ] Option Plan

Intellectual Property

- [ ] List of patents with status
- [ ] Trademarks
- [ ] Copy of patents
- [ ] Other IP activity
- [ ] Status of filings, including ensuring payments are current
- [ ] Depending on the deal/industry: Freedom to operate; expert opinion/valuation; non-competes, and/or clearances

Contracts

- [ ] Copies of material contracts (including license agreements, if any)
- [ ] Review of license agreements for IP and financial impact
- [ ] Employment agreements
- [ ] IP ownership
- [ ] Regulatory Issues

Other Legal

- [ ] Any claims, threatened or pending claims or litigation
- [ ] Notification of lawsuits

07/07

Chapter 9 - Dilution, Follow-on Rounds, Sidecar Funds, and Exits

Executive Summary

An Angel investment in a start-up company marks the beginning of the funding process, not the end. Angels are still faced with various critical challenges and opportunities long after the cheque has been cashed. While some of these issues have been dealt with in earlier chapters, they are of such importance to the success of early-stage financing they deserve a bit more granularity and focus. For example, down-rounds remain a critical impediment to successful angel investors. These are declining valuations that can accompany the entry of new investors (especially VCs) into subsequent financing rounds. In some cases, down-rounds are substantial enough to severely diminish or even eliminate the equity stake held by Angels and other early investors, including the founder and family and friends.

The point of this chapter is to assist Angels in monitoring, managing, and mentoring their investments. Key here is to ensure there is a measure of protection from the ravages of dilution, explore ways to top up existing Angel rounds, and prepare Angels to create profitable exits.

9.0 Introduction

Like death and taxes, dilution has in the past been seen as an inevitable outcome of an Angel investment. It has almost become a truism. Each new round of investment outside an Angel group has the potential to dilute the previous round. Far too many Angels have found their investments obliterated by a Series A financing that was done at a much lower valuation than the Angel round. If the company requires the money to stay solvent and to take it to profitable revenues, the Angel has little alternative other than to take the deal, licks his or her financial wounds, and learn to introduce some anti-dilution protection in future term sheets.

Of course, such a move does not always provide full protection and may in fact be little more than a psychological prophylactic to the Angel negotiating the deal. After all, the venture capitalists can still apply the golden rule – he who has the gold makes the rules – and set take-it-or-leave-it terms that will almost entirely wash out the Angels. That was certainly true in the 2001-to-2003 tech-wreck period, when down-rounds were all the rage. (A down-round occurs when new investments are made at a lower pre-money valuation than the previous post-money valuation.) But more recently, Angels are seen by VCs as playing an important role in the funding ecosystem and have increasingly benefited from this realization. This is not pure altruism on the part of the VCs. For several years, Angels truncated their investments in early-stage companies as a direct result of successive dilutive cram-downs of their investments. Then the VCs began to wonder why all the good early-stage deals had vanished. Gradually, the two groups have been able to work a detente of sorts, but the friction has not disappeared totally.

9.1 Angel Protection

In order to provide a measure of protection, Angels need to consider the following:

- Investing in companies that will only require one-or-two rounds of Angel financing, thus avoiding entirely the potential cram-down from VCs. Several years ago, funding a company to profitability from Angel investments alone would have been considered a fantasy. Today, in some circumstances, it is possible to get start-ups to the stage where an Angel can profitably exit. In certain sectors, advances in technology have contributed to this trend. The advent of Web 2.0 has meant that while it used to take $5 million to get a tech-based company to a revenue-positive position (well outside the reach of most Angel groups), the same can now be accomplished in many cases with $500,000, well within Angel parameters.

- Co-investing and syndicating with other Angel groups at the same valuation. Despite the fact that it can be difficult for individual Angel groups to stay the course of a large, long-term investment, it is possible for a $5 million raise to be completed entirely by Angels. It's still somewhat rare today, but growing in "do-ability" every quarter as relationships among Angel groups mature and take common approaches to term sheets, due diligence, and valuation determination.

- Co-investing with seed VCs, including BDC. This is a nice idea; however, the reality is that there are few VCs in Canada interested or capable of doing early-stage rounds. BDC, Growthworks, Argon, (which is just completing its first round in Canada) and a few others are the notable exceptions. It is advisable for an Angel group to begin establishing a working relationship early with these VCs by putting a few high-potential deals in front of them. Since the Angels and seed VCs would be investing on the same terms at the same valuation, the risk of a down-round is diminished if the company requires a Series A round from a new VC, even if that deal is syndicated among other venture capital firms.

- Building an anti-dilution provision in the term sheet. Essentially this says that if the company issues new shares at a valuation lower than the previous financing rounds, anti-dilution will be exercised. For example, if an Angel group invests $1 million and negotiates with the founder for a $4 million valuation, then the post-money valuation is pre-money valuation plus investment or $5 million. However, if another round of $3 million is raised at a pre-money valuation of $4 million, then the Angels have lost 20 percent of their investment.

Protective Devices

Generally anti-dilution provisions come in two flavours: full ratchets and weighted average. There are also half-ratchets and two-thirds ratchets and probably some other fractional ratchets as well as broad-based weighted average anti-dilution protections and narrow-based protections, but this is supposed to be an exercise in clarity, so we will keep it simple. Angels are advised to leave the math to the lawyers when papering the deal. For the purposes of this text, an overview is sufficient.

Full ratchets: This protection "ratchets" the Angels' conversion prices down to the lowest price at which any stock is subsequently sold. The full ratchet permits Angel investors to re-price their shares based on the share price paid by later investors. The Venture Law Group cites the following example:

> *If a company sells 1,000,000 shares of Series A preferred stock at $1.00 per share and later is forced to sell 100,000 shares of Series B Preferred Stock at $.50 per share, the conversion rate of the Series A Preferred Stock is adjusted so that such shares are convertible into 2,000,000 shares of Common Stock (as if the shares of Series A Preferred Stock had originally been sold at $.50 per share).*(1)

This mechanism works exactly the same with an Angel round and a Series A VC round. The math is the same, just the names have changed.

Weighted Average Ratchet: This provision also effects a re-pricing of Angels' shares in the event that stock is subsequently sold at a lower price. When the company sells stock at a price lower than the conversion price of the existing shares held by Angels, that conversion price is reset based on an average of all the prices at which the company has sold stock, including warrants, options, or convertible securities. There are different formulae that can be used to weight the average value for this purpose, but the point for Angel investors is to give more value to the stock outstanding at the pre-adjusted conversion price.

Angels tend more toward weighted average provisions than full ratchets, since the former are less dilutive to founder's shares and it is in the best interests of all concerned to ensure that the entrepreneur remains motivated. However, start-ups, no matter what formula is chosen, consider these devices an impediment to future financings. Angels see anti-dilutive provisions as an investment safety net. To a certain extent, both are correct, which can become of source of conflict.

9.2 Sidecar Funds – Supercharging an Angel Group Investment

The National Angel Organization defines a sidecar fund – as the name suggests – as a committed source of capital that "rides" or invests alongside an Angel group. A sidecar fund is simply a pool of capital, managed by the Angel group, which operates in tandem with its investment activities on a deal-by-deal basis. This "bank" of capital is supplied by the group's Angels, or from non-aligned investors who wish to participate in the investments without formal membership. In many ways, it acts like an investment club for Angels, providing them with another vehicle to add additional funds for deals in start-ups.

The sidecar fund is also a way for investing institutions, such as governments, BDC, VCs, and others, to leverage the expertise of the Angel community. A sidecar investment by these groups can reduce their need to expend scarce in-house resources while ensuring that the investee benefits from the entrepreneurial expertise of the Angel group.

While there are variations on the sidecar theme, the fund basically can be applied and managed in three ways:

1) **Discretionary**: The fund is held in trust and applied by the Angel investees, at their discretion, to top-up their financings in entrepreneurial companies. This allows a larger number of Angels to participate in a wider number of deals. If, for example, a typical Angel within a group invests in two deals per year totalling $150,000, a modest investment in a fund could allow him or her to participate as part of a pool in multiple deals over the same period.

2) **Pre-set conditions**: It can kick in automatically when a predetermined minimum investment threshold has been reached. Automatic top-ups are funds owned by the Angel group, but have pre-set conditions such as a minimum number of active Angel members investing in a specific deal, a minimum deal size, and approval and oversight provided by the Angel group's board of directors;

3) **Externally managed**: The fund can be operated by an independent professional manager and act much like a venture capital fund that is formally associated with an Angel group. In this case, it will usually provide at least one board member to the fund. While there have been some notable successes to this approach in the U.S., from such groups as the Band of Angels, the Canadian market so for has shown little appetite for this approach.

Size of Funds

At first, there are generally no maximums to the size of the pool, which is often involved in several financings and is refreshed at the pleasure of the group. However, to be meaningful, a minimum threshold should be established.

Once successful, many sidecar funds have capped participation, either based on a percentage of what Angel group members invest per year or at a specific dollar figure. They have taken this initiative out of an abundance of caution to avoid distraction, since the primary function of an Angel group is to make direct member investments in start-ups. The originating Angel group doesn't want to risk having the sidecar tail wagging the dog.

Advantages of Sidecar Funds

Sidecar funds are efficient since they are rewarded on the same terms as the Angel members in any given deal, they enable multiple parties to participate in the same deals, and they piggyback on the pre-screening and due diligence conducted by the group. They also provide Angels with a source of additional capital that can allow entrepreneurial companies to grow to revenue and profitability without the expensive, distracting, time-consuming, and dilutive undertaking of a VC round. Sidecars are a stable and disciplined way of filling the gap between what the Angels have to invest and what the entrepreneur requires. And deals can be closed more quickly since a potential syndication with other Angel groups or seed VCs is avoided.

These funds are also an excellent way for Angel groups to expand their network by attracting unaligned high net-worth individuals to test-drive Angel investing. They allow these individuals to "kick the tires" and appreciate the benefits before they officially take on full membership.

As at the writing of this text, sidecar funds do not exist in Canada, although they have become the topic du jour for many Angel groups (especially in western Canada) during the last two-or-three years. However, they are well entrenched in the U.S., with such successful groups as Common Angels, Tech Coast Angels, Band of Angels, and The Angels Forum. Before the year is out, we anticipate several sidecars will be launched in Canada.

Cautions on Sidecars

There are a couple of important caveats. Sidecar funds require some discipline and a real measure of fiduciary responsibility. In short, they have to be managed properly by a member of the Angel group with a financial background, or by a reliable third-party who brings relevant expertise to the process. At the same time, they should not be seen as a way to provide additional income to the Angel group. A modest fee can be applied against expenses, but sidecars should never replace membership dues and sponsorships as a form of revenue. Costs should be covered but the main purpose of sidecars is to bring addition power to Angels' investments.

9.3 Follow-on Rounds: An Inevitable Necessity for Some Investments

Despite earlier comments on the desirability of avoiding follow-on rounds for Angel-backed companies, additional financings are sometimes required to take the company to the next level and provide the Angel group with a respectable exit.

Anatomy of Successful Follow-ons

For example, Band of Angels out of California, one of the most active groups in the U.S., which has just come off a banner year, announced that of the 24 financings made last year, 13 of its portfolio companies received follow-on financings. The Band participated in all of these transactions for at least their pro-rata. Seven of these financings were up-rounds, four were flat- rounds and only two were down-rounds. All rounds were negotiated with VCs. In short, the majority of the deals avoided cram-downs, which is kudos to the negotiating skills of the Band.

It is also worth mentioning that the Band makes special note that the "lack of a robust exit market is of concern to everyone – some VCs have seen no profitable exists in their portfolio in literally years." Of course, the same is true in Canada, but the 110-member Band, with investments in 200 companies and 9 IPOs, was able to exit two companies for a profit in 2006.

"We'll need more exits than these to make seed investing activity profitable, as well as fun, but at least we've had more than our share recently," the Band commented in a recent newsletter. They also pointed to the IPO market as a strong possibility for U.S. exits, as it has demonstrated some strength lately.

The IPO Option

IPOs are by no means a given. With the advent of more rigorous corporate governance and disclosure regulations in the U.S., which have drastically driven up the cost of maintaining a listing on an American exchange, many micro-cap companies have been all but excluded from the IPO market there. That is perhaps why Nasdaq and the American market in general have gone large-cap over the past several years. Smaller companies just don't have the financial resources to list.

With lower listing charges, the small-cap equity market is more accessible in Canada, especially with the introduction of the CNQ Exchange. As well, the AIM Exchange in the U.K., which although expensive taps into many highly motivated investors, has also helped smaller Canadian and U.S. companies to complete both concurrent (at the time of listing) financings and follow-on rounds once they are public. However, there has been a recent wrinkle for start-ups listing on TSX Venture. The Exchange is currently pushing its own brand of after-market support with the purchase of a Toronto-based investor-relations firm, apparently in the hope of satisfying the need of foreign companies for local investor communications. The implicit conflicts in this approach – with an exchange effectively making itself responsible for the investor communications of some of its listed companies -- albeit through a subsidiary – and the potential for real or perceived inequitable treatment of listed companies, combine to shake confidence in the TSX as a world-class exchange with an eye on best practices.

Alternative Sources

Some of the more progressive banks in Canada (BDC is included in this list) can also be a limited source of follow-on financing, depending on the financial strength of the enterprise. If, for example, the company has achieved profitable revenues and requires money to expand its operations, small-scale debt financing is a viable option.

However, it must be remembered that banks have little or no tolerance for risk. They are great providers of low-cost money to companies that don't need a cash injection to survive. But, at the risk of repetition, they are not in the risk business. One might argue that given their size and propensity for large and sustainable profits that they could and should be encouraged to venture more into the commercialization of innovation, but this is really a topic for another time. In any case, establishing a relationship with a local bank is simply smart business for current and future needs. And Angel groups need to encourage their portfolio companies to begin early the process of creating secured or unsecured operating lines of credit.

Summary

Regardless of the source of the follow-on financing, successful negotiating with the new investor is the key to avoiding the dreaded Angel cram-down. Since anti-dilution provisions have already been baked into the original deal, there is a measure of protection that has been built in. But nothing in Angel investing is automatic, and woe to the Angel investor who does not become actively involved in the negotiation process with a new third-party investor.

If relationships with VCs have been formed early and the Angels have secured a co-investment with a venture capital firm on the same terms, then the next round of venture financing should be relatively smooth. If it's a new party that's being added, a new set of challenges are inevitable.

There are several key points that will help the whole process:

- Pick your battles. Have a clear idea of what is important to maintain and what you can afford to let go. Remember that this fresh infusion of cash is vital to the overall success of the company and that without it, the future value of the Angel investment will inevitably be diminished. The suggested terms worth preserving are liquidation preferences, quarterly financial reports, a board seat, and exits. There are others that individual Angel groups may want to add, but these are the basics.

- Ensure that the capital structure remains clean so that it is relatively easy for an investment banker or later-stage VC to participate in a future deal.

- Don't be blinded by the assertion that: "It's always done this way." There are few if any "musts" when it comes to financing deals. The VC may have a preference, but that's entirely different from an absolute.

- Ensure that you are dealing with a quality VC in the event that this is the chosen option. VCs are not all alike. Some have successful track records, others tend to over-manage to the point of potential destruction to the progress of the company. Find out who you are dealing with in advance. A little homework will save days of fruitless discussion later on.

- If it's a syndicated VC financing, insist on dealing with the lead VC only – the one who has the authority to negotiate on behalf of all parties. You don't want to be in the position of doing three or four separate deals.

- Keep clear records. If the Angel members involved in the negotiation reject the opportunity, they need to make sure they have kept a documented record of their deliberations and the reasons for turning down the deal.

Once a VC deal has been successfully completed, the Angel group needs to be prepared to take a bit more of a back seat in terms of the demands placed on the company for financial reporting and milestone deliverables. All VCs take an active interest in managing their investments. That, however, does not mean that the Angels can or should exclude themselves from their ongoing role in mentoring. The need may be less but is seldom eradicated.

9.4 Exits: An Angel Home Run

All Angel investors live for the day when they can exit a deal. An exit, as the name implies, means that there is enough money in an investee company for the Angel to cash out of the investment at multiples that reward the risk.

On the subject of multiples, there is currently a bit of a debate as to what is acceptable and what is woefully inadequate.

On the one hand, everyone would like a 10-bagger (10X return on the investment (ROI)) plus, realized in three-to-five years. Many Angels have also argued for a 30 percent ROI, presumably over a shorter period.

But let's deal with the multiples first.

A 30 percent per annum ROI over three years is only a 2.2X return, while 30 percent ROI over five years is a bit less than 4X. Conversely, if the Angels demand a 10X return over only three years that is a staggering 115 percent annualized ROI. Over five years that's almost 60 percent. Still pretty high, but these are risky investments, and Angels should be rewarded for taking that risk.

As we have said before, virtually all research references state that Angels should get 5X-to-20X return. Most seem to say that 10X is realistic and so that should probably be considered a reasonable "best-practice" number.

To see how this works in action, try the ROI calculator at

http://www.moneychimp.com/calculator/discount_rate_calculator.htm

The reality is that it takes time to grow a successful company. A range of 7-to-10 year exits should be considered the norm in an Angel portfolio with a few shorter-term exits in the three-to-five year range included in the mix.

Types of Exits

- Sale to a corporation, individuals, or a small group
- Merge with another corporation
- License the technology
- Franchise the company
- Take the company public

Exit Category	Method	Positives	Negatives
Sale of the company to a corporation, an individual or a small group, including current management (the leveraged buy-out or LBO)	The company is bought outright by a corporation on an all cash basis or a mixture or a blend of cash and stock	The Angel receives cash for the deal at a satisfactory multiple	As long as the multiples satisfactorily reward the Angel for the risk, there are no negatives. However, this LBO exit can require the purchasing employees to borrow funds, which for newly minted enterprises can be difficult
Licensing the technology	The technology is licensed in whole or in part on an exclusive or non-exclusive basis	The Angel receives what amounts to an ongoing royalty stream, based on his or her percentage ownership of the company	The payback for the Angel investment can be a very long and protracted process. However, if a lump-sum upfront payment can be negotiated, the Angel can still exit with a respectable multiple
Merge with a corporation	The company folds its operations into an existing entity	While the founder is compensated in cash and/or stock, the Angel generally wants cash only. One of the basic tenets of Angel investing is to redeploy profits into other ventures	Merger can fail. The cultures of the companies don't mesh, economies of scale aren't realized, and management is disillusioned. This can cause upset since the Angel has contributed time in mentoring the company to a successful exit
Franchise the Company	The business model is cloned and sold to other investors on a local, regional, national, or international basis	Angel investors could receive cash for each franchise. The existing management is retained to oversee the operation and to build out the franchise model	As with licensing, the Angel investors can experience a protracted payout period without an upfront cash payment. The founders usually require other investors to raise cash for this type of settlement

Taking the Company Public via an IPO (initial public offering, RTO (reverse take-over) or CPC (capital pool company)	The company is listed on one of the stock exchanges in Canada or the U.K. (Note: with the high cost of maintaining a listing in the U.S. and the onerous reporting demands, an American listing is not advised.)	For the Angel investor, publicly traded shares are converted to cash	As long as the escrow periods for investors are reasonable, this exit strategy is a win for Angels.

A final note regarding exits in syndicated deals comes from a recent report by the British Business Angels Association. "Exits are important," it says. " But it is important to appreciate that in very early stage companies it is difficult to identify the exit at the point of initial investment. Angels will have ideas and preferences at the beginning of when and for how much the company should exit and they will build towards that. If Angels have a difference of opinion after the investment is made, for instance if someone is looking for a quick win and another is looking for a quick return, it can create a significant headache. Each Angel within the syndicate should have a clear understanding of the common plan."

10.0 Alberta

Recent History of Angel Groups in Alberta

The Deal Generator was launched in 2002 as an initiative of the Edmonton Economic Development Corporation and has evolved into the Alberta Deal Generator in 2005 in line with a partnership agreement between non-profit entities TEC Edmonton and Calgary Technologies Inc. The Alberta Deal Generator now provides services across the province.

The Angel network operating in Calgary is currently operating as the Venture Alberta Forum and exists as a local chapter of a larger syndicate of angel groups across North America.

AVNet, the Agri Value-added Investor Network, headquartered in Turner Valley, is a private not-for-profit Angel network developed with support from Alberta Agriculture, Food and Rural Development.

Investment Climate

Overall Alberta ranks first across Canada in providing an investment climate conducive to supporting investment capital as a mechanism for economic development. Alberta is the only province to have completely eliminated corporate capital taxation and is considered a leader in the trend away from these taxes, given their high economic costs. In combination with a 10% provincial corporate income tax, the second lowest of all the provinces, Alberta's corporate tax structures are a boon to corporate growth. Alberta's government is clearly the most fiscally prudent with a budgetary surplus equal to 2.3% GDP over the past 5 years and, with the only flat-rate 10% personal income tax in Canada, Alberta stands as an attractive option for the accredited investor community.

There are three active Angel organizations operating in Alberta augmented by the activities of lone Angels and informal groups of independent Angels.

Alberta is one of only two provinces (along with PEI) that have no legislation allowing for Labour Sponsored Venture Capital Corporations. As a result, few venture capital firms are headquartered in Alberta. Those that do exist are reported to be small and largely focused on financing real estate, oil and gas, or agri-value and agri-biproducts, sectors that have traditionally not provided Angel groups with strong returns. Discussions revealed a sense that the lack of a strong venture capital community significantly hampers the Angel investment community's ability to the foster growth and expansion of technology companies due to a dearth of follow-on capital. This impression is supported by a recent Ernst & Young survey that found that the number one competitive disadvantage of doing business in Alberta is the lack of available financing, particularly for manufacturing and knowledge-based companies that are the bread and butter of most organized Angel groups.

Provincial Tax Implications

In Alberta, an "accredited investor" in relation to Angel investment activities is defined under Multilateral Instrument 45-103 as:

- an individual who, either alone or with a spouse, beneficially owns, directly or indirectly, financial assets having an aggregate realizable value that before taxes, but net of any related liabilities, exceeds $1,000,000;
- an individual whose net income before taxes exceeded $200,000 in each of the two most recent years or whose net income before taxes combined with that of a spouse exceeded $300,000 in each of the two most recent years and who, in either case, reasonably expects to exceed that net income level in the current year, or;
- a person or company, other than a mutual fund or non-redeemable investment fund, that, either alone or with a spouse, has net assets of at least $5,000,000, and unless the person or company is an individual, that amount is shown on its most recently prepared financial statements.

Investment Structures Employed by Albertan Angel Groups

The Alberta Deal Generator operates under an agreement with the securities commission that allows them to collect a 2% success fee with no carry. Under the agreement, the Angel group management is permitted to provide counsel and coaching to companies up to the time of their presentation to the group, but is expressly prohibited from participating in any further marketing of the opportunity or in the follow-on due diligence process and closing of the investment.

As evident across the western provinces there are two camps surrounding equity investment structures. Those Angels with strong entrepreneurial backgrounds within the technology sector tend to advocate for common equity, while many others insist on preferred share structures.

Convertible debt is not often employed but seems to be viewed favourably. Due to the lack of a strong venture capital community to provide for the follow-on capital requirements of Angel-backed companies, it is relatively common for Angel groups to provide multiple rounds of financing to their portfolio companies. In such circumstances, existing investors will frequently set up a convertible debt structure to support their original equity investment.

Voting trusts are not routinely employed among Angel investments though there are reports of frequent syndication between Angel groups, as well as between Angel groups and independent Angels.

Emerging Best Practices

Angel groups in Alberta are led by paid managers with experience in the investment process, an operational structure that has emerged over recent years as a best practice across North America in that it seems to provide an easier path for the Angel members. The manager's role in these groups is not just restricted to the up-front work of sourcing and screening investment opportunities, coordinating member events, and managing member communications, as their professional capabilities reflect an ability to coach companies on their presentations. It was noted though, that it would be extremely useful to have the resources (time and funding) to provide potentially investable companies that are too early stage for Angel funding with connections to the management expertise and mentorship available within the groups membership and the larger community.

Under the constraints imposed by the securities commission, the Alberta Deal Generator manager handles all of the details so the members are able to focus their efforts on investment due diligence and structuring the investments. In the course of the investigation leading to the development of this document, it was reported that the inability to facilitate the due diligence effort following the companies presentations was a limiting factor in closing investments. As seen in many regions, it is often difficult to recruit Angel group members to champion a due diligence effort. Without the capability to provide support in the completion of investor due diligence, negotiations and closing, it is simply too easy for potential investments to fall apart due to loss of momentum.

Venture Alberta Forum exists as a chapter of a larger syndicate of Angel groups across North America and thus is the only Angel group in the province without a geographic or sector focus.

Angel groups across Alberta have adopted the policy that members make their own individual investment decisions, combining their efforts towards due diligence, and investing under a single set of terms. This investment structure reflects the typical investor's need for control over his or her investment capital and is widely accepted as a best practice among Angel groups across North America.

The Deal Generator has enjoyed substantive and ongoing support from government agencies and local non-profit entities serving the entrepreneurial communities. Though the Angel groups themselves have dedicated managers and operate under their own Board of Advisors or Directors, their relationships with these external organizations permits them inexpensive and efficient access to resources and facilities. Discussions revealed strong support for the sponsorship/partnership model as the affiliation with established entities within the community provided the Angel group with credibility with investors, companies and potential sponsors from the outset of operations.

The organized Angel groups in Alberta require that members be accredited investors but varied from group to group in their requirement for members to participate actively through the investment of their own funds. There were also differences in how members were charged for membership with the Deal Generator reporting that there was no fee associated with membership. This group focused on cost recovery from entrepreneurs who pay a fee to present plus the 2% success fee for any monies raised from the group.

Alberta Angel groups differed in their practices of surrounding meeting structures but all maintain a policy of promoting only pre-screened companies. Managers ensure the companies selected through the screening process do receive coaching in advance of the meeting to ensure they fully understand the process, are prepared for questions likely to arise during the Q&A, and make the best possible first impression. The Deal Generator further revealed that maintaining a schedule of early morning meetings served as an effective means of discouraging the participation of individuals whose primary focus was on networking as opposed to identifying potential investment opportunities.

10.1 British Columbia

Recent History of Angel Groups in British Columbia

Vantec (Vancouver Angel Technology Network) was launched in 1999 under the guidance of Mike Volker, a Simon Fraser University Industry Liaison Officer and active Angel along with the late Al Fowler an Industry Liaison Officer for UBC. With administrative support from sponsor Vancouver Enterprise Forum, a local non-profit networking association for technology entrepreneurs, and facilities provided for their monthly meetings by the Simon Fraser University TIME Centre, Vantec continues operations as an independent, largely volunteer-run non-profit organization.

The Vancouver-based Angel Forum was founded in 1997 by Bob Chaworth-Musters as an independent non-profit organization. The Forum operates as a bi-annual event for entrepreneurs seeking start-up and growth capital to connect with an exclusive investor audience. Although Western Diversification and BDC have participated in the Angel Forum as event sponsors, this Angel organization operates without the support of government or external non-profit assistance.

The Okanagan Angel Network was launched in Kelowna in 2002 with the support of the Okanagan Science and Technology Council. Following the Vantec model, the organizers of the Angel Network are volunteers.

In the course of preparing this document, several independent references were made regarding the planning of a forth angel group in Victoria. Discussions revealed that the relatively high population density and relative wealth of the area would seemingly make the island the next logical location for a regional Angel group; though concerns were voiced that local accredited investors may reflect a population of older, more risk-adverse capital.

Provincial Investment Climate

Overall British Columbia ranks second only to Alberta in providing an investment climate conducive to supporting investment capital as a mechanism for economic development. This is a notable change for a province, which as recently as 2000 was openly criticized for its hefty taxes and unfriendly business climate. The success of new tax credits and structures serves as a valuable example to policy-makers across Canada.

British Columbia currently maintains the second lowest personal income-tax rate across Canada. The province has recently eliminated the non-financial corporate tax, and at 12%, the provincial statutory corporate income-tax rate is also considered low relative to other provinces. Overall, the provincial government is considered one of the most fiscally prudent across Canada with a budgetary deficit equivalent to only 0.8% of GDP over the past 5 years.

Deemed largely as the result of favourable tax credits that support private investor activity there are three active Angel organizations operating in British Columbia augmented by the activities of lone Angels and informal groups of independent Angels. There is also a plethora of friends and family financing into privately held companies across the region. British Columbia's tax credit to resident investors who invest in registered venture capital funds is also considered directly responsible for the robust and active venture capital industry by Canadian standards. There are reportedly three or four seed and early-stage funds in operation.

Provincial Tax Implications

In British Columbia, an "accredited investor" in relation to Angel investment activities is defined under Multilateral Instrument 45-103 as:

- an individual who, either alone or with a spouse, beneficially owns, directly or indirectly, financial assets having an aggregate realizable value that before taxes, but net of any related liabilities, exceeds $1,000,000;
- an individual whose net income before taxes exceeded $200,000 in each of the two most recent years or whose net income before taxes combined with that of a spouse exceeded $300,000 in each of the two most recent years and who, in either case, reasonably expects to exceed that net income level in the current year, or;
- a person or company, other than a mutual fund or non-redeemable investment fund, that, either alone or with a spouse, has net assets of at least $5,000,000, and unless the person or company is an individual, that amount is shown on its most recently prepared financial statements.

The British Columbia Equity Capital Program has been successfully implemented to encourage equity investment in eligible small businesses. To mitigate some of the risk involved in making early-stage equity investments, the Province provides a 30% refundable tax credit to investors who invest in eligible small businesses under the program. It has been reported that this BC private tax credit collected over $1.30 in payroll, income and sales taxes for each $1.00 of tax credit, and the payback period on tax credits was 2.8 years. The program is credited with facilitating significant economic activity both within and outside of the Greater Vancouver area. The program has also created new jobs and provided more corporate and individual income taxes to the provincial government, which pays for the cost of running the program.

To qualify for the tax credit, a small business must meet the following requirements to qualify as an 'eligible small business' under the program:

- together with affiliates, have no more than 100 employees;
- pay at least 75% of the wages and salaries to employees who regularly report to work in British Columbia; and
- be substantially engaged in a one of the five qualifying activities:

1. Manufacturing, processing or export of value-added goods produced in British Columbia;
2. Destination tourism;
3. Research and development of proprietary technology;
4. Development of interactive digital new media product; or
5. Community diversification outside of the Lower Mainland and the Capital Region.

Another government initiative that has greatly mitigated risk to the angel investor is the Provincial top-up for the Federal Scientific Research and Experimental Development (SR&ED) program. Although this program has not received wide acclaim, the resultant 68% credit, provided to all companies from British Columbia who successfully apply for SR&ED credits without the need for further paperwork, also serves as an effective measure to support the development and commercialization of new technologies.

Investment Structures employed by British Columbian Angel Groups

As evident across the western provinces there are two camps surrounding equity investment structures, with some favouring common and others who insist on preferred share structures. However British Columbia maintains a large and vocal contingent of entrepreneurs within the active Angel community who are strong advocates for common equity.

Convertible debt is rarely employed due to past experience with venture capitalists negotiating back the discounts in follow-on capital rounds.

Voting trusts are not routinely employed among Angel investors though there are reports of frequent syndication between Angel groups, as well as between Angel groups and independent Angels, and within formal venture capital.

Emerging Best Practices

Despite the trend toward professional management of Angel groups across North America, Vantec has set a strong president within the province of British Columbia as a highly successfully Angel organization managed largely by volunteer Angels. Both Vantec and the Okanagan Angel Network operate as dedicated non-profit corporations structured on a "sponsor model," which requires a candidate company to identify an Angel investor who is willing to assist in preparing the company to present to the Angel network and serve as a champion with the Angel participants following the presentation. This approach has been seen to be limiting by many organizations due to resultant decreases in deal-flow shown to the membership and large demand placed on the deal "champion," and has been largely abandoned by manager-led groups. Though, as a management model, it greatly reduces the logistical and promotional load normally carried by a paid manager, and has been augmented by the limited administrative assistance and facilities that have been sourced through sponsoring or affiliated non-profit organizations.

In line with their voluntary management mandate neither Vantec nor the Okanagan Angel Network collect any fees beyond a nominal "coffee fund" contribution by members. The Angel Forum, whose model is different on many levels, employs a fee structure in line with most venture capital forums, though at levels well under that industry's norms.

Also distinct from most regions, some Angel groups in British Columbia have not routinely restricted participation in investment meetings to accredited investors though reports indicate no infractions in terms of information disclosure. Formal group membership though, is restricted to accredited investors in order to ensure compliance with the Securities Commission regulations in raising capital.

Vantec, the Okanagan Angel Network and the Angel Forum all offer training and feedback to entrepreneurs prior to their investor presentations.

Angel groups across British Columbia have all adopted the policy that members make their own individual investment decisions, combining their efforts towards due diligence, and investing under a single set of terms. This investment structure reflects the typical investor's need for control over his or her investment capital and is widely accepted as a best practice among Angel groups across North America.

10.2 Manitoba

Recent History of Angel Groups in Manitoba

The WAO (Winnipeg Angel Network), which currently exists as the only organized Angel investor group in the province, was launched in 2005 under the guidance of Ken Cooper, the former president of the Winnipeg Stock Exchange. Startup operations were funded privately by the WSE Holding Corp. WAO is currently planning the launch of a small members-only sidecar fund to facilitate syndication of investments between the members.

Investment Climate

Overall Manitoba is positioned as below average among the provinces in providing an investment climate conducive to investment capital as a mechanism for economic development. Manitoba reduced its corporate income tax in July 2007 and, though further reductions are planned, remains third highest across Canada. Manitoba's government is considered to be relatively fiscally prudent with a budgetary surplus of 0.1% GDP over the past 5 years, but ranks low with respect to the attractiveness of upper level personal income tax rates, which are currently maintained at 17.4% for incomes over $65,000.

There is just one organized Angel group operating in Manitoba augmented by the activities of lone Angels as well as several informal groups of independent Angels known to pursue investment opportunities relating to specific religious or community development interests. Investigations related to the development of this report identified another Angel group, MAIN (Manitoba Angel Investment Network), which launched in association with NRC and Western Diversification in 2005 but failed to get off the ground.

Manitoba has historically provided a mix of direct investment programs and a provincial tax credit to resident investors who invest in Labour Sponsored Venture Investment Funds. However, the spectacular failure of Manitoba's Crocus Fund has ultimately resulted in few options for early-stage, high growth potential companies seeking growth capital in Manitoba and angel resources are in high demand.

Provincial Tax Implications

The Manitoba Securities Commission Rule 45-103 defines an "accredited investor" in relation to Angel investment activities as:

- an individual who, either alone or with a spouse, beneficially owns, directly or indirectly, financial assets having an aggregate realizable value that before taxes, but net of any related liabilities, exceeds $1,000,000;
- an individual whose net income before taxes exceeded $200,000 in each of the two most recent years or whose net income before taxes combined with that of a spouse exceeded $300,000 in each of the two most recent years and who, in either case, reasonably expects to exceed that net income level in the current year, or;
- a person or company, other than a mutual fund or non-redeemable investment fund, that, either alone or with a spouse, has net assets of at least $5,000,000, and unless the person or company is an individual, that amount is shown on its most recently prepared financial statements.
- Manitoba is planning to broaden its existing Community Enterprise Development Tax Credit, which after January 1, 2008 is expected to include a new 30% non-refundable income tax credit for individuals and corporations who invest directly in emerging enterprises. The announcement of this program is expected in November 2007 to coincide with the release of the new provincial budget.

Investment Structures

The Winnipeg Angel Group model supports independent investing. There is no structure in place to actively promote collaboration in due diligence and deal syndication between members, and the group does not require members to report on any investments made. As a result, though members report that a couple of syndicates may have been formed within the group, there is no hard data available. No typical or preferred investment structures have prevailed.

Emerging Best Practices

The Winnipeg Angel Group operates as a non-profit, web-based confidential network led by a part-time manager who receives a periodic management fee. The organization was designed as an inexpensive delivery mechanism for the online distribution of screened deal flow to accredited investor members. Although it has been anticipated that the new provincial tax incentives could lead to increased Angel activity, and potentially a demand for a regular program of scheduled events, the group has intentionally remained loosely structured. WAO values member independence is over team involvement.

Investment proposals submitted to WAO receive a preliminary screening to ensure those that are clearly not qualified are removed. Those companies that do pass the initial screen are then charged a nominal circulation fee and their proposal is made available to the Angel membership for review. Companies who receive interest from one or more members are provided with the opportunities to meet with those interested parties as a group. While the WAO manager facilitates the meeting arrangements, there is no active participation in the meeting and investors are left to follow through with the due diligence process and investment closing on their own.

WAO membership is offered for a small fee at both corporate and individual levels. Accredited investors are asked to pay an additional fee to receive investment proposals directly.

Recent History of Angel Groups in Saskatchewan

10.3 Saskatchewan

SAINT (Saskatchewan Angel Network), which exists as the only organized Angel investor group in the province, was launched in 2006 as an initiative of Saskatchewan Advanced Technology Association (SATA). SAINT is currently in the process of establishing their organization as a separate and distinct non-profit organization under control by its own Board with funding assistance provided by NRC-IRAP.

Investment Climate

Overall, Saskatchewan is well positioned among all the provinces in providing an investment climate conducive to investment capital as a mechanism for economic development. Saskatchewan's corporate income tax of falls squarely in the middle but the province dramatically reduced its use of corporate capital taxes in 2006 bringing its ranking to third among all the provinces. Saskatchewan is not considered particularly fiscally prudent with a budgetary deficit of 0.6% GDP over the past 5 years but ranks third among the provinces with respect to the attractiveness of upper level personal income tax rates, which are currently maintained at 15% for incomes over $107,367.

There is just one Angel organization operating in Saskatchewan augmented by the activities of lone Angels and informal groups of independent angels.

Saskatchewan has historically provided a mix of direct investment programs and a 20% provincial tax credit to resident investors who invest in Labour Sponsored Venture Investment Funds. This has resulted in a relatively robust venture capital industry by Canadian standards. However, there are no venture capital firms reported to operate in the seed and early commercialization space outside of the agri-value and agri-biproduct sectors which have not typically provided Angel investors with strong returns.

Provincial Tax Implications

In Saskatchewan, an "accredited investor" in relation to Angel investment activities is defined under the Saskatchewan Securities Act, National Instrument 45-106 as:

- an individual who, either alone or with a spouse, beneficially owns, directly or indirectly, financial assets having an aggregate realizable value that before taxes, but net of any related liabilities, exceeds $1,000,000, or;

- an individual whose net income before taxes exceeded $200,000 in each of the two most recent years or whose net income before taxes combined with that of a spouse exceeded $300,000 in each of the two most recent years and who, in either case, reasonably expects to exceed that net income level in the current year.

One government initiative with great potential to mitigated risk to the angel investor is a 15% top-up as a non-refundable tax credit for research and development expenditures qualified under Federal Scientific Research and Experimental Development (SR&ED) program. Saskatchewan also allows expenditures related to research and development to be directly deducted from taxable corporate income.

Investment Structures

SAINT operates under an agreement with the provincial securities commission which permits the organization to collect a $200 application fee from companies seeking equity investment capital, as well as a 1% success fee with no carry. Under the agreement, the Angel group management is expressly prohibited from deal screening, or participation in any further marketing beyond the presentation of an opportunity at a scheduled investment forum. They are further prohibited from providing assistance or services towards investor due diligence process and closing of the investment.

Distinct among the western provinces, though in line with most groups across North America, Saskatchewan investors favour preferred share structures, though circumstances that justify common equity investments are seen occasionally. Convertible debt is rarely seen.

Voting trusts are not routinely employed among Angel investments though recent deals have specified rights to a dedicated signatory for the Angel syndicate. It was reported that syndication between Angel groups, as well as between Angel groups and independent Angels was routine.

Emerging Best Practices

In its newly acquired role as an independent entity, SAINT has expressed its intention to secure a dedicated manager.

Under the constraints imposed by the securities commission which specifically prohibits deal screening, all company submissions are made available to the entire membership. The recent adoption of Angelsoft software has provided, among other features, a standard template to applicant companies and has greatly eased the burden on the membership in reviewing submitted deal flow.

SAINT has adopted the policy that members make their own individual investment decisions, combining their efforts towards due diligence, and investing under a single set of terms. This investment structure reflects the typical investor's need for control over his or her investment capital and is widely accepted as a best practice among angel groups across North America.

SAINT requires that members be accredited investors and charge a modest annual membership fee. The group has not operated on a fixed annual schedule, preferring to meet when qualified companies are available to present. Investment meetings to date have involved video conferencing to enable simultaneous participation by investors located in both Regina and Saskatoon, but this system has proven expensive. Future meetings featuring the same presenting companies are planned to be held separately in each city.

Negotiation FAQ

Who should negotiate the term sheet?

Each side should have only a single negotiator who has authority to make decisions. On the company side, the CEO is almost always the obvious person (if the CEO cannot conduct the negotiation, then they should not be the CEO). On the Angel side, it could be the person who will eventually sit on the board, a person who has particular expertise at negotiation, or perhaps the person who is investing the most money. The key is to ensure that this person keeps everyone else in the loop, but OUT of the actual negotiations.

What is the most important issue that affects the negotiation?

Negotiating power and BATNA is far and away the most important issue. If the entrepreneur has multiple offers they will get a better deal with a higher valuation. If the entrepreneur has positive cash flow, they can afford to continue to seek a better deal. If the entrepreneur has no other financing options and is running out of cash, then they will get a worse deal with a lower valuation.

Which deal terms are the most important to each party?

There are a number of important terms that are entirely reasonable and uncontroversial. Excessive negotiation over terms like drag-along and tag along, right of first refusal and giving up a board seat should be viewed as a red flag. Every deal is different, but in general the most important terms to the investor would be deal structure, weighted average anti-dilution, valuation and board seats. The most important terms for the entrepreneur would be valuation, amount of money raised, control, size of the option pool and management compensation.

Are there any deal terms an Angel should avoid?

Asking for full ratchet anti-dilution and anything more than 2X liquidation preference would normally be considered negotiating in bad faith. You should avoid proposing such terms, even if you plan to use these as "throw away" clauses that you concede on later. Don't throw out an anchor that is not fair and will damage the relationship.

How much pre-negotiation should occur prior to the draft term sheet being issued?

There is really no such thing as "pre-negotiation". Early exploratory discussions and relationship building meetings are a vital part of the negotiation process.

You want to drop the term sheet anchor only once you think your anchor is close to the terms that may be acceptable. You should have a series of broad-based informal discussions to determine whether convertible debenture, preferred shares, or common shares make the most sense and have a feel for which terms will be acceptable or not.

You should normally leave room for additional negotiations after the term sheet is issued, but often the real negotiations (brainstorming, finding common ground, building the relationship…) have already taken place.

Are any deal terms non-negotiable?

Virtually every aspect of the deal terms is open to negotiation. Although NAO has developed suggested best practice guidelines for large investments and preferred share structures, these really form the starting point in the negotiations and provide structure to the discussions.

Everything is negotiable. Many terms, however, are so standard that there is little reason to discuss them except for clarification (such as drag-along and tag-along rights and right of first refusal). If there are any terms that someone feels strongly enough about that they could be considered deal-breakers, then this should be clarified early in the negotiation. Be prepared for deal-breakers to break deals (or cause some members of the syndicate to drop out).

Keep in mind that most entrepreneurs will want to negotiate a "better" deal than the one initially offered. Nobody likes the first offer to be presented as a "take-it-or-leave-it". Leave some wiggle room in the opening offer and stay flexible.

It is possible that some Angel groups may choose to adopt a policy of non-negotiation over deal terms. In these cases, you need to do a lot more pre-negotiation (which of course then becomes the actual negotiation) before issuing a term sheet. If this is the stated policy of the group, then be sure that the entrepreneurs know this in advance or they may be offended by this tactic.

What are the stages of negotiation and milestones involved?

Every deal is different and the prior experience of both parties and level of negotiating power will affect everything. Closing a deal should take 3-6 months. Some of the activities and milestones may include the following:

- Entrepreneur makes the formal Investment Presentation to the Angel group after being carefully screened. (Milestone)
- Angels who are interested in the deal conduct preliminary due diligence which may include visits to the facility, meetings with the management team, reviewing additional information, and meeting with various board members. Some amount of negotiation occurs to ensure that the valuations are within range and determine which deal structure is appropriate. (2-4 weeks)
- Angels who are committed to the deal appoint a lead negotiator. (Milestone)

- The negotiators have a series of face-to-face meetings and confer with legal counsel and colleagues to negotiate acceptable term sheet conditions. At some stage a Draft Term Sheet is issued by the Angel group (2-6 weeks).
    - Agree to basic principles and fair practices
    - Set a series of scheduled meetings
    - Discuss interests and brainstorm options for mutual gain
    - Trial balloons and feedback
    - Dinner and lunch meetings in addition to negotiation meetings
    - Narrow down range of potentially acceptable alternatives
    - Agree to tentative term sheet terms to be proposed to all stakeholders
    - Obtain final buy-in and approval from stakeholders
- Both parties sign the final term sheet. (Milestone)
- Formal Due Diligence Period (4-8 weeks)
- Both parties sign the final term sheet. (Milestone)
- Formal Sign-Off on Due Diligence (Milestone)
- Lawyers draft the formal agreements (4-8 weeks concurrent with Due Diligence Period)
- Various iterations of subscription, shareholder, option agreements, reps and warrants…
- All parties sign all formal agreements (Milestone)
- Closing Date (Milestone)

Fig. 1 – Sample Accredited Investor Declaration

I, ____hereby declare that:

As a resident of Canada:

- I alone, or together with my spouse beneficially own assets that have an aggregate realizable value exceeding C$1 million (excluding the principal residence, before taxes but net of liabilities); or
- My net income before taxes exceeded C$200,000 in each of the two most recent calendar years or my net income before taxes combined with that of my spouse exceeded C$300,000 in each of the two most recent calendar years and, in either case, we reasonably expect to exceed that net income level in the current calendar year; or
- My company, limited partnership, trust or estate, other than an individual or investment fund, has net assets of at least C$5million as shown on its most recently prepared financial statements; or

As an investment representative of a Canadian Venture Capital Fund:

- My investment fund distributes or has distributed securities under a prospectus.

Or as a resident of the United States of America:

- I alone, or together with my spouse have a net worth exceeding US$1million; or
- My individual income exceeded US$200,000, or my joint income with my spouse exceeded US$300,000, in the previous two calendar years and we reasonably expect to reach the same income level in the current calendar year
- My corporation, partnership, limited liability company or other organization described in Section 501(c)(3) of the United States Internal Revenue Code, or Massachusetts or similar business trust, not formed for the specific purpose of acquiring the LP Units, with total assets in excess of US$5million.

AND I MAKE THIS DECLARATION knowing that it is a pre-condition to my acceptance as an attendee of any Angel investment event.

DATED this ____________ day of _______________________________, 2007.

SIGNATURE ____

Fig. 2 – Sample Group Membership Application

The annual membership fee for 2007 is $XXX per individual plus GST. Once accepted there is a nominal fee of $XXX (Plus GST) for each Investment Dinner you attend.

All members are subject to the following terms:

- Each Angel member must meet the criteria for Accredited Investor status as defined by the Ontario Securities Commission:

  (i) I am an active independent equity investor in privately held companies.

  (ii) I alone, or together with my spouse, beneficially own assets that have an aggregate realizable value exceeding C$1 million (excluding the principal residence, before taxes but net of liabilities); or

  (iii) my net income before taxes exceeded $200,000 in each of the past two years, and I have a reasonable expectation of exceeding that net income level in the current year; or

  (iv) my net income before taxes, together with that of my spouse, exceeded $300,000 in each of the past two years, and we have a reasonable expectation of exceeding that combined net income level in the current year;

- Each Angel Member must pay the annual membership fee and the individual dinner fees by personal credit card, personal cheque, or personal holding company cheque. No corporate cheques will be accepted.
- Each Angel Member is required to disclose their individual investment activities to the Membership. This information is confidential and will be treated as such. Members only invest in those opportunities that appeal to them individually. Members may invest in all or none of the opportunities presented, and of course are free to invest elsewhere.
- Each Angel Member is required to declare any involvement with companies brought to the group for consideration.
- Members are expected to be active individual investors. Members' investment activity will be reviewed annually as a consideration for renewal.
- Each Angel Member agrees to release their contact information for inclusion in the roster to be provided to the Membership for the purpose of facilitating their private investment activities. Distribution of the roster or solicitation of services will prompt immediate dissolution of membership. Offending members will forfeit any fees (membership or otherwise) paid. Appeals can be made to the Membership committee.

Name: ____________________

Title: ____________________

Company: ____________________

Address: ____________________

City/Prov/PC: ____________________

Office: ____________________

Cell: ____________________

Residence: ____________________

Fax: ____________________

E-mail: ____________________

Web Address: ____________________

Assistant Name: ____________________

Assistant's Email: ____________________

1) List your individual investment activities in privately held companies over the past 24 months (company name, amount you invested, total size of round):

2) Outline your relevant operational experience:

   - experience in growing companies (from 4 to 200 employees or from zero to $100m in annual revenues, etc.)
   - management role (CEO, CFO, etc.)
   - relevant specific knowledge (international markets, distribution, etc.)

3) Outline your relevant deal knowledge:

   - experience in raising capital, negotiating financings, shareholders agreements, M&A, IPO etc.

4) Preferred individual investment size per deal:
    - ($50k - $100k), ($100k- $200k), ($200k- $500k) or (> $500k)
5) Preferred stage of investment:
    - (seed, start-up or later stage)
6) Preferred investment sectors:
7) Preferred involvement level with investee companies:
    - (Passive, Board Member, Operational Role)
8) Sectors in which you would not consider investing (ex. Oil & gas, mineral exploration, real estate):

*Attachment of your resume or CV would be very much appreciated.

Fig. 3 – Summary of Administrative and Management Functions

Summary of Administrative and Management Functions

	Assignment			Comments
	Members	Administrator	Other	
ADMINISTRATIVE				
Member Meetings				
Drafting of the agenda				
Forwarding of agenda and supporting materials				
Follow-up on meeting RSVP's				
Coordinating meeting arrangements at meeting venues				
Preparation of meeting materials				
Chairing of the meeting				
Tracking proxies / recording votes				
Taking and transcribing of minutes				
Other Meetings (screening, executive committee, audit etc.)				
Meeting scheduling				
Drafting of the agenda				
Forwarding of agenda and supporting materials				
Follow-up on meeting RSVP's				
Chairing the meeting				
Taking minutes				
Coordination & tracking of follow-up on action items				
Miscellaneous				
Developing operating document templates (checklists, report templates)				
Custody of Member records				
Creation and preparation of special reports and summaries				
Communications				
Website creation				
Website updating and maintenance				
Posting information to members-only website				
Dissemination of general information to Members				
Public Relations				
Responding to press inquiries				
Press releases				
Preparation and updating of collateral materials				
Public speaking engagements				
Public representation of the organization				
Networking				
Participation in Angel investment organizations (ACA, state organizations, etc.)				
Participation in Economic Development organizations				
Building relationships with other angel investment organizations				
Building relationships with VCs				
Building investment referral relationships				
Legal				
Primary liaison with organization's legal counsel				
Maintenance and updating of legal documents				
Coordinating resolution of legal questions and issues				

Drafting of resolutions and amendments to legal documents				
Custody of organizations legal records				
Legal signature authority				
Other				

	Assignment			Comments
	Members	Administrator	Other	
FINANCIAL				
Bookkeeping and Accounting (Organization)				
Set-up of bookkeeping system				
Invoicing				
Posting of receipts and payments				
Bank reconciliation				
Preparation of financial statements				
Review of financial statements and resolution of discrepancies				
Preparation of periodic member financial statements				
Bank signature authority				
Audit				
Solicitation and selection of audit firm				
Liaison with auditor during field work				
Review of the draft audit / analysis and resolution of audit questions				
Taxes and K-1s				
Ensuring timely receipt of K-1s from portfolio companies				
Management of the tax preparation process				
Liaison with the tax accountant				
Review of tax return and resolution of discrepancies				
Other				

	Assignment			Comments
	Members	Administrator	Other	
DEAL FLOW AND INVESTMENTS				
Intake and Screening				
Active deal prospecting				
Initial review of investment inquiries				
Communication with inquiring companies				
Assuring that minimum documents are provided				
Advice and assistance to companies in preparation on presentation material				

Scheduling and coordination of screening meetings				
Dissemination of information to Members involved in screening process				
Participation in screening meetings with companies				
Tracking of the status of prospect companies				
Selection of presenting companies				
Coordination of company presentation to Members				
Evaluation and Due Diligence				
Recruitment of team members				
Leadership of the evaluation/due diligence effort				
Coordination of team meetings and conference calls				
Dissemination of documents to team members				
Review and analysis of business plan and supporting documents				
Market research				
Background checks and reference calls				
Economic analysis of the investment				
Drafting of the evaluation/due diligence report and supporting documents				
Responding to Member questions				
Investment Structuring				
Drafting of the investment term sheet				
Negotiation of term sheet with company				
Execution of Letter of Intent				
Closing				
Liaison with legal counsel in preparation of investment documents				
Negotiation with company on final documents				
Execution of the investment documents				
Financial				
Solicitation of Member investment commitments				
Collection of Member funds				
Disbursement of investment funds				
Miscellaneous				
Communication with company when decision is made to not invest				
Drafting of legal documents related to the investment group				
Other				

	Assignment			Comments
	Members	Administrator	Other	
PORTFOLIO COMPANY MANAGEMENT				
Maintenance of legal records				
Monitoring of company progress				
Reporting of company status to Members				
Assuring receipt and distribution of company financials and other				

Assuring receipt and distribution of company financials and other information				
Participation / attendance at company Board meetings				
Providing company with advice and assistance				
Resolution of investor-company issues				
Tracking of key dates				
Granting of approvals related to investor rights				
Other				

Fig. 4 – Sample Term Sheet

The standard term sheets of fifteen long-standing Angel investment groups and the NVCA sample term sheet was used to develop the an initial template which was then refined in consultation with Ontario Angels, lawyers, venture capitalists and brokers. The resulting document reflecting local best practices is recommended for use as a basis for negotiations with entrepreneurs. (Notes and comments appear italicized and bracketed.)

Summary Terms for Series A Preferred Stock

Company:	[Insert: Full Legal Name of the Company] (the "Company")
Summary:	This term sheet summarizes the terms proposed for an investment by [Insert name of Angel Group], a group of investors (the "Investors"), in the Company. It is intended solely as a basis for further discussion and does not constitute a legally binding obligation.
Investors:	All Investors are Accredited Investors.
Currency:	Canadian Dollars
Closing:	On or about [Insert Date] As soon as practicable following the Company's acceptance of this Term Sheet and satisfaction of the Conditions to Closing (the "Closing"). (*Provide for multiple closings if applicable*).
Amount:	Minimum Investment to close is $[Insert]
Total Securities Offered:	Maximum [Insert] preferred shares
Price:	$[Insert] per preferred share (the "Original Purchase Price")
Valuation:	$[Insert] pre-money valuation, fully diluted, the total number of shares to include an unallocated employee pool of at least 20% of the total, in addition to founders' shares.
Use of Proceeds:	The Company will use the proceeds from the Financing for the following purposes: [Insert brief description here, include a more detailed table in an Appendix if required]
Dividends:	The Series A Preferred will be entitled to an annual per share dividend equal to 10% of the Purchase Price, payable when, as and if declared by the Board of Directors of the Company. Non-cumulative dividends as declared. Series A Preferred Stock to participate in all dividends declared

on an “as converted” basis. No dividends payable on Common Stock or any other Class of Preferred without payment of similar and all accrued dividends to the Series A Preferred Stock.

(*Dividends typically fall within 7% to 10% of the original purchase price and are not cumulative*)

Liquidation Preference: In the event of any liquidation, dissolution or winding up of the Company, the Investors will be entitled to receive for each share of Series A Preferred, prior to any distribution to the holders of Common Stock, an amount equal to 100% of the Original Purchase Price plus all accumulated but unpaid dividends thereon. Any remaining proceeds to be shared pro rata among stockholders.

If the Company has insufficient assets to permit payment of the Preference Amount in full to all holders of Series A Preferred, then the assets of the Company will be distributed ratably to the holders of Series A Preferred in proportion to the Preference Amount each such holder otherwise would be entitled to receive.

A merger or consolidation of the Company in which its shareholders do not retain a majority of the voting power in the surviving corporation, or a sale of all or substantially all the Company’s assets, each will be deemed to be a liquidation, dissolution or winding up of the Company.

(*The liquidation preferences provide the Angel investor with first rights to any proceeds held by the company in the event the company fails. As drafted, this provision provides the Preferred shareholders reimbursement of the amount of their original investment plus their accumulated dividends, with any remaining funds being made available to the Common shareholders*.)

Conversion: Series A Preferred Stock converted on a one-for-one basis into Common Stock unless conversion rate is subject to anti-dilution adjustment. Mandatory conversion of Series A Preferred Stock on closing of underwritten public offering at an initial price to the public at a valuation of at least $25 million and gross proceeds the Company of at least $15 million.

(*The purpose of Conversion is to simplify the company’s capital structure for an IPO*.)

Anti-Dilution: Weighted average to any lower price in any subsequent round of financing.

(*To protect against dilution upon conversion of the preferred shares anti-dilution provisions will adjust the conversion price of the preferred shares to allow the Angel investor to receive a greater number of common shares upon conversion. In the event that the Company issues additional securities at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be adjusted in accordance with the following formula:*

***Alternative 1**: "Typical" weighted average: CP2 = CP1 * (A+B) / (A+C)*

CP2 = New Series A Conversion Price

CP1 = Series A Conversion Price in effect immediately prior to new issue

A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)

B = Aggregate consideration received by the Corporation with respect to the new issue divided by CP1

C = Number of shares of stock issued in the subject transaction]

***Alternative 2**: Full-ratchet – the conversion price will be reduced to the price at which the new shares are issued.*

***Alternative 3**: No price-based anti-dilution protection.)*

Voting Rights: Equal to common equivalent shares. Investors in Series A Preferred Stock, voting separately, to elect one (1) Director of 5 person Board of Directors.

Board Seat: The Investors shall be entitled to appoint one member as Voting Trustee to the Company's Board of Directors.

Redemption: Required offer of redemption in equal instalments beginning on the fifth anniversary of the Initial Closing at an effective compound rate of return of 10% per annum plus accrued but unpaid dividends. Voting rights to elect majority of Directors and 10% cumulative dividend if failure to redeem.

(*Companies will typically resist Redemption clauses and the implementation of redemption rights should always be as a last resort when no liquidity options (IPO or Acquisition) are present and there is no other means for the investors to cash out.*)

Information Rights: The Company will deliver to shareholders:

1. Audited financial statements or Reviewed (as determined by investors) for each fiscal year within 90 days after the end of the fiscal year and management-prepared quarterly financial statements for the first three quarters of the year within 30 days after the end of each quarter.

2. Annual budgets at least 30 days prior to the beginning of each fiscal year.

3. Quarterly updates on progress and accomplishments and anticipated progress against target in next period.

4. Notification of any material defaults or litigation; and any other information reasonably requested.

5. The voting trustee also will have standard inspection and visitation rights.

The foregoing rights will expire at the date the Company completes its Qualified IPO and the Company has no outstanding obligations to investors.

Right of First Refusal on Sales by the Company: Investors will have a right to maintain their pro rata interest in the Company on a fully diluted basis in any subsequent offering of securities other than a public offering.

Right of First Refusal on Sales by Founders and Co-Sale Rights:	Investors will have a 30 day right of first refusal to purchase a proportional part of shares offered for sale by founders and management of the Company ("Founders"), if management wishes to sell stock before an initial public offering, or if Investors so choose, have the right to sell a proportional part of their holdings along with Founders or management before an initial public offering.
Follow-Along Rights:	Investors will have the right to sell a proportional part of their holdings if management sells before initial public offering.
Drag-Along Rights:	The holders of the Common or Preferred Stock shall enter into a drag-along agreement whereby if a majority of the holders of Series A Preferred Stock agree to a sale or liquidation of the Company, the holders of the remaining Preferred and Common Stock shall consent to and raise no objections to such sale.
Negative Covenants:	Consent of holders of two-thirds of Series A Preferred Stock required for merger, dissolution, sale of substantially all assets, dividends on common stock, amendments to certificate of incorporation and by-laws, etc.
Non-competition and Non-solicitation Agreements:	In addition to standard confidentiality/developments agreements, key employees to execute agreements not to compete with or solicit employees of the Company or its subsidiaries, directly or indirectly, for one year after termination of employment.
Vesting:	Stock and options issued to employees, independent directors and consultants would be subject to vesting/repurchase over 4 years. At least 75% of each Founder's shares would be subject to 3 years of vesting.
Costs and Expenses:	Fees of a single counsel representing all investors of the Angel group participating in this round estimated at $[Insert], and their reasonable expenses will be borne by the Company unless the transaction is not completed because the Investors withdraw their commitment without cause.
Agreement:	This investment will be made pursuant to a definitive purchase agreement and related documents which will contain customary representations, warranties, covenants and indemnities, which are

mutually acceptable. Except for the confidentiality provisions of this term sheet, binding obligations will be created only by the definitive purchase agreement.

Conditions of Closing:

1. Completion of a satisfactory due diligence investigation of the Company and its legal affairs by the Investors.
2. The execution and delivery of definitive documents to include standard disclosure schedules, representations and warranties, in form and substance satisfactory to the Investors and the Company.
3. The absence of any material change in the business of the Company.

(*other material conditions as appropriate on a case by case basis*)

Signatures:

Fig. 5 – Sample Shareholder's Agreement

The terms of a shareholder's agreement are based on the successfully negotiated terms as laid out in the term sheet. We have developed this sample agreement from sources available online with reference to agreements related to a representative sampling of local Angel investments.

Summary Terms for a Shareholder's Agreement

THIS AGREEMENT made as of the ____ day of [], 200[].

A M O N G:

[Insert: Investor], ("Shareholder")

- and -

[Insert: Full Legal Name of the Company] (the "Company")

(Collectively the Company and the Shareholder are the "Parties").

WHEREAS the Shareholders, as of the date hereof, are the registered and beneficial owners of [Insert: total number of shares of the investors group] the issued and outstanding shares in the capital stock of the Company, a company formed under the laws of the Province of Ontario;

AND WHEREAS the Shareholders have agreed to appoint the Voting Trustee as the Shareholders' voting trustee on the terms and conditions hereinafter contained;

AND WHEREAS the shareholders wish to enter into this Agreement for the purpose of restricting the transfer of shares in the capital stock of the Company, and regulating certain other matters in connection with the business and affairs thereof and of the Company;

NOW THEREFORE in consideration of the foregoing and mutual covenants and agreements contained herein, the parties agree as follows:

Article 1. Authorized and Issued Capital: The parties hereto acknowledge that the authorized capital of the Company consists of an unlimited number of shares of the following classes:

Common

Series A preferred

of which the shares issued and the outstanding as fully-paid and non-assessable and any option to acquire shares in the capital of the Company are set out under Schedule "A."

Article 2. Defined Terms:

- "Agreement" means this agreement including all schedules and exhibits to this agreement and includes any and every agreement made at any time (whether past, present or future) which amends or supplements or restates any agreement which is, or is included in, this Agreement;
- "Articles" shall mean the articles of incorporation of the Company dated [];
- "Book Value per Share" means the book value of the equity of the Company on the relevant date divided by the number of shares on a fully diluted basis.
- "Business Day" means every day except Saturdays, Sundays and statutory holidays in the Province of Ontario;
- "Notice" shall mean an instrument in writing;

3. Term of this Agreement: This Agreement shall take effect on the date hereof and shall continue in force until the earlier of:

- the date this Agreement is terminated by written agreement of the Parties;
- the date on which there is only one Shareholder;
- the date there is an initial public offering of shares of the Company;
- the date on which all of the shares of the Company are acquired by a reporting issuer within the meaning of the Securities Act (Ontario);
- the sale of all of the shares of the Company to a third party; or
- the date on which the Company is dissolved, wound up, makes an assignment in bankruptcy or has a receiving order in bankruptcy made against it.

Article 4. Business and Affairs of the Company:

4.0 The business and affairs of the Company shall be managed by a Board of Directors. The Board of Directors shall initially consist of five directors, including (i) the CEO, (ii) One outside Director selected by the management group, (iii)1 person designated by the [Insert Angel Group name] holders of the Series A Preferred Stock (the "Voting Trustee") and (iv) two individuals knowledgeable in the industry who are not otherwise affiliated with the Company who are approved by the other two statutory directors (the CEO and the Voting Trustee). The initial Voting Trustee will be designated by the Investors during preparation of documents. Subsequently, any Director that resigns will designate a successor, subject to approval by the Investors. Three (3) directors shall constitute a quorum for the transaction of any business at any meeting of the board of directors. At all meetings of the board of directors, every motion to be carried must receive a majority of the votes cast, subject to the provisions of subparagraphs 4.4 and 4.5. Unless otherwise agreed, board meetings will be held at the head office of the Company.

4.1 In the event that the Voting Trustee of the Series A Preferred Shareholders shall fail to vote and act as a director to carry out the provisions of this agreement, then the shareholders agree to exercise their right as shareholders of the Company and in accordance with the Articles of the Company to remove such Voting Trustee from the Board and to elect in the place or stead thereof such individual who will use his/her best efforts to carry out the provisions of this agreement but only in the event that the Shareholders whose Voting Trustee has been removed fails to appoint a successor within a period of fourteen days from the date such Voting Trustee has been removed.

4.2 The election, appointment and determination of officers and the auditors and advisors of the Company, the defining of their duties and functions and the salaries and remuneration to be paid to them will be a function of the board of directors. Until changed by the board of directors, the Officers of the Company and their annual salaries shall be:

Office Held:	Name:	Annual Salary ($C):
CEO		
CFO		
And so on…		

All direct out-of-pocket expenses will be reimbursed provided these fall within guidelines set out by the Board of Directors from time to time. Until otherwise agreed, each officer of the Company will commit to spending his/her full time on the affairs of the Company.

Until changed by the board of directors, the auditors and advisors of the Company shall be:

- Auditor: [Insert]
- Legal Advisors: [Insert]

4.3 There shall be kept, in such bank or banks (including trust companies) as may be determined by the board of directors, bank accounts of the Company in which shall be deposited all monies received by the Company in the course of carrying on business from time to time. All payments on account of the Company shall be made by cheques drawn on the bank account and all cheques, drafts or other instruments drawn and made for the purposes of the business of the Company shall be executed by such directors, officers or employees as may from time to time be authorized so to do by the board of directors.

4.4 All parties who are employees of or consultants to the Company shall use their best efforts to promote and maintain the interests of the Company.

4.5 Subject to paragraph 3.6, all decisions relating to the management and control of the business of the Company shall be determined by the board of directors of the Company, provided always that the following matters shall be determined by a Special Directors' Resolution:

- any capital expenditures greater than $2,000;
- any lease commitments greater than $2,000;
- the acquisition of any business interests by the Company;
- the elections of officers of the Company;
- the payment of any cash dividends or stock dividends to Shareholders of the Company;
- the issuance of any debt obligations of the Company;
- the disposal of the whole or any part of the business, undertaking, or assets of the Company outside the normal course of business of the Company;
- the transfer of any shares of the Company;
- changes or variations in the objects or powers of the Company;
- the liquidation or winding up of the Company;
- the approval of any contracts or transactions outside the normal course of business;
- the execution of any contract involving a consideration greater than $5,000 within the normal course of business;
- the lending of money by the Company;
- the guarantee by the Company of the debts or obligations of any other person, firm or body corporate;
- any non-budgeted expenditures greater than $1,000;
- business plan and/or budgets.

4.6 The following decisions shall be determined by a Unanimous Directors' Resolution:

- alterations, variations or changes to the authorized or issued capital of the Company;
- the salaries and bonuses of officers and directors of the Company;

- the issue, redemption or purchase of any Shares; and
- changes in the number of directors of the Company.

4.7 The board of directors shall meet at least four times during each fiscal year of the Company. Any director can call a meeting provided 10 days notice is given. Notice may be waived. During the first year from the date of this agreement, the board of directors shall meet on a monthly basis. Directors may elect to attend a board meeting by telephone conference call.

4.8 Each Shareholder shall, for so long as s/he is the owner of shares of the Company devote such of his/her business, time and energy as may be reasonably required to carry on the business of the Company and the Shareholder shall use his/her best efforts, skill and abilities to promote the interests of the Company. Each Shareholder agrees that he/she will not engage, without the consent of the other Shareholders, in a business that is directly competitive to that of the Company.

4.9 The Company agrees to provide to the Shareholders

- audited financial statements or Reviewed (as determined by Investors) for each fiscal year within 90 days after the end of the fiscal year and management-prepared quarterly financial statements for the first three quarters of the year within 30 days after the end of each quarter;
- annual budgets at least 30 days prior to the beginning of each fiscal year;
- quarterly updates on progress and accomplishments and anticipated progress against target in next period;
- notification of any material defaults or litigation; and any other information reasonably requested; and
- The voting trustee also will have standard inspection and visitation rights.

4.10 The Parties agree that a Company Business Plan will be prepared and maintained on an on-going basis with at least annual reviews and updates. This Business Plan will define the operational details of the Company and will include, but not be limited to, items such as: budgets, forecasts, capital expenditures, salaries and wages, hours of operation, market information (products, services, pricing, discounts, etc). The Plan will serve the purpose of giving management direction as to the day-to-day operation of the Company.

Article 5. Right of First Refusal:

5.0 Notice of Third Party Offer: If a Shareholder (the "Transferring shareholder") receives and wishes to accept a bona fide offer from a third party who is arm's length (the "Third Party Offer") to purchase all or any portion of the shares of the Company owned by such Shareholder (the "Offered Shares"), the Transferring Shareholder shall forthwith provide the other Shareholders (the "Recipient Shareholders") with a copy of the Third Party Offer and a written notice setting forth its intention to accept the Third Party Offer.

5.1 Option of Recipient Shareholders: Upon receipt of a Notice delivered pursuant to Section 5.0 hereof, the Recipient Shareholders shall have the right, exercisable within thirty (30) days of the receipt of the notice from the Transferring Shareholder (the "First Refusal Exercise Period"), to purchase the Offered Shares from the Transferring Shareholder (such right being hereinafter called the "Right of First Refusal"), at the same price and upon the same terms and conditions as are contained in the Third Party Offer, provided, however, that each Recipient Shareholder who wishes to exercise the Right of First Refusal (each an "Accepting Shareholder") shall, within the First Refusal Exercise Period, provide the Transferring Shareholder with a written notice setting forth the number of Offered Shares it is willing to purchase. If the total number of Offered Shares set forth in such notices exceeds the actual number of Offered Shares then the sale and purchase of the Offered Shares to the Accepting Shareholders shall occur in the proportion that the number of voting shares of the Company owned by each Accepting Shareholder bears to the total number of voting shares of the Company owned by all of the Accepting Shareholders. If the total number of Offered Shares set forth in such notices is less than the actual number of Offered Shares then the Recipient Shareholders shall be deemed for all purposes to have refused to exercise the Right of First Refusal.

5.2 Effect of Exercise of Right of First Refusal: The exercise by the Accepting Shareholders of the Right of First Refusal shall be deemed to be irrevocable acceptance by the Accepting Shareholders of an offer by the Transferring Shareholder to sell all of the Offered Shares to the Accepting Shareholders at the same price and upon the same terms and conditions as are contained in the Third Party Offer, and in the proportions set forth in Section 5.2 hereof.

5.3 Effect of Failing to Exercise Right of First Refusal: If the Recipient Shareholders do not exercise the Right of First Refusal in the manner set forth above the Transferring Shareholder, subject to the provisions of Article 6 hereof, shall be at liberty at any time within thirty (30) days from the expiry of the First Refusal Exercise Period to accept the Third Party Offer, and thereafter complete the sale of the Offered Shares to the Third Party Purchaser upon the terms and conditions set forth in the Third Party Offer, provided, however, that if the sale is not completed within 180 days from the Expiry of the First Refusal Exercise Period, the Offered Shares shall again be subject to the terms and provisions of this Agreement.

5.4 Terms of Purchase and Sale: The sale and purchase of the Offered Shares pursuant to this Article 5 shall be completed at the price and on the terms and conditions set forth in the Third Party Offer provided, however, that if the third party is purchasing the Offered Shares he shall be required to become a party to this Agreement.

Article 6. Tag-Along and Drag-Along Provisions:

6.0 Trigger for Tag and Drag Along: If, following the operation of the provisions of Article 5, the Transferring Shareholder is selling the Offered Shares pursuant to a Third Party Offer then the provisions of this Article Six shall be applicable.

6.1 Tag-Along Right: Each remaining Shareholder shall have the right to require that the Transferring Shareholder cause the third party to purchase all of the shares of the Company owned by such remaining Shareholder (the "Tag-Along Shares") along with the Offered Shares (such right being hereinafter called the "Tag-Along Right"), at the same price and upon the same terms and conditions as are contained in the Third Party Offer, provided that:

a. Exercise Period: If a remaining Shareholder wishes to exercise the Tag-Along Right he must, within at least ten (10) Business Days of the expiry of the First Refusal Exercise Period, deliver a Notice to the Transferring Shareholder setting forth his intention to exercise the Tag-Along Right.

b. Effect of Exercise of Tag Along Right: The exercise by a remaining Shareholder of the Tag-Along Right shall constitute an irrevocable offer by such remaining Shareholder to sell his Tag-Along Shares to the third party at the same price and upon the same terms and conditions as are contained in the Third Party Offer.

c. The Transferring Shareholder to Request Acceptance of Tag Along Offer: If a remaining Shareholder exercises the Tag-Along Right, the Transferring Shareholder shall request that the third party deliver to such remaining Shareholder a Notice accepting the offer by the remaining Shareholder to sell his Tag-Along Shares. If the third party refuses, declines or otherwise fails to accept such offer, the Transferring Shareholder shall not be permitted to sell and the third party shall not be permitted to purchase the Offered Shares.

d. Terms of Purchase and Sale: The sale and purchase of the Tag-Along Shares shall be completed at the price and on the terms and conditions set forth in the Third Party Offer.

Article 7. Anti-Dilution Provision:

In the event that from and including [Closing Date] to and including [the “Adjustment Date” – usually 18 months from closing], the Corporation allots and issues:

1. Any of its Common Shares from treasury, other than in respect of:

    a. The Warrants;

    b. The Third Round Dilution Shares;

    c. The Down Round Dilution Shares;

    d. Any of the:

i. SOP Shares as constituted as of the date hereof; or

ii. The Other Share Option Shares as constituted as of the date hereof,

pursuant to option agreements entered into prior to [Closing Date] and at an exercise price that is less than CDN$[] Cdn. per share and which have been disclosed to the Series A Minority Shareholders in writing;

2. Any options to acquire any of its Common or Preferred Shares from treasury (other than in respect of the Warrants, the Series A Dilution Shares, the Down Round Dilution Shares) (collectively, “Options”); or

3. Any indebtedness, Shares (other than Common Shares) or other securities convertible into or exchangeable for Common Shares (collectively, the "Convertible Securities"),

   the Corporation shall, on the Adjustment Date, calculate (consistent with the principles and the numerical example set out in Schedule "D") the weighted average issue price per share of the aggregate of all such Common Share issuances or deemed issuances in the case of Options or Convertible Securities in accordance with the principles set out in Schedule "D" (whether such issuances were in cash or in kind or in services but in the case of in kind and or in services consideration, valued at fair market value). The Corporation shall forthwith communicate the weighted average issue price per share and its method of calculation (which shall be consistent with the principles and the numerical example set out in Schedule "D") to the Series A Round Minority Shareholders. In the event such weighted average issue price per share is calculated to be less than “B”, as such letter is defined in the definition of Down Round Dilution Shares per share (a “Down Round” or collectively, the “Down Rounds”), then the Corporation shall:

   a. Issue the Down Round Dilution Shares to the Third Round Minority Shareholders forthwith following the Adjustment Date against payment by the Third Round Minority Shareholders of the nominal subscription price of CDN$1.00 therefore;

   b. Adjust upward the Third Round Dilution Shares (in the event the Third Round Minority Shareholders are entitled to receive the same) by issuing additional Common Shares in an amount equal to the Down Round Dilution Shares forthwith following the Adjustment Date against payment by the Third Round Minority Shareholders of the nominal subscription price of $1.00 Cdn. therefore; and

4. in the event that:

   a. The Third Round Minority Shareholders are entitled to receive the Third Round Dilution Shares, then the Exercise Price (as defined in the Warrants) shall be further adjusted downward (with retroactive effect to June 16th, 2003) to equal "C", as such letter is defined in the definition of Down Round Dilution Shares; or

b. The Third Round Minority Shareholders are not entitled to receive the Third Round Dilution Shares, the Exercise Price as defined in the Warrants shall be adjusted downward (with retroactive effect to June 16th, 2003) to equal "C", as such letter is defined in the definition of Down Round Dilution Shares.

Article 8. Provisions Applicable to a Sale and Purchase of Shares:

8.0 Defined Terms: For the purposes of this Article 7, unless there is something in the subject matter or context inconsistent therewith:

a. "Purchaser" shall mean the person that is purchasing shares of the Company;

b. "Vendor" shall mean any Shareholder who sells all of their Shares;

c. Resignation as Director and Officer: If the Vendor or a nominee of the Vendor is an employee or an officer or director of the Company as of the closing date, such person shall tender his written resignation as an employee and/or director and/or from any and all offices with the Company on the closing date.

d. Credit Loans Repaid: Any Credit Loan of the Vendor shall be repaid by the Company in the same proportions, at the same time or times and in the same manner as the purchase price for the shares being sold and purchased is paid.

e. Debit Loans Repaid: Any Debit Loan of the Vendor shall be repaid to the Company in the same proportions, at the same time or times and in the same manner as the purchase price for the shares being sold and purchased is paid.

f. Releases: The Vendor shall execute an absolute release in favour of the Company and the Purchaser dealing with all matters, except payment of the balance of the purchase price and applicable interest, in a form and substance acceptable to the solicitors for the Company.

g. Other Documents: The Vendor and the Purchaser shall execute all such other documents as are necessary to complete the transfer of the shares being sold and purchased, as required by the solicitors for the Purchaser.

h. Indemnities: The Company shall make all reasonable attempts to obtain a release of the Vendor from any personal guarantees of the debts of the Company given by the Vendor.

Article 9. Management Contracts and Non-Competition:

9.0 The parties to this Agreement who are salaried full-time employees of the Company shall be required to execute a management contract.

9.1 In addition to standard confidentiality/developments agreements, key employees to execute agreements not to compete with or solicit employees of the Company or its subsidiaries, directly or indirectly, for one year after termination of employment.

9.2 Every director and officer of the Company shall exercise the powers and discharge the duties of his/her office honestly, in good faith and in the best interests of the Company, and in connection therewith shall exercise the degree of care and diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

9.3 It is the responsibility of each director to familiarize him/herself with the legal and regulatory obligations associated with being a director of a company incorporated in Ontario, being especially mindful of potential personal liabilities associated with, among other things, employment matters and taxes.

Article 10. General:

10.0 Severability: Each and every term, condition and provision of this Agreement is and shall be severable one from the other and if any term, condition or provision hereof is at any time declared by a court of competent jurisdiction to be void, invalid or unenforceable, same shall not extend to invalidate, make void or unenforceable any other term, condition or provision of this Agreement.

10.1 Notice: Any Notice or other communication required or permitted to be given to any party under this Agreement shall be in writing and may be given by hand delivery to the party or sent by e-mail or facsimile or by mailing the same by prepaid registered mail, return receipt requested, addressed as follows:

To the shareholders: at his, her or its respective addresses, telephone numbers, fax numbers and electronic mail address in Schedule "A" or "B" as case may be.

If to: the Company:	[Company Name]
	[Company address]
	Attention: [Company CEO]
	Telephone No.: []
	Facsimile No: []
If to: the Shareholder	[Shareholder Name]
	[Address]
	Telephone No.: []

Facsimile No: []

or to any other address, fax number, or person that the party designates. Any notice, if delivered personally, by courier, will be deemed to have been given when actually received; if transmitted by fax before 3:00 p.m. on a Business Day, will be deemed to have been given on that Business Day; and if transmitted by fax after 3:00 p.m. on a Business Day, will be deemed to have been given on the Business Day after the date of the transmission.

10.2 Good Faith Consideration: Each of the Shareholders and the Company further agree that they will each consider in good faith any reasonable proposals put forward by a Shareholder.

10.3 No Prior Agreements: The provisions of this Agreement shall supersede any and all previous agreements between any of the parties hereto.

10.4 Amendments: No changes or modifications of this Agreement shall be valid or binding upon any party nor shall any waiver of any term or condition hereof be binding on any party unless such change or modification or waiver shall be in writing and signed by at least 66% of the Shareholders. Amendments hereto may be made by written instrument executed by at least 66% of the Shareholders hereto, and when so made shall, together with this instrument, constitute one and the same agreement.

10.5 Enurement: This Agreement shall enure to the benefit of and shall be binding upon the parties hereto and their respective legal representatives (which for greater certainty shall include a trustee in bankruptcy), successors and permitted assigns.

10.6 Counterparts: For the convenience of the parties, any number of counterparts hereof may be executed, and different counterparts may be executed by different parties, and each of such counterparts shall be deemed to be an original instrument, and all of which taken together shall constitute one agreement.

10.7 Other Documents: The parties hereto covenant and agree that they will execute such other and further instruments and documents as are or may become necessary or convenient to effectuate and carry out the intent of this Agreement.

10.8 Other Acts: The parties hereto covenant and agree that they shall cause all such things and acts to be done to ensure that at all times, the terms of this Agreement are carried out and complied with.

10.9 Time: Time shall be the essence of this Agreement and of every part hereof and no extension or variation of this Agreement shall operate as a waiver of this provision.

10.10 Independent Legal Advice: Each of the parties hereto acknowledges that he has obtained independent legal advice in connection with the negotiation and execution of this Agreement or, having been advised to do so, has declined to obtain independent legal advice, and further acknowledges and agrees that he has read, understands, and agrees to be bound by all of the terms and conditions contained herein.

IN WITNESS WHEREOF this Agreement has been executed as of the day and year first above written.

Signatures:

Attach Schedules:

A: Founding (and other Existing) Shareholder Particulars (number and class of shares, and contact information)

B: Particulars of Minority Shareholders, Option Holders, Warrant Holders, Rights Holders and Other Potential Shareholders

C: Current Balance of Shareholders' Loans

D: Anti-Dilution Calculation Principles

Fig. 6 – Sample Subscription Agreement

The terms of a subscription agreement are also based on the successfully negotiated terms as laid out in the term sheet. We have developed this sample agreement from sources available online and examples provided to us from friends in the local top tier legal firms, with reference to agreements related to a representative sampling of local Angel investments.

Form of Subscription

TO: [Insert: Full Legal Name of the Company] (the "Corporation")

1. Subject to the terms and conditions of this Form of Subscription, the undersigned (hereinafter referred to as the "Subscriber") hereby irrevocably subscribes for and agrees to purchase [number of shares purchased] Series A Preferred Shares (the "Initial Subscription") of the Corporation described below (the "Securities") at a subscription price of CDN $[] per share. The Initial Subscription shall be completed on [closing date] (the "Initial Closing") or such other date as the parties may agree. At the Initial Closing, the undersigned shall pay the subscription price for the Initial Subscription by delivering to the Corporation a direct deposit wire transfer to the Corporation, in the amount of CDN$[].

2. If and whenever at any time or from time to time the Corporation shall (i) subdivide, re-divide or change its then outstanding Common Shares into a greater number of shares; (ii) reduce, combine, consolidate or change its then outstanding Common Shares into a lesser number of shares; or (iii) issue Common Shares to holders of its outstanding securities by way of a dividend or other distribution, appropriate proportional adjustments shall be made to the number of Common Shares issuable pursuant to the Additional Tranche, and in the subscription price payable pursuant to section 2. However, no such adjustment shall be made to reflect the issuance of shares, warrants or other securities:

   a. To the Minority Shareholders or as part of the Third Round Financing, as those terms are defined in the Shareholders' Agreement;

   b. To directors, officers, employees or consultants (as such term is defined in Ontario Securities Commission Rule 45-503) (collectively, the "Consultants") of the Corporation or its Affiliates under or pursuant to any bona fide share or other security option plan approved by the Corporation's board of directors (a "Stock Option Plan"); or

   c. To other persons on an individual basis pursuant to options, warrants or other securities now or in the future authorized by the Board of Directors of the Corporation.

3. The undersigned acknowledges that the Initial Subscription is subject to the acceptance of this Form of Subscription by the Corporation on or before the Initial Closing. It is understood and agreed that this Subscription Form and all monies tendered in respect of the Initial Subscription shall be returned forthwith to the undersigned at the address indicated below if this subscription is not accepted by the Corporation on or before the Initial Closing.

The Subscriber acknowledges (on its own behalf and, if applicable, on behalf of each person on whose behalf the Subscriber is contracting) that:

a. this subscription is subject to rejection or allotment by the Corporation in whole or in part at any time;

b. the Securities subscribed for by it hereunder form part of a larger issuance and sale by the Corporation of up to a maximum [number] Securities at a subscription price of $[price] per share (the "Offering"); and

c. the original certificate representing the Securities purchased by the Subscriber shall be held in trust by the Corporation's legal counsel.

d. Representations, Warranties and Covenants by Subscriber:

e. In consideration of the Corporation accepting this subscription and conditional thereon:

The undersigned agrees to be bound, as a party to and as one of the Minority Shareholders in the Corporation, by the terms of the Shareholders' Agreement from time to time amended and in effect (the "Shareholders' Agreement"). The undersigned also agrees to execute and deliver the Shareholders' Agreement in nine (9) counterparts on or before the Initial Closing, and to this end the undersigned hereby irrevocably constitutes and appoints the person from time to time holding the office of President of the Corporation, with full power of substitution, as its, his or her true and lawful attorney and agent, with full power and authority in its, his or her name, place and stead, and for his use and benefit, to execute, swear to, acknowledge, deliver, record and file the Shareholders' Agreement on his behalf. The power of attorney hereby granted is coupled with an interest, is irrevocable, shall survive the death or incapacity of the undersigned, may be exercised by the person from time to time holding the office of the President of the Corporation on behalf of the undersigned by a facsimile signature or by listing all of the persons executing any instrument with a single signature as an attorney and agent for all of them, shall survive the delivery of an assignment by the undersigned or the whole or any portion of his shareholdings in the Corporation, and will extend to and be binding upon the heirs, executors, administrators, legal personal representatives, successors and assigns of the undersigned.

b) The undersigned hereby represents, warrants and confirms:

   i. that the undersigned has the legal capacity and competence to execute this Agreement and to take all actions required pursuant hereto and all necessary approvals by directors, shareholders and members of the undersigned, otherwise have been given to authorize it to execute this Form of Subscription and the Shareholders' Agreement, and to take all actions required to be delivered or performed by it hereunder has been duly authorized by all necessary action;

ii. that the undersigned is a "non-Canadian" person within the meaning of the Investment Canada Act (the "Investment Act") and is a "non-resident" in Canada within the meaning of the Income Tax Act (Canada);

iii. that the undersigned has received, and has furnished to the Corporation true and complete copies of, all necessary or material consents and approvals from governmental agencies and third parties in connection with its investment and holding of shares in the Corporation. If pursuant to the Investment Act, the undersigned is required to provide notice to the Minister (the "Minister") under the Investment Act of the undersigned's investment in the Corporation and its holding of Shares in the Corporation, the undersigned shall:

   a. Confirm in writing to the Corporation that the required notification of the undersigned's investment in the Corporation and its holding of shares in the Corporation pursuant to this Form of Subscription, the Shareholders' Agreement or otherwise has been given by the undersigned to the Minister. In this regard the undersigned covenants that, if required, it will file the requisite form of Notification with the Minster within the time periods prescribed under the Investment Act and shall, in a timely fashion, fully respond to any requests for further or other information from the Minister;

   b. Deliver to the Corporation a true copy of any confirmation or deemed confirmation that the undersigned may receive from the Minister that the undersigned's investment in the Corporation and its holding of shares in the Corporation pursuant to this Form of Subscription, the Shareholders' Agreement or otherwise is not a reviewable transaction under the Investment Act;

   c. To the extent that the undersigned's investment in the Corporation and its holding of shares in the Corporation pursuant to this Form of Subscription, the Shareholders' Agreement or otherwise is a reviewable transaction under the Investment Act, the undersigned covenants that it will file the requisite form of Application for Review with the Minster within the time periods prescribed under the Investment Act and shall, in a timely fashion, fully respond to any requests for further or other information from the Minister; and

   d. From time to time following the acceptance of this Form of Subscription by the Corporation, join in any request that the Corporation may make for an opinion of the Minister under Section 37 of the Investment Act (the "Investment Opinion") that the undersigned's investment in the Corporation and his holding of shares in the Corporation pursuant to this Form of Subscription and the Shareholders' Agreement:

      A. Is neither the acquisition of control or the establishment of a new business in Canada by a non-Canadian; and

B. That in consequence of that investment and the undersigned's holding of shares in the Corporation pursuant to this Form of Subscription and the Shareholders' Agreement, the Corporation is considered a Canadian under the Investment Act controlled by Canadians. The undersigned covenants that he will provide, in a timely fashion, all information as to the ultimate ownership and control of the undersigned and other relevant information, as the Corporation or the Minister may request in connection with the said request for the Investment Opinion or the fulfilment thereof.

iv. That the undersigned acknowledges receipt from that the Corporation of an information statement in the form appended as Schedule "B" concerning the Corporation in the form of Form 45-501F3 prescribed under the Ontario Securities Commission Rule 45-501; such information statement having been provided to the undersigned at least four (4) days prior to the date of this Form of Subscription;

v. That the undersigned:

A. Is purchasing the Initial Subscription and the Additional Tranche as principal,

B. Is resident in or is subject to the laws of the Province of Ontario, and

C. Has reviewed the materials and definitions attached as Schedule "C" and is an "accredited investor" (as that phrase is defined in Ontario Securities Commission Rule 45-501) by virtue of satisfying the indicated criterion on Schedule "C";

vi. That the undersigned shall file all reports and do all such things as may be required pursuant to the Securities Act (Ontario) and all other applicable securities laws in connection with the subsequent sale of any of the Common Shares acquired pursuant to this Agreement.

5. Representations and Warranties of the Corporation:

The Corporation hereby represents and warrants to the Subscriber and the Corporation acknowledges that the Subscriber is relying upon such representations and warranties in connection with the transactions contemplated hereby as follows:

a. the Corporation has been duly incorporated and validly existing under the Business Corporations Act (Ontario) and has not been dissolved, and is not the majority owner of any subsidiaries;

b. the Corporation has the corporate power and capacity to own its assets and to carry on its business as it is presently being carried on, the Corporation has the corporate power and capacity to enter into, deliver and perform its obligations under this Subscription Agreement and all other agreements, contracts, instruments and actions required to be delivered or performed by the Corporation hereunder;

c. this Subscription Agreement and each of the agreements, contracts, instruments and actions required to be delivered or performed by the Corporation hereunder have been duly authorized by all necessary corporate action of the Corporation. This Subscription Agreement and each of the agreements to be delivered hereunder have been duly executed and delivered by the Corporation and are valid and binding obligations of the Corporation enforceable in accordance with their terms, subject to limitations on enforcement imposed by bankruptcy, insolvency and other laws affecting creditors' rights generally and to general principles of equity; and

d. neither the entering into nor the delivery of this Subscription Agreement nor the completion of the transactions and agreements contemplated hereby by the Corporation will in any material respect conflict with or result in the (and the Corporation is not now in) breach or violation of any of the terms, conditions or provisions of, or constitute a default under or result in the creation of any encumbrance under, or relieve any other person from its obligations under: (a) any of the provisions of the articles or by-laws of the Corporation, (b) any agreement or other instrument to which the Corporation is a party or by which the Corporation or any of its property or assets is bound, or (c) to the best of its knowledge, any applicable law, rule, regulation, order, decree, judgment, injunction or other restriction of any government, governmental agency or court to which the Corporation is subject.

6. The undersigned confirms:

a. that it has conducted his own due diligence investigations into the business and affairs of the Corporation; and

b. that he has not received nor relied upon any offering memorandum, documents or business plans, purporting to describe the business and affairs of the Corporation prepared primarily for delivery to and review by a prospective purchaser to assist that person to make an investment decision in respect of securities being sold by the Corporation.

c. The undersigned further confirms and acknowledges that the undersigned does not expect to receive, and has not been accorded hereby, any statutory right action as set out in section 130.1 of the Securities Act (Ontario) or otherwise.

7. Closing:

a. The obligations of the undersigned to purchase the Common Shares pursuant to the Initial Subscription (the completion of each such purchase is referred to as a "Closing") is subject to the fulfilment on or before each Closing of each of the following conditions:

b. The representations and warranties of the Corporation shall be true and correct on and as of the date of each Closing with the same effect as though such representations and warranties had been made on and as of the date of such Closing;

c. The Corporation shall have performed and complied with all agreements, obligations and conditions contained in this Agreement and in the Shareholders' Agreement that are required to be performed or complied with by it on or before each Closing;

d. The Shareholders' Agreement shall have been executed and delivered by the undersigned or its attorney pursuant to the power of attorney contained herein, it shall be in full force and effect as of each Closing and no party shall be in material breach or material default thereof; and

e. No order to cease or suspend trading in any securities of the Corporation has been issued or made nor have any proceedings been announced or commenced for the making or issuance of any such order by any securities regulatory authority in Canada.

   a. At each Closing

f. The Corporation will deliver to the undersigned a certificate or certificates, registered in the undersigned's name, representing the Common Shares (as adjusted by Section 3 hereof, if applicable) to be purchased by the undersigned at such Closing; and

g. The undersigned shall deliver a certified cheque or bank draft payable to the Corporation, or a direct deposit wire transfer to the Corporation, in an amount equal to the purchase price (as adjusted by Section 3 hereof, if applicable) payable in respect of the Common Shares to be purchased by the undersigned at such Closing.

8. Notwithstanding any other provision of this Form of Subscription, the obligation of the undersigned to purchase the Additional Tranches at the Closing therefore is subject to there having not occurred any serious adverse change, financial or otherwise, in the assets, liabilities or business or in the financial condition, capital or prospects of the Corporation from that as they exist, respectively, on March 31st, 2003.

9. This Form of Subscription, and when executed, delivered and accepted, the Shareholders' Agreement, constitute the entire agreement among the parties hereto pertaining to the subject matter hereof and supersede all prior agreements, negotiations, discussions and understandings, written or oral, among the parties hereto, including without limitation, letters of intent between the undersigned and the Corporation relating to a proposed purchase and sale of the Initial Subscription and the Additional Tranche provided for in this Form of Subscription. There are no representations, warranties, conditions, other agreements or acknowledgements, whether direct or collateral, expressed or implied, that form part of or affect this Form of Subscription, or which induced any party to enter into this Form of Subscription or on which reliance is placed by any party, except as specifically set forth in this Form of Subscription, and when executed and delivered, the Shareholders' Agreement.

The undersigned and the Corporation acknowledge and agree that they have required that this Agreement and all related documents, be drafted in English. Les parties aux presentes ont exigées que ce contrat et les documents y afférents soient redigés en anglais.

IN WITNESS WHEREOF this subscription has been executed by the undersigned.

Investor Signature:

SUBSCRIPTION ACCEPTED this [] day of [], 200[]

Company Signature:

Attach Schedules:

A: Shareholders Agreement

B: Form 45-501F3

C: Accredited Investor Certification

Fig. 7 – Sample Voting Trust

The terms of a voting trust are straightforward and most legal firms and many venture capital companies maintain templates for this purpose. We have developed a simplified template as follows:

Voting Trust

THIS AGREEMENT made as of the ____ day of [], 200[].

A M O N G:

[Insert: Investor 1],

[Insert: Investor 2],

[Insert: Investor 3],

and

so on to include all the shareholders of the Series A Preferred investment round

(hereinafter collectively referred to as the "Shareholders")

- and -

[Insert: Nominee for Voting Trustee],

(hereinafter referred to as the "Voting Trustee")

WHEREAS the Shareholders are the registered and beneficial owners of [Insert: total number of shares of the investors group] Series A Preferred Shares and in the capital of [Insert: Full Legal Name of the Company] (the "Company"), a company formed under the laws of the Province of Ontario;

AND WHEREAS the Shareholders have agreed to appoint the Voting Trustee as the Shareholders' voting trustee on the terms and conditions hereinafter contained;

NOW THEREFORE in consideration of the foregoing and mutual covenants and agreements contained herein, the parties agree as follows:

1. **Appointment of the Voting Trustee**: The Shareholders hereby appoint the Voting Trustee in respect of all of the Shares which are at any time and from time to time owned by the Shareholders or acquired by them in the future.
2. **Acknowledgement by Shareholders**: Each Security holder does hereby acknowledge to and with the Voting Trustee that such Security holder now has full right, power and authority to execute, deliver and perform this agreement and for greater certainty and without limitation, that

such Security holder has not previously entered into any agreement or arrangement, oral or written, with respect to the voting of the Shares.

3. **Exercise of Voting Rights**: Until the termination of this Agreement in accordance with the provisions hereof, the Voting Trustee shall, in respect of the Shares, exclusively possess and be entitled, in person, by proxy or by attorney, in its sole discretion to exercise all the rights of voting appertaining to the Shares and all rights in connection with the initiation, taking part in and consenting to any action as shareholders of the Company. In furtherance of the foregoing, the Shareholders shall from time to time and at all times during the term of this Agreement do whatever may be requested by the Voting Trustee, including the execution and delivery of appropriate instruments of proxy, to enable or facilitate the exercise of any and all such rights by or on behalf of the Voting Trustee.

4. **Applicability of Agreement**: The Shareholders agree that the provisions of this Agreement relating to the deposit of proxies with respect to the voting rights attaching to the Shares shall apply mutatis mutandis to:

    - any shares or securities of the Company into which such Shares may be converted, changed, reclassified, re-divided, re-designated, subdivided or consolidated;
    - any shares or securities which are received by the Shareholders as a stock dividend or distribution payable in shares or securities of the Company which entitle the holder thereof to vote at any meeting of the shareholders of the Company; and
    - any shares or securities of the Company or of any successor or continuing company to the Company which may be received by the Shareholders on a reorganization, amalgamation, consolidation or merger, statutory or otherwise.

5. **Right to Receive Dividends and Distributions**: Save as herein specifically provided, each of the Shareholders shall be entitled to receive any and all dividends and distributions on and in respect of the Shares to which they would otherwise be entitled.

6. **Acceptance by the Voting Trustee**: The Voting Trustee hereby accepts its appointment as voting trustee.

7. **Term of Agreement**: The term of this Agreement shall be in effect until the execution of an agreement in writing by the Voting Trustee and the Shareholders terminating this Agreement.

8. **Protection of the Voting Trustee**: By way of supplement to the provisions of law or of any statute for the time being in effect relating to trustees, it is agreed that:

    - the Voting Trustee shall not incur any liability or responsibility by reason of any error of law or mistake or any matter or thing done or omitted to be done under or in relation to this Agreement except for its wilful and wrongful neglect or default; and

- the Voting Trustee may, in relation to this Agreement, act on the opinion or advice of or opinion obtained from any lawyer, broker or other expert and shall not be responsible for any loss occasioned by so acting, and shall incur no liability or responsibility for deciding in good faith not to act upon any such opinion or advice.

9. **Acts of the Voting Trustee, the Trustees and General Limitation of Liability**:

   For greater certainty, where any reference is made herein to an act to be performed or which may not be performed by the Voting Trustee, such reference shall be construed and applied for all purposes as if it referred to an act to be performed or which may not be performed by the trustees of the Voting Trustee (the "Trustees") on behalf of the Voting Trustee or by some other person duly authorized to do so by the Trustees or pursuant to the provisions hereof, and where reference is made herein to actions, rights or obligations of the Trustees, such reference shall be construed and applied for all purposes to refer to actions, rights or obligations of the Trustees in their capacity as Trustees, and not in their other capacities, unless the context otherwise requires.

   The parties hereto acknowledge that the Trustees are entering into this Agreement solely in their capacity as trustees, on behalf of the Voting Trustee. The Trustees shall not be subject to any personal liability for any debts, liabilities, obligations, claims, demands, judgments, costs, charges or expenses against or with respect to the Voting Trustee arising out of anything done or permitted or omitted to be done in respect of the execution of the duties of the office of Trustee for or in respect to the affairs of the Voting Trustee. No property or assets of the Trustees, owned in their personal capacity or otherwise, will be subject to any levy, execution or other enforcement procedure with regard to any of the Voting Trustee's obligations hereunder or under any other related agreements. No recourse may be had or taken, directly or indirectly, against the Trustees in their personal capacity or against any incorporator shareholder, director, officer, employee or agent of the Trustees or any successor of the Trustees. The Voting Trustee shall be solely liable therefore and resort shall be had solely to the assets of the Voting Trustee for payment or performance thereof.

10. **Amendment**: This agreement may not be amended except by instrument in writing executed by all the parties hereto.

11. **Governing Law**: This Agreement is made pursuant to and shall be governed by and construed in accordance with the laws of the Province of Ontario.

12. **Assignment & Successors**: This Agreement shall [not] be assignable by the parties hereto and shall enure to the benefit of and be binding upon the parties hereto and their respective heirs, executors, administrators, legal personal representative, successors [and assigns] and upon any trustee or receiver in bankruptcy or upon any other trustee or appointee or their successors or assigns upon whom shall devolve by operation of law or otherwise, any interest or claim in and to the property of or the interest herein of any party.

13. **Counterparts**: This agreement may be executed in one or more counterparts by original or telefacsimile signature, each of which when executed shall be deemed to be an original and such counterparts shall together constitute one and the same instrument.

14. **Entire Agreement**: This agreement sets forth the entire agreement and understanding of the parties to this agreement with respect to the subject matter hereof.

Signatures:

#'s

3 Fs: The 3 F's stand for friends, family, and founder (otherwise known as "love money"). These individuals are often the first sources of equity capital used to start a new venture (seed capital).

Raising capital from the 3 F's should generate anywhere between $100,000 - $200,000 in start-up financing. Angel investors typically invest in companies that have exhausted these resources but are not in the appropriate stage for venture capital investment (over $1,000,000).

Most Angels will first want to see an investee tap this resource as a matter of risk mitigation. Utilization of the 3 F's by an investee company also shows a sign of good faith to investors that the founders are committed to their venture.

800 Pound Gorilla: Slang for the most important party to a transaction/or in a group.[1]

Reference:
1. http://www.specialinvestor.com/terms/2093.html

A

A Round: A financing event whereby venture capitalists invest in a company that was previously financed by founders and/or Angels. The "A" is from Series "A" Preferred stock. See "B" round.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=230

Accredited Investor: An individual (i.e. non-corporate) "accredited investor" is either a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase OR a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year. For the complete definition of accredited investor, see the OSC website.

Some limited partnerships and Angel investor networks accept only accredited investors

Active Angel: An Angel investor that is involved as a manager or as a board member of the investee company (post-funding).

Advisory Board: A group of external advisors to a private equity group or portfolio company. Advice provided varies from overall strategy to portfolio valuation. Less formal than a Board of Directors.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=195

Affiliated Angel: Angel investors can be classified into two groups: affiliated and non-affiliated. An affiliated Angel is someone who has some sort of contact with an entrepreneur or an investee business but is not necessarily related to or acquainted to the entrepreneur. It makes sense for those seeking Angel funding to start their investment search by seeking an affiliated Angel since he or she is already familiar with the investee business and has a vested interest in the relationship.[1]

Affiliated Angels can be any of the following:

- Professionals - such as lawyers, accountants, and doctors, etc.
- Business associates - suppliers/vendors, customers, employees, competitors[1]

References:
1. http://www.entrepreneur.com/encyclopedia/term/82114.html

Angel Alliance: Angel groups that meet regularly to review opportunities.

Reference:
http://www.angelcapitalassociation.org/dir_downloads/resources/Research_ChangingStrategies.pdf

Angel Financing: Capital raised for a private company from independently wealthy investors. This capital is generally used as seed financing.[1]

Reference:
1.http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=3

Angel Group: Organizations, funds and networks formed for the specific purpose of facilitating Angel investments in start-up companies.[1]

Members study investment opportunities as a group and consult among themselves about attractive deals. Ultimately, members of a group are entitled to make their own decisions as to whether or not they will invest in an opportunity. Often only a fraction of the total group invests in any one deal.

The key benefits provided by Angel groups are that they provide members with greater financial resources, domain knowledge, and deal sourcing opportunities.

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=314

Angel Investor: A person who provides backing to very early-stage businesses or business concepts.[1] Typically a high net-worth individual that invests their personal time and cash into start-up and early stage ventures.[2]

An Angel investor provides capital for a business start-up, usually in exchange for ownership equity. Angels typically invest their own funds, unlike venture capitalists, who manage the pooled money of others in a professionally-managed fund. However, a small but increasing number of Angel investors are organizing themselves into Angel networks or Angel groups to share research and pool their investment capital.[3]

References:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=280
2. http://www.answers.com/topic/angel-investors
3. "Angel investor." Wikipedia. Wikipedia, 2007. Answers.com 25 May. 2007. http://www.answers.com/topic/angel-investors

Angelsoft: Angelsoft is a software package geared towards streamlining the deal flow process between Angel investors and entrepreneurs. The package includes components that allow entrepreneurs to upload business plan summaries, enable Angels to review deals, and provide collaboration between Angels on processes such as due diligence.

Angelsoft website: http://www.angelsoft.net/europe/index.html

Anti-dilution Provisions: Contractual measures that allow investors to keep a constant share of a firm's equity in light of subsequent equity issues. These may give investors pre-emptive rights to purchase new stock at the offering price. [See Full Ratchet and weighted Average][1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=249

Arch Angel: Usually an outsider hired by a syndicate of Angel investors to perform due diligence on investment opportunities and coordinate allotment of investment duties among members. Archangels typically have no financial commitment to the syndicate.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=250

Asymmetric Market: A market definition describing the differing levels of information available to investors versus investees.

B

B Round: A financing event whereby professional investors such as venture capitalists are sufficiently interested in a company to provide additional funds after the "A" round of financing. Subsequent rounds are called "C", "D", and so on.

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=231

Balance Sheet: A condensed financial statement showing the nature and amount of a company's assets, liabilities, and capital on a given date.

A company's assets are balanced against the owner's equity less liabilities.

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=207

BATNA: BATNA is an abbreviation for best alternatives to a negotiated agreement. In negotiation theory, the BATNA is the course of action that will be taken by a party if the current negotiations fail and an agreement cannot be reached. If the current negotiations are giving you less value than your BATNA, there is no point in proceeding. Prior to the start of negotiations, the parties should have ascertained their own individual BATNAs.[1]

A party should generally never accept a worse resolution than its BATNA. Care should be taken, however, to ensure that deals are accurately valued, taking into account all considerations (such as relationship value, time value of money, likelihood that the other party will live up to their side of the bargain, etc.) These other considerations are very difficult to value, since they are often based on uncertain considerations, rather than easily measurable and quantifiable factors.[1]

A BATNA can be an extremely useful leveraging tool in negotiations. However, for many investee companies who are in critical need of funding, the BATNA in many cases means going out of business.

References:
1. "Best alternative to a negotiated agreement." Wikipedia. Wikipedia, 2007. Answers.com 25 May. 2007. http://www.answers.com/topic/best-alternative-to-a-negotiated-agreement

Benchmarks: Benchmarks are performance goals against which a company's success is measured. Benchmarks are often used by investors to help determine whether a company should receive additional funding or whether management should receive extra stock.[1]

Companies can either be benchmarked against their own set standards or against other companies/competitors.

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Book Value: Book value of a stock is determined from a company's balance sheet by adding all current and fixed assets and then deducting all debts, other liabilities and the liquidation price of any preferred issues. The sum arrived at is divided by the number of common shares outstanding and the result is book value per common share.

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=208

Bootstrap: A situation in which an entrepreneur starts a company with little capital. An individual is said to be boot strapping when he or she attempts to found and build a company from personal finances or from the operating revenues of the new company.[1]

Compared to using venture capital, boot strapping can be beneficial as the entrepreneur is able to maintain control over all decisions. On the downside, however, this form of financing may place unnecessary financial risk on the entrepreneur. Furthermore, boot strapping may not provide enough investment for the company to become successful at a reasonable rate.[1]

Also see Sweat Equity.

Reference:
1. "bootstrap." Investopedia. Investopedia Inc., 2000. Answers.com 25 May. 2007. http://www.answers.com/topic/bootstrap

Bridge Financing: A limited amount of equity or short-term debt financing typically raised within 6-18 months of an anticipated public offering or private placement meant to "bridge" a company to the next round of financing.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=7

Bridge Loan: Bridge loan is a short-term loan that is used until a person or company can arrange a more comprehensive longer-term financing. The need for a bridge loan arises when a company runs out of cash before it can obtain more capital investment through long-term debt or equity.[1]

A bridge loan is a type of bridge financing.

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Burn Out / Cram Down: Extraordinary dilution, by reason of a round of financing, of a non-participating investor's percentage ownership in the issuer.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=124

Business Plan: A document that describes the entrepreneur's idea, the market problem, proposed solution, business and revenue models, marketing strategy, technology, company profile, competitive landscape, as well as financial data for coming years. The business plan opens with a brief executive summary, most probably the most important element of the document due to the time constraints of venture capital funds and Angels.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=10

Buyout: Buyout is defined as the purchase of a company or a controlling interest of a corporation's shares or product line or some business. A leveraged buyout is accomplished with borrowed money or by issuing more stock.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

C

Call Option: The right to buy a security at a given price (or range) within a specific time period.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=196

Capital Gain: The difference between an asset's purchase price and selling price, when the selling price is greater. Long-term capital gains (on assets held for a year or longer) are taxed at a lower rate than ordinary income.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=12

Capital Under Management: Capital under management is the amount of capital available to a management team for venture investments.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Capitalization Table: Also called a "Cap Table", this is a table showing the total amount of the various securities issued by a firm. This typically includes the amount of investment obtained from each source and the securities distributed -- e.g. common and preferred shares, options, warrants, etc. -- and respective capitalization ratios.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=13

CARG: Compound Annual Growth Rate. The year over year growth rate applied to an investment or other aspect of a firm using a base amount.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=157

Chinese Wall: A barrier against information flows between different divisions or operating groups within banks and securities firms. Examples include a policy barrier between the trust department from making investment decisions based on any substantive inside information that may come into the possession of other bank departments. The term also refers to barriers against information flows between corporate finance and equity research and trading operations.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=282

Cleantech: The Cleantech Network uses the following industry segments in its definition of Cleantech: Energy Generation; Energy Storage; Energy Infrastructure; Energy Efficiency; Transportation; Water & Wastewater; Air & Environment; Materials; Manufacturing/Industrial; Agriculture; Recycling & Waste; See Cleantech Defined for further explanation.[1]

References:
1. http://cleantech.com/index.cfm?pageSRC=FrequentlyAskedQuestions

Closing: Closing is the final event to complete the investment, at which time all the legal documents are signed and the funds are transferred.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Common Stock: A security that represents ownership in a corporation. Holders of common stock exercise control by electing a board of directors and voting on corporate policy. Common stockholders are on the bottom of the priority ladder for ownership structure. In the event of liquidation, common shareholders have rights to a company's assets only after bondholders, preferred shareholders and other debt holders have been paid in full.[1]

Reference:
1. "common stock." Investopedia. Investopedia Inc., 2000. Answers.com 25 May. 2007.
http://www.answers.com/topic/common-stock

Company Buy-Back: The redemption of private or restricted holdings by the portfolio company itself. In essence the company is buying out the VC's/Angels interest.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=284

Conversion Ratio: The number of shares of stock into which a convertible security may be converted. The conversion ration equals the par value of the convertible security divided by the conversion price.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=20

Conversion Rights: Rights by which preferred stock "converts" into common stock. Usually, one has this right at any time after making an investment. Company may want rights to force a conversion upon an IPO; upon hitting of certain sales or earnings' targets, or upon a majority or supermajority vote of the preferred stock. Conversion rights may carry with them anti-dilution protections.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=315

Convertible Debenture: A convertible debenture is a type of business loan that leaves the lender the option of taking stock in the company instead of repayment.[1]

For example, a convertible bond can be converted into stock.[2]

Convertibles are appropriate for investors who want higher income than is available from common stock, together with greater appreciation potential than regular bonds offer. From the issuer's standpoint, the convertible feature is usually designed as a sweetener, to enhance the marketability of the stock or preferred.[3]

References:
1. "convertible debenture." Wikipedia. Wikipedia, 2007. Answers.com 25 May. 2007. http://www.answers.com/topic/convertible-debenture-1
2. "convertible debenture." Investopedia. Investopedia Inc., 2000. Answers.com 25 May. 2007. http://www.answers.com/topic/convertible-debenture-1
3. http://www.fundingpost.com/glossary/venture-glossary.asp

Corporate Venture Capital: Corporate venture capital is a subsidiary of a large corporation which makes venture capital investments.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Corporate Venturing: Corporate Venturing is a practice of a large company, taking a minority equity position in a smaller company in a related field.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Corporation: A legal, taxable entity chartered by a state or the federal government. Ownership of a corporation is held by the stockholders. Two forms: "C Corp." and "S Corp." - the latter of which provides flow-through taxation and is not available in Canada.[1]

Corporations also have limited liability, meaning that stockholders are not fiscally responsible for claims against the company beyond their investment.

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=24

Covenant: A protective clause in an agreement.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=25

Cram Down: Extraordinary dilution, by reason of a round of financing, of a non-participating investor's percentage ownership in the issuer.[1] Also referred to as burn out.

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=124

Cumulative Voting Rights: When shareholders have the right to pool their votes to concentrate them on an election of one or more directors rather than apply their votes to the election of all directors. For example, if the company has 12 openings to the Board of Directors, in statutory voting, a shareholder with 10 shares casts 10 votes for each opening (10x12= 120 votes). Under the cumulative voting method however, the shareholder may opt to cast all 120 votes for one nominee (or any other distribution he might choose). Compare Statutory Voting.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=147

D

Deal Flow: A term used by a venture capitalists and Angel investors, used to measure the number of potential investments that are reviewed in any given period. Can also be defined as the creation and maintenance of a flow of business proposals for evaluation and decision for financial backing.[1]

References:
1. "Deal flow." Wikipedia. Wikipedia, 2007. Answers.com 25 May. 2007.
http://www.answers.com/topic/deal-flow-1

Deal Killers: Deal killers are individuals or terms that prevent the completion of a deal. Terms must be changed or individuals removed to continue the deal flow process in these cases.

Deal Screening: Deal screening is the process in which investors decide what deals they won't to invest in. Angel groups are often presented with numerous, unsolicited business proposals that are subject to deal screening measures to save time and effort in finding good investment opportunities.

Deal Sourcing: Networking with referring agents for deal flow. Potential sources of deals include members, professional service providers, entrepreneurial support groups, investment forums, and venture capitalists.

Deal Structure: An agreement made between the investor and the company defining the rights and obligations of the parties involved. The process by which one arrives at the final term and conditions of the investment.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=317

Debt Financing: Debt Financing means when a firm raises money for working capital or capital expenditures by selling bonds, bills, or notes to individual and/or institutional investors. In return for lending the money, the individuals or institutions become creditors and receive a promise to repay principal and interest on the debt.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Dilution Protection: Applies to convertible securities. Standard provision whereby the conversion ratio is changed accordingly in the case of a stock dividend or extraordinary distribution to avoid dilution of a convertible bondholder's potential equity position. Adjustment usually requires a split or stock dividend in excess of 5% or issuance of stock below book value. Share Purchase Agreements also typically contain anti-dilution provisions to protect investors in the event that a future round of financing occurs at a valuation that is below the valuation of the current round.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=34

Direct Financing: Direct financing is a financing without the use of underwriting. Direct financing is often done by investment bankers.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Director: Person elected by shareholders to serve on the board of directors. The directors appoint the president, vice president and all other operating officers, and decide when dividends should be paid (among other matters).[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=27

Disclosure Document: A booklet outlining the risk factors associated with an investment.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=28

Diversification: The process of spreading investments among various different types of securities and various companies in different fields.[1]

References:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=35

Domain Knowledge: Domain knowledge can also be described as the "subject area of expertise" in a particular industry, topic, or program. In essence, domain knowledge is the level of knowledge and experience that someone has in a particular subject.

For entrepreneurs, it is important that they have domain knowledge specific to their industry, its technologies, and other subject areas of importance. It is also crucial that Angel investors have domain knowledge related to their investee companies to ensure that proper deal assessments can be made.

Angel investors typically look for deals that fall within their area of subject expertise or domain knowledge (e.g. software, bio-technology, web 2.0, etc.)

Down Round: A round of financing where investors purchase stock from a company at a lower valuation than the valuation placed upon the company by earlier investors.[1]

Down rounds cause dilution of ownership for existing investors. This often means the company's founders stock or options are worth much less, or even nothing at all. Unfortunately, sometimes the only other option is going out of business (see BATNA). In this case down rounds are necessary and welcomed.[1]

Down rounds are commonplace when a red hot economy turns bad. A perfect example was the dot-com crash of 2000-2001.[1]

References:
1. "downside." Investopedia. Investopedia Inc., 2000. Answers.com 25 May. 2007. http://www.answers.com/topic/downside

Drive-By Deal: Drive-By Deal is a slang often use when referring to a deal in which a venture capitalist invests in a start-up with the goal of a quick exit strategy. The VC takes little to no role in the management and monitoring of the startup.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Due Diligence: Due diligence involves a legal, financial and strategic review of the documents, operating history, contractual relationships and organizational structure of a company being acquired.

E

Early Stage: A state of a company that typically has completed its seed stage and has a founding or core senior management team, has proven its concept or completed its beta test, has minimal revenues, and no positive earnings or cash flows.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=37

EBITA: "Earnings Before Interest, Taxes, Depreciation and Amortization": A measure of cash flow calculated as: Revenue - Expenses (excluding tax, interest, depreciation and amortization). EBITDA looks at the cash flow of a company. By not including interest, taxes, depreciation and amortization, we can clearly see the amount of money a company brings in. This is especially useful when one company is considering a takeover of another because the EBITDA would cover any loan payments needed to finance the takeover.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=155

Economies of Scale: Economic principle that as the volume of production increases, the cost of producing each unit decreases.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=141

Elevator Pitch: An extremely concise presentation of an entrepreneur's idea, business model, company solution, marketing strategy, and competition delivered to potential investors. Should not last more than a few minutes, or the duration of an elevator ride.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=38

Entrepreneur Angel: This Angel investor has plenty of experience starting companies but comes from a different industry than the investee company.

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

Equity: Equity can be defined as the stock or any other security representing an ownership interest. On the balance sheet, equity is the amount of the funds contributed by the owners (the stockholders) plus the retained earnings (or losses). Also referred to as "shareholder's equity".[1]

Angel investors typically seek equity positions in the realm of 20-40% in an investee company depending on the amount of capital invested and/or the risk involved in the deal. Angel-held equity in an investee company can be threatened by dilution if the investee company is overvalued during the Angel investment stage.

References:
1. "equity." Dictionary of Banking Terms. Barron's Educational Series, Inc, 2006. Answers.com 25 May. 2007. http://www.answers.com/topic/equity-business-and-economics

Equity Kicker: Option for private equity investors to purchase shares at a discount. Typically associated with mezzanine financings where a small number of shares or warrants are added to what is primarily a debt financing.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=163

Exercise Price: The price at which an option or warrant can be exercised.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=199

Exit Strategy: A fund's intended method for liquidating its holdings while achieving the maximum possible return. These strategies depend on the exit climates including market conditions and industry trends. Exit strategies can include selling or distributing the portfolio company's shares after an initial public offering (IPO), a sale of the portfolio company or a recapitalization.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=41

Exits: The means by which a private equity firm realizes a return on its investment. Private equity investors generally receive their principal returns via a capital gain on the sale or flotation of investments. Exit methods include a trade sale (most common), flotation on a stock exchange (common), a share repurchase by the company or its management or a refinancing of the business (least common). A

Secondary purchase of the LP interest by another private equity firm are becoming an increasingly common phenomenon.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=288

F

Financial Return Angel: This Angel investor invests solely for financial return and does not take a hands on approach with the investee company.

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

Financier: Financier is a person or financial institution engaged in the lending and management of money and makes a living participating in commercial financing activities.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

First Refusal Rights: A negotiated obligation of the company or existing investors to offer shares to the company or other existing investors at fair market value or a previously negotiated price, prior to selling shares to new investors.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=320

First Stage Capital: First Stage Capital is the money provided to entrepreneur who has a proven product, to start commercial production and marketing, not covering market expansion, de-risking, and acquisition costs.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Flotation: When a firm's shares start trading on a formal stock exchange, such as the NASDAQ or the NYSE. This is probably the most profitable exit route for entrepreneurs and their financial backers.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=260

Follow-On Rounds: Follow-On is a subsequent investment made by an investor who has made a previous investment in the company, generally a later stage investment in comparison to the initial investment.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Forced Buyback: Redemption of convertible debt, convertible preferred stock or common stock on pre-specified terms in situations where the company's value has not appreciated according to the agreed upon plan.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=321

Founder Vesting: A term imposed on founders of seed and early stage deals in which the founder ownership is subject to a vesting schedule with nothing up front and linear vesting over, typically, four years. The first twelve months ownership is often "cliff" vested after the first year with monthly vesting thereafter. For more mature companies, vesting credit can be applied at the time of investment. The purpose of this term is to protect investors from an early, unplanned exit by the founder and to provide investors with the equity necessary to attract a new management team.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=322

Full Ratchet: An anti-dilution provision that, for any shares of common stock sold by a company after the issuing of an option (or convertible security), applies the lowest sale price as being the adjusted option price or conversion ratio for existing shareholders.[1]

Full-ratchet anti-dilution protection allows an investor to have his or her percentage ownership remain the same as the initial investment. For example, an investor who paid $2 per share for a 10% stake would get more shares in order to maintain that stake if a subsequent round of financing were to come through at $1 per share. The early round investor would have the right to convert his shares at the $1 price, thereby doubling his number of shares.[1]

Reference:
1. "Full Ratchet." Investopedia. Investopedia Inc., 2000. Answers.com 05 Jun. 2007. http://www.answers.com/topic/full-ratchet

G

General Partner: The partner in a limited partnership responsible for all management decisions of the partnership. The GP has a fiduciary responsibility to act for the benefit of the limited partners (LPs), and is fully liable for its actions.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=50

Golden Parachute: Employment contract of upper management that provides a large payout upon the occurrence of certain control transactions, such as a certain percentage share purchase by an outside entity or when there is a tender offer for a certain percentage of a company's shares.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=148

Ground Floor: Ground floor is a term used for the first stage of a new venture or investment opportunity.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Guardian Angel: This type of Angel investor offers previous entrepreneurial experience and industry experience. This Angel typically invests in the industry in which it has domain experience and/or entrepreneurial success.[1]

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

H

Harvest: Reaping the benefits of investment in a privately held company by selling the company for cash or stock in a publicly held company, also known as an "exit strategy".[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=323

High-Tech Business: High-technology businesses are those enterprises engaged in securing growth and revenue from industry sectors characterized by rapidly changing and advanced technology. In fact, advanced technology has come to be utilized in so many different industries that members of the business community now often regard it as its own unique industry subset, with applications across the spectrum of the world of commerce. Today, high-tech businesses are involved in industries as diverse as food exporting, retail product design, oil extraction, and a host of others.[1]

Angel investors have traditionally been attracted to the high-tech sector for a variety of reasons including scalability, and patentability of new technologies. There is also a strong investor pool in Canada that has domain knowledge in high-tech industry which encourages investment in this sector. Research in Motion (RIM) is an example of a high-tech company that received Angel funding.

References:
1. "High-Tech Business." Encyclopaedia of Small Business. The Gale Group, Inc, 2002. Answers.com 25 May. 2007. http://www.answers.com/topic/high-tech-business

Hockey Stick Projections: The general shape and form of a chart showing revenue, customers, cash, or some other financial or operational measure that increases dramatically at some point in the future. Entrepreneurs often develop business plans with hockey stick charts to impress potential investors.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=245

Hot Issue: A newly issued stock that is in great public demand. Technically, it is when the secondary market price on the effective date is above the new issue offering price. Hot issues usually experience a dramatic rise in price at their initial public offering because the market demand outweighs the supply.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=53

I

Incubator: An entity designed to nurture business concepts or new technologies to the point that they become attractive to venture capitalists. An incubator typically provides both physical space and some or all of the services-legal, managerial, and/or technical-needed for a business concept to be developed. Incubators often are backed by venture firms, which use them to generate early-stage investment opportunities.[1]

The MaRS discovery district in Toronto is an example of a business incubator.

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=293

Information Rights: Rights granting access to company's information, i.e. inspecting the company books and receiving financial statements, budgets and executive summaries.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=325

Institutional Investors: Institutional Investors refers mainly to insurance companies, pension funds and investment companies collecting savings and supplying funds to markets but also to other types of institutional wealth like endowment funds, foundations, etc.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Investment Banks: Investment Bank is a financial intermediary that performs a variety of services which includes underwriting, acting as an intermediary between an issuer of securities and the investing public, facilitating mergers and other corporate reorganizations, and also acting as a broker for institutional clients.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

IP (Intellectual Property): A venture's intangible assets, such as patents, copyrights, trademarks, and brand name.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=261

IPO (Initial Public Offering): The sale or distribution of a stock of a portfolio company to the public for the first time. IPOs are often an opportunity for the existing investors (often venture capitalists) to receive significant returns on their original investment. During periods of market downturns or corrections the opposite is true.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=55

IRR (Internal Rate of Return): A typical measure of how VC Funds measure performance. IRR is a technically a discount rate: the rate at which the present value of a series of investments is equal to the present value of the returns on those investments.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=161

ISO (Incentive Stock Option): Incentive Stock Option. Plan which qualifying options are free of tax at the date of grant and the date of exercise. Profits on shares sold after being held at least 2 years from the date of grant or 1 year from the date of exercise are subject to favourable capital gains tax rate.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=222

J

J-Curve Effect: The curve realized by plotting the returns generated by a private equity fund against time (from inception to termination). The common practice of paying the management fee and start-up costs out of the first draw-down does not produce an equivalent book value. As a result, a private equity fund will initially show a negative return. When the first realizations are made, the fund returns start to rise quite steeply. After about three to five years, the interim IRR will give a reasonable indication of the definitive IRR. This period is generally shorter for buyout funds than for early-stage and expansion funds.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=247

K

Key Employees: Professional management attracted by the founder to run the company. Key employees are typically retained with warrants and ownership of the company.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=62

L

Latent Angels: Those high net-worth individuals in an Angel group who have never made an investment.

Issue: Need to convert latent Angels into active Angels.

Reference: http://www.cfi-institute.org/AudioBlog/Latent_Angels.html

Dr. Jeffrey Sohl, UNH Center for Venture Research, discusses a troubling trend linked to the swelling number of new Angel groups: the sharp climb in the proportion of "latent Angels" in these groups, from 32% in 1998 to 66% in 2005. "Latent Angels" are those high net-worth individuals in an Angel group who have never made an investment.

Dr. Sohl discusses the implications of this trend and stresses the importance to the market of increasing the numbers of Angel investments, not Angel groups.

Reference: http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=62

LBO (Leveraged Buyout): A takeover of a company, using a combination of equity and borrowed funds. Generally, the target company's assets act as the collateral for the loans taken out by the acquiring group. The acquiring group then repays the loan from the cash flow of the acquired company. For example, a group of investors may borrow funds, using the assets of the company as collateral, in order to take over a company. Or the management of the company may use this vehicle as a means to regain control of the company by converting a company from public to private. In most LBOs, public shareholders receive a premium to the market price of the shares.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=65

Lead Investor: Also known as a bell cow investor. Member of a syndicate of private equity investors holding the largest stake, in charge of arranging the financing and most actively involved in the overall project.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=165

Life Sciences: Any of several branches of science, such as biology, medicine, anthropology, or ecology, that deal with living organisms and their organization, life processes, and relationships to each other and their environment. Also called bioscience.[1]

Life sciences are a popular investment sector for Angels as evident by Angel groups dedicated to this specific field (ie. Toronto Life Science Angels).

Reference:
1. "life science." The American Heritage® Dictionary of the English Language, Fourth Edition. Houghton Mifflin Company, 2004. Answers.com 20 Jun. 2007. http://www.answers.com/topic/biology-1

Lifestyle Firm: Category comprising around 90 percent of all start-ups. These firms merely afford a reasonable living for their founders, rather than incurring the risks associated with high growth. These ventures typically have growth rates below 20 percent annually, have five-year revenue projections below $10 million, and are primarily funded internally-only very rarely with outside equity funds.[1]

Lifestyle businesses are often avoided by Angel investors as there isn't sufficient potential for high returns based on the risk of investment.

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=263

Limited Partnership: Limited partnership is a business organization with one or more general partners, who manage the business and assume legal debts and obligations and one or more limited partners, who are liable only to the extent of their investments. Limited partnership is the legal structure used by most venture and private equity funds. Limited partners also enjoy rights to the partnership's cash flow, but are not liable for company obligations.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Liquidation: 1) The process of converting securities into cash. 2) The sale of the assets of a company to one or more acquirers in order to pay off debts. In the event that a corporation is liquidated, the claims of secured and unsecured creditors and owners of bonds and preferred stock take precedence over the claims of those who own common stock.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=69

Liquidation Preference: The amount per share that a holder of a given series of Preferred Stock will receive prior to distribution of amounts to holders of other series of Preferred Stock of Common Stock. This is usually designated as a multiple of the Issue Price, for example 2X or 3X, and there may be multiple layers of Liquidation Preferences as different groups of investors buy shares in different series. For example, holders of Series B Preferred Stock may be entitled to receive 3X their Issue Price, and then if any money is left, holders of Series A Preferred Stock may be entitled to receive 2X their Issue Price and then holders of Common Stock receive whatever is left. The trigger for the payment of the Liquidation Preference is a sale or liquidation of the company, such as a merger or other transaction where the company stockholders end up with less than half of the ownership of the new entity or a liquidation of the company.[1]

In essence, liquidity preference is the right to receive a specific value for the stock if the business is liquidated.[2]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=234
2. http://www.fundingpost.com/glossary/venture-glossary.asp

Liquidity Event: An event that allows a VC to realize a gain or loss on an investment. The ending of a private equity provider's involvement in a business venture with a view to realizing an internal return on investment. Most common exit routes include Initial Public Offerings [IPOs], buy backs, trade sales and secondary buy outs. See also: Exit strategy[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=164

Lock-Up Period: Lock-Up Period is the period an investor must wait before selling or trading company shares subsequent to an exit, usually in an initial public offering the lock-up period is determined by the underwriters.[1]

Investment banks that underwrite initial public offerings generally insist upon lockups of at least 180 days from large shareholders (1% ownership or more) in order to allow an orderly market to develop in the shares. The shareholders that are subject to lockup usually include the management and directors of the company, strategic partners and such large investors. These shareholders have typically invested prior to the IPO at a significantly lower price to that offered to the public and therefore stand to gain considerable profits. If a shareholder attempts to sell shares that are subject to lockup during the lockup period, the transfer agent will not permit the sale to be completed.[2]

Revenue:
1. http://www.fundingpost.com/glossary/venture-glossary.asp
2. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=70

M

Management Buy-In: Management Buy-In or MBI is the purchase of a business by an outside team of managers who have found financial backers and plan to manage the business actively themselves.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Management Buy-Out: A private equity firm will often provide financing to enable current operating management to acquire or to buy at least 50 per cent of the business they manage. In return, the private equity firm usually receives a stake in the business. This is one of the least risky types of private equity investment because the company is already established and the managers running it know the business - and the market it operates in - extremely well.[1]
Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=224

Management Fee: Compensation for the management of a venture fund's activities, paid from the fund to the general partner or investment adviser. This compensation generally includes an annual management fee.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=71

Management Team: The persons who oversee the activities of a venture capital fund/Angel group.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=72

Market capitalization: The total dollar value of all outstanding shares. Computed as shares multiplied by current price per share. Prior to an IPO, market capitalization is arrived at by estimating a company's future growth and by comparing a company with similar public or private corporations. (See also Pre-Money Valuation)[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=73

Merger: Combination of two or more corporations in which greater efficiency is supposed to be achieved by the elimination of duplicate plant, equipment, and staff, and the reallocation of capital assets to increase sales and profits in the enlarged company.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=74

Mezzanine Debt: Mezzanine debts are debts that incorporates equity-based options, such as warrants, with a lower-priority debt. Mezzanine debt is actually closer to equity than debt, in that the debt is usually only of importance in the event of bankruptcy. Mezzanine debt is often used to finance acquisitions and buyouts, where it can be used to prioritize new owners ahead of existing owners in the event that a bankruptcy occurs.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Mezzanine Financing: Mezzanine financing, also sometimes referred to as subordinated debt or financing, is a rarely used but viable financing option for small businesses in search of capital for rapid growth. Under this arrangement, an entrepreneur borrows some of the money that he or she requires to execute the next stage of company growth (whether through acquisition, expansion of existing operations, etc.), then raises additional funds by selling stock in the company to the same lenders. Mezzanine debt is usually unsecured or junior debt that is subordinate to traditional loans or senior debt.[1]

Mezzanine financing is usually late-stage venture capital (often the final round of financing prior to an IPO). It is for a company expecting to go public usually within 6 to 12 months, usually so structured to be repaid from proceeds of a public offerings, or to establish floor price for public offer.[2]

Also referred to as "mezzanine capital."

References:
1. "Mezzanine Financing." Encyclopaedia of Small Business. The Gale Group, Inc, 2002. Answers.com 25 May. 2007. http://www.answers.com/topic/mezzanine-financing
2. http://www.fundingpost.com/glossary/venture-glossary.asp

Mezzanine Level: Mezzanine level is a term used to describe a company which is somewhere between start-up and IPO. Venture capital committed at mezzanine level usually has less risk but less potential appreciation than at the start-up level, and more risk but more potential appreciation than in an IPO.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Mutual Fund: A mutual fund, or an open-end fund, sells as many shares as investor demand requires. As money flows in, the fund grows. If money flows out of the fund the number of the fund's outstanding shares drops. Open-end funds are sometimes closed to new investors, but existing investors can still continue to invest money in the fund. In order to sell shares an investor usually sells the shares back to the fund. If an investor wishes to buy additional shares in a mutual fund, the investor must buy newly issued shares directly from the fund. (See Closed-end Funds)

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=76

N

Narrow-Based Weighted Average Ratchet: A type of anti-dilution mechanism. A weighted average ratchet adjusts downward the price per share of the preferred stock of investor A due to the issuance of new preferred shares to new investor B at a price lower than the price investor A originally received. Investor A's preferred stock is re-priced to a weighed average of investor A's price and investor B's price. A narrow-based ratchet uses only common stock outstanding in the denominator of the formula for determining the new weighed average price.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=233

NDA (Non-Disclosure Agreement): An agreement issued by entrepreneurs to potential investors to protect the privacy of their ideas when disclosing those ideas to third parties.[1]

Due to the high volume of business plans that are screened by Angel investors, it is uncommon for Angels to sign NDAs in the interest of time.

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=236

Net Financing Cost: Also called the cost of carry or, simply, carry, the difference between the cost of financing the purchase of an asset and the asset's cash yield. Positive carry means that the yield earned is greater than the financing cost; negative carry means that the financing cost exceeds the yield earned.[1]

Revenue:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=78

Net Income: The net earnings of a corporation after deducting all costs of selling, depreciation, interest expense and taxes.[1]

Revenue:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=214

Net IRR: IRR if a portfolio or fund taking into account the effect of management fees and carried interest.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=311

New Issue: A stock or bond offered to the public for the first time. New issues may be initial public offerings by previously private companies or additional stock or bond issues by companies already public. New public offerings are registered with the Securities and Exchange Commission.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=79

Newco: The typical label for any newly organized company, particularly in the context of a leveraged buyout.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=80

Non-affiliated Angel: A non-affiliated Angel has no connection with either the entrepreneur or the investee business.

NPV (Net Present Value): A firm or project's net contribution to wealth. This is the present value of current and future income streams, minus initial investment.[1]

NPV is often used as a tool in determining valuations for Angel investments. It is often difficult to determine a reasonable NPV in early-stage companies that are not yet generating revenues.

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=265

O

Operational Expertise Angel: This Angel has specific domain/industry knowledge and expertise but doesn't have much entrepreneurial background.

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

Option Pool: The number of shares set aside for future issuance to employees of a private company.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=83

Outstanding Stock: The amount of common shares of a corporation which are in the hands of investors. It is equal to the amount of issued shares less treasury stock.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=216

Oversubscription: Occurs when demand for shares exceeds the supply or number of shares offered for sale. As a result, the underwriters or investment bankers must allocate the shares among investors. In private placements, this occurs when a deal is in great demand because of the company's growth prospects.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=84

P

Partnership: A non-taxable entity in which each partner shares in the profits, loses and liabilities of the partnership. Each partner is responsible for the taxes on its share of profits and loses.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=87

Partnership Agreement: The contract that specifies the compensation and conditions governing the relationship between investors (LP's) and the venture capitalists (GP's) for the duration of a private equity fund's life.[1]
Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=201

Passive Angel: An Angel Investor that is only involved in a deal through monetary means and does not seek an active interest in management of an investee firm.

Reference: Frances Fast

Patent: A government license that gives the holder exclusive rights to a process, design or new invention for a designated period of time.[1]

The exclusive right granted to a patentee in most countries is the right to prevent or exclude others from making, using, selling, offering to sell or importing the claimed invention. The rights given to the patentee do not include the right to make, use, or sell the invention themselves. The patentee may have to comply with other laws and regulations to make use of the claimed invention.[2]

References:
1. "patent." Investopedia. Investopedia Inc., 2000. Answers.com 25 May. 2007. http://www.answers.com/topic/patent

2. "patent." Wikipedia. Wikipedia, 2007. Answers.com 25 May. 2007. http://www.answers.com/topic/patent

Pay to Play: A "Pay to Play" provision is a requirement for an existing investor to participate in a subsequent investment round, especially a Down Round. Where Pay to Play provisions exist, an investor's failure to purchase its pro-rata portion of a subsequent investment round will result in conversion of that investor's Preferred Stock into Common Stock or another less valuable series of Preferred Stock.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=274

Pitch: Pitch is the set of activities intended to persuade someone to buy a product or take a specific course of action.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Poison Pill: A right issued by a corporation as a preventative anti-takeover measure. It allows rightholders to purchase shares in either their company or in the combined target and bidder entity at a substantial discount, usually 50%. This discount may make the takeover prohibitively expensive.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=149

Portfolio Company: A portfolio company is a company or entity in which a venture capital firm or buyout firm invests. All of the companies currently backed by a private equity firm can be spoken of as the firm's portfolio.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Post-Money Valuation: A post-money valuation is a term used in private equity or venture capital which refers to the valuation of a company or asset immediately after an investment or financing. External investors, such as venture capitalists and Angel investors, will use a pre-money valuation to determine how much equity to demand in return for their cash injection to an entrepreneur and his/her start-up company. The implied post-money valuation is calculated as the dollar amount of investment divided by the equity stake gained in an investment.[1]

Example: If an investor makes a $100 million investment in a company in return for twenty percent of the company's equity, the implied post-money valuation is $500 million. To calculate the pre-money valuation, the amount of the investment is subtracted from the post-money valuation. In this case, the implied pre-money valuation is $400 million.

This basic example illustrates the general concept. However, in actual, real-life scenarios, the calculation of post-money valuation can be more complicated -- because the capital structure of companies often includes convertible loans, warrants, and option-based management incentive schemes.[1]

Reference:
1. "post-money valuation." Wikipedia. Wikipedia, 2007. Answers.com 25 May. 2007. http://www.answers.com/topic/post-money-valuation

Pre-Money Valuation: A pre-money valuation is a term used in private equity or venture capital that refers to the valuation of a company or asset prior to an investment or financing. External investors, such as venture capitalists and Angel investors will use a pre-money valuation to determine how much equity to demand in return for their cash injection to an entrepreneur and his or her start-up company.[1]

Example: If an investor makes a $100 million investment into a company in return for 20% of the company's equity, the implied post-money valuation is $500 million. To calculate the pre-money valuation, the amount of the investment is subtracted from the post-money valuation. In this case, the implied pre-money valuation is $400 million.[1]

References:
1. "pre-money valuation." Wikipedia. Wikipedia, 2007. Answers.com 25 May. 2007. http://www.answers.com/topic/pre-money-valuation

Preferred Dividend: A dividend ordinarily accruing on preferred shares payable where declared and superior in right of payment to common dividends.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=129

Preferred Return (Hurdle Rate): The minimum return to investors to be achieved before a carry is permitted. A hurdle rate of 10% means that the private equity fund needs to achieve a return of at least 10% per annum before the profits are shared according to the carried interest arrangement.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=298

Preferred Stock: A class of capital stock that may pay dividends at a specified rate and that has priority over common stock in the payment of dividends and the liquidation of assets. Many venture capital investments use preferred stock as their investment vehicle. This preferred stock is convertible into common stock at the time of an IPO.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=33

Private Equity: Equity securities of companies that have not "gone public" (are not listed on a public exchange). Private equities are generally illiquid and thought of as a long-term investment. As they are not listed on an exchange, any investor wishing to sell securities in private companies must find a buyer in the absence of a marketplace. In addition, there are many transfer restrictions on private securities. Investors in private securities generally receive their return through one of three ways: an initial public offering, a sale or merger, or a recapitalization.[1]

Private equity investments are not subject to the same high level of government regulation as stock offerings to the general public. Private equity is also far less liquid than publicly traded stock.[2]

Angel investment is a form of private equity.

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=89
2. http://www.fundingpost.com/glossary/venture-glossary.asp

Private Securities: Private securities are securities that are not registered and do not trade on an exchange. The price per share is set through negotiation between the buyer and the seller or issuer.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=92

Prospectus: A formal written offer to sell securities that provides an investor with the necessary information to make an informed decision. A prospectus explains a proposed or existing business enterprise and must disclose any material risks and information according to the securities laws. Companies offering securities, mutual funds, and offerings of other investment companies including Business Development Companies are required to issue prospectuses describing their history, investment philosophy or objectives, risk factors and financial statements. Investors should carefully read them prior to investing.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=93

R

Raising Capital: Raising Capital refers to obtaining capital from investors or venture capital sources.

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Ratchet: Ratchets reduce the price at which venture capitalists can convert their debt into preferred stock, which effectively increases their percentage of equity. Often referred to as an "antidilution adjustment." See Anti-dilution, full ratchet and weighted average.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=329

Recapitalization: The reorganization of a company's capital structure. A company may seek to save on taxes by replacing preferred stock with bonds in order to gain interest deductibility. Recapitalization can be an alternative exit strategy for venture capitalists and leveraged buyout sponsors. (See Exit Strategy and Leveraged Buyout)[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=94

Red Herring: The common name for a preliminary prospectus, due to the red SEC required legend on the cover. (See Prospectus)[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=96

Redemption: The right or obligation of a company to repurchase its own shares.

Redemption Rights: Rights to force the company to purchase shares (a "put") and more infrequently the company's right to force investor to sell their shares (a "call"). A Put allows one to liquidate an investment in the event an IPO or public merger becomes unlikely. One may also negotiate a Put effective when the company defaults or fails to make payments upon a key employee's death, etc.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=275

Right of First Refusal: The right of first refusal gives the holder the right to meet any other offer before the proposed contract is accepted.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=136

Rights Offering: Issuance of "rights" to current shareholders allowing them to purchase additional shares, usually at a discount to market price. Shareholders who do not exercise these rights are usually diluted by the offering. Rights are often transferable, allowing the holder to sell them on the open market to others who may wish to exercise them. Rights offerings are particularly common to closed-end funds, which cannot otherwise issue additional ordinary shares.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=102

Risk: Risk is the quantifiable likelihood of loss or less-than-expected returns. Risk includes the possibility of losing some or all of the original investment. Risk is usually measured using the historical returns or average returns for a specific investment.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Risk Capital: Risk capital are funds made available for start-up firms and small businesses with exceptional growth potential.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

ROI (Return On Investment): A performance measure used to evaluate the efficiency of an investment or to compare the efficiency of a number of different investments. To calculate ROI, the benefit (return) of an investment is divided by the cost of the investment; the result is expressed as a percentage or a ratio.[1]

$$\text{ROI} = \frac{(\text{Gain from Investment} - \text{Cost of Investment})}{\text{Cost of Investment}}$$

Return on investment is a very popular metric because of its versatility and simplicity. That is, if an investment does not have a positive ROI, or if there are other opportunities with a higher ROI, then the investment should be not be undertaken.[1]

Angel investors are often looking for returns anywhere from 3X - 10X their initial investment depending on the level of investment risk. Angels seek high ROIs to compensate for the majority of deals that do not generate a positive return (as low as 10% of all Angel deals provide a positive ROI).

References:
1. "ROI." Investopedia. Investopedia Inc., 2000. Answers.com 25 May. 2007. http://www.answers.com/topic/return-on-investment

Round Closure: Round closure refers to the time needed close an Angel financing round. Often shorter than Venture Capital rounds. In some instances round closure can occur within 6-8 weeks for Angels.[1]

References:
1. Venture Support Systems Project: Angel Investors (Pg. 23)
Lucinda Linde (Marlin Capital) and Alok Prasad (Pittiglio, Rabin, Todd & McGrath) under the direction

of Kenneth P. Morse and Matthew Utterback of the MIT Sloan School and Howard Stevenson and Michael Roberts of the Harvard Business School, February, 2000.

Round of Funding: Round of funding is the stage of financing a start-up company is in. The usual progression is from start-up to first round to mezzanine to pre-IPO.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

S

Scalable: Expandable. Referring to hardware or software, the term is a popular buzzword in the IT world. A "highly scalable" device or application implies that it can handle a large increase in users, workload or transactions without undue strain.[1]

Scalable does not always mean that expansion is free. Extra-cost hardware or software may indeed be required to handle more work. Nevertheless, scalability is a positive feature of a product that is sold to fast-growing companies, because it implies that growth can be accommodated without having to make major changes or learn new procedures.[1]

Scalability of an investee business offering is often a key criteria considered by Angel investors. A business offering must also be scalable to ensure a critical mass in sales can be reached and subsequently provide a reasonable ROI to the investor.

Reference:
1. "scalable." Computer Desktop Encyclopaedia. Computer Language Company Inc., 2007. Answers.com 25 May. 2007. http://www.answers.com/topic/scalable

Second Stage Capital: Second Stage Capital is the capital provided to expand marketing and meet growing working capital need of an enterprise that has commenced production but does not have positive cash flows sufficient to take care of its growing needs.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Secondary Public Offering: Secondary Public Offering refers to a public offering subsequent to an initial public offering. A secondary public offering can be either an issuer offering or an offering by a group that has purchased the issuer's securities in the public markets.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Seed Capital: Seed Capital is the money used to purchase equity-based interest in a new or existing company. This seed capital is usually quite small because the venture is still in the idea or conceptual stage.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Seed Stage Financing: An initial state of a company's growth characterized by a founding management team, business plan development, prototype development, and beta testing.
Series A - first round of institutional investment capital
Series B - second round of institutional investment capital
Series C - third round of institutional investment capital[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=110

Series A Preferred Stock: The first round of stock offered during the seed or early stage round by a portfolio company to the venture investor or fund. This stock is convertible into common stock in certain cases such as an IPO or the sale of the company. Later rounds of preferred stock in a private company are called Series B, Series C and so on.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=113

Shell Corporation: A corporation with no assets and no business. Typically, shell corporations are designed for the purpose of going public and later acquiring existing businesses. Also known as Specified Purpose Acquisition Companies (SPACs).[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=194

Sidecar Fund: A sidecar fund is a committed source of capital that rides or invests alongside an Angel group. Sidecar funds invest in deals that have been vetted by and are being invested in by the Angel membership.[1]

Often the criteria for investing sidecar funds requires qualification on several fronts and can also be at the discretion of a managing director or by vote of Angel group members.

A sidecar fund is an attractive way to include Angel investors that want to diversify their investment portfolio or for investors who aren't actively involved in an Angel group.

References:
1. Payne, Bill. Sidecar Funds and Angel Groups

Silent Partner: A silent partner is an investor who does not have any management responsibilities but provides capital and shares liability for any losses experienced by the entity. Silent partners are liable for in any losses up to the amount of their invested capital and participate in any tax and cash flow benefits.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Special Purpose Vehicle: A special company, usually outside the United States, established by a company to meet a specific financial problem, often to pay lower taxes (e.g., a re invoicing subsidiary or offshore insurance company).[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=300

Spin Out: A division or subsidiary of a company that becomes an independent business. Typically, private equity investors will provide the necessary capital to allow the division to "spin out" on its own; the parent company may retain a minority stake.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=301[[http://www.fundingpost.com/glossary/venture-glossary.aspl]]

Start-up: Start-up is a new business venture in its earliest stage of development.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Statutory Voting: A method of voting for members of the Board of Directors of a corporation. Under this method, a shareholder receives one vote for each share and may cast those votes for each of the directorships. For example: An individual owning 100 shares of stock of a corporation that is electing six directors could cast 100 votes for each of the six candidates. This method tends to favour the larger shareholders.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=219

Stock Options: 1) The right to purchase or sell a stock at a specified price within a stated period. Options are a popular investment medium, offering an opportunity to hedge positions in other securities, to speculate on stocks with relatively little investment, and to capitalize on changes in the market value of options contracts themselves through a variety of options strategies. 2) A widely used form of employee incentive and compensation. The employee is given an option to purchase its shares at a certain price (at or below the market price at the time the option is granted) for a specified period of years.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=115

Subscription Agreement: The application submitted by an investor wishing to join a limited partnership. All prospective investors must be approved by the General Partner prior to admission as a partner.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=116

Sweat Equity: Sweat equity is a term used to describe the contribution made to a project by people who contribute their time and effort. It can be contrasted with financial equity which is the money contributed towards the project. It is used to refer to a form of compensation by businesses to their owners or employees. The term is sometimes used in partnership agreements where one or more of the partners contributes no financial capital. In the case of a business start-up, employees might, upon incorporation, receive stock or stock options in return for working for below-market salaries.[1]

Also see Bootstrap.

Reference:
1. "sweat equity." Wikipedia. Wikipedia, 2007. Answers.com 25 May. 2007. http://www.answers.com/topic/sweat-equity

Syndication: A number of investors offering funds together as a group on a particular deal. A lead investor often coordinates such deals and represents the group's members. Within the last few years, syndication among Angel investors (an Angel alliance) has become more common, enabling them to fund larger deals closer to those typifying a small venture capital fund.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=268

T

Tender Offer: An offer to purchase stock made directly to the shareholders. One of the more common ways hostile takeovers are implemented.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=153

Term Sheet: The term sheet outlines the key terms of a proposed financing between an investor and an investee company. Setting terms is a unique process and can vary from deal to deal. Agreeing to a term sheet is often done after the due diligence process by the Angel investor but before incurring any legal fees needed to close the deal.[1]

Reference:
1. Venture Support Systems Project: Angel Investors (Pg. 35)
Lucinda Linde (Marlin Capital) and Alok Prasad (Pittiglio, Rabin, Todd & McGrath) under the direction of Kenneth P. Morse and Matthew Utterback of the MIT Sloan School and Howard Stevenson and Michael Roberts of the Harvard Business School, February, 2000.

Third Stage Capital: Third Stage Capital is the capital provided to an enterprise that has established commercial production and basic marketing set-up, typically for market expansion, acquisitions, product development, etc.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Time Value of Money: The basic principle that money can earn interest, therefore something that is worth $1 today will be worth more in the future if invested. This is also referred to as future value.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=160

Traction: Traction is the ability of a business to effortlessly pull itself with power and purpose past its goals and objectives. In other words, the business is firing on all cylinders and just seems to be clicking along. Time, money and programs yield a return much greater than the investment. With growth and changing market expectations, demands are being placed upon businesses that are exceeding the capabilities or capacities of the business.[1]

Reference:
1. http://www.strategicmgmtresources.com/Articles.html

Tranched Payment: Otherwise known as a milestone payment. Tranched payment refers to a staged investment process. A tranched payment is released in specified amounts following the completion of agreed upon milestones between the investors and the investee company.

Tranche: Funds flowing from investors to a company that represent a partial round or an "early close." Subsequent funds of the single round are generally under the same terms and conditions as the first tranche (or early close), however, those funding the early tranches may receive bonus warrant coverage, in consideration of the additional risk. (a French word meaning a slice or cutting)[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=332

Turnaround: Turnaround is the term used when the poor performance of a company or the business experiences a positive reversal.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

U

Underwriter: Underwriter is an investment banking firm committing successful distribution of a public issue, failing which the firm would take the securities being offered into its own books. An underwriter may also be a company that backs the issue of a contract, agreeing to accept responsibility for fulfilling the contract in return for a premium.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Upper Quartile: The point at which 25% of all returns in a group are greater and 75% are lower.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=304

V

Valuation (Or Deal Valuation): In Angel investing, valuation is the process of estimating the market value of an investee firm. It is often important to make a distinction between pre-money valuation and post-money valuation. There are a variety of quantitative measures that can be used to determine the valuation of a company, but many qualitative factors affect the value that can be placed on a firm as well. Many experts in the Angel investment community have equated the valuation process to being more of an art than a science.

Venture: Venture is often use for referring to a risky start-up or enterprise company.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Venture Capital: Venture capital is an important source of financing for start-up companies or others embarking on new or turnaround ventures that entail some investment risk but offer the potential for above average future profits; also called risk capital. Sources of venture capital include wealthy individual investors; subsidiaries of banks and other corporations organized as small business investment companies (SBICs); groups of investment banks and other financing sources who pool investments in venture capital funds or Venture Capital Limited Partnerships.[1]

Some venture capital sources invest only at a certain stage of entrepreneurship, such as the start-up or seed money stage, the first round or second round phases that follow, or at the mezzanine level immediately preceding an initial public offering. In return for taking an investment risk, venture capitalists are usually rewarded with some combination of profits, preferred stock, royalties on sales, and capital appreciation of common shares.[1]

Angel financing is often an intermediate level of private equity that bridges a companies equity needs between the start-up stage (3 F's) and the venture capital stage.

References:
1. "venture capital." Dictionary of Finance and Investment Terms. Barron's Educational Series, Inc, 2006. Answers.com 25 May. 2007. http://www.answers.com/topic/venture-capital

Venture Capital Firm: Venture capital funds pool and manage money from investors seeking private equity stakes in small and medium-size enterprises with strong growth potential.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Venture Capitalist: Venture Capitalist is a term used of an investor who provides capital to either start-up ventures or support small companies who wish to expand but do not have access to public funding.[1]

Reference:
1. http://www.fundingpost.com/glossary/venture-glossary.asp

Vesting Period: A vesting period is a period of time an investor or other person involved in financial matters must wait until they are capable of officially exercising a financial or investment option. Typically the entire grant does not vest at one time. Specific percentages of the grant vest at designated periods of time over the life of the grant - could apply to restricted or deferred stocks also

Reference:
1. "Vesting Period." Wikipedia. Wikipedia, 2007. Answers.com 21 Jun. 2007. http://www.answers.com/topic/vesting-period

Voting Trust: A legal trust created to combine the voting power of shareholders. With the establishment of the voting trust, the shareholders' legal title (their stock) and voting rights are transferred to a designated trustee for a set duration.[1]

A voting trust is often the best practice for any company likely to attract venture capital financing in the future.

Reference:
1. "voting trust." Investopedia. Investopedia Inc., 2000. Answers.com 28 May. 2007. http://www.answers.com/topic/voting-trust

W

Warrant: A warrant is a security that entitles the holder to buy stock of the company that issued it at a specified price, which is much higher than the stock price at time of issue. Warrants are frequently attached to bonds or preferred stock as a sweetener, allowing the issuer to pay lower interest rates or dividends. Frequently, these warrants are detachable, and can be sold independently of the bond or stock. Warrants are much like call options, but the money goes to the issuer, not an option writer, and it initially has a lifespan of many years. When the warrant is exercised the company issues new shares of stock, so the number of outstanding shares increases.[1]

Reference:
1. "warrant." Wikipedia. Wikipedia, 2007. Answers.com 25 May. 2007. http://www.answers.com/topic/warrant-wordnet

Wash-Out Round: A financing round whereby previous investors, the founders, and management suffer significant dilution. Usually as a result of a washout round, the new investor gains majority ownership and control of the company. Also known as burn-out or cram-down rounds.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=244

Write-Off: The act of changing the value of an asset to an expense or a loss. A write-off is used to reduce or eliminate the value an asset and reduce profits.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=122

Write-Up/ Write-Down: An upward or downward adjustment of the value of an asset for accounting and reporting purposes. These adjustments are estimates and tend to be subjective; although they are usually based on events affecting the investee company or its securities beneficially or detrimentally.[1]

Reference:
1. http://vcexperts.com/vce/library/encyclopedia/glossary_view.asp?glossary_id=123

Y

Yield Rate: The annual rate of return on an investment, expressed as a percentage.[1]

Reference:
1. http://www.investorwords.com/5362/yield.html

Chapter 7 – Valuation

1) Economics A-Z http://www.economist.com/research/Economics/alphabetic.cfm?term=risk

2) Thoughts on Valuation 2 - Credit Suisse First Boston.

3) PriceWaterhouseCooper (MoneyTreeTM)

4) Venture One Research

5) America's Growth Capital

6) Thomson Financial

7) National Venture Capital Association

Chapter 9 – Dilution, Down-rounds, Sidecar Funds, and Exits

1) Venture Law Group, Law Q&A Forum, *Garage.com*, www.garage.com/forums/law/qandaArchive.shtml.

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