The Definitive Guide to Raising Money from Angels

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1 What to Expect From This Book

Starting a successful business is one of the most rewarding experiences in life. For most of us, each phase in development is satisfying; from startup to successfully raising money, to achieving positive cash flow, to success in rapidly growing the company, and finally to harvesting the results of our efforts by selling the company.

Most experts agree that access to capital is one of the most difficult aspects of starting and growing a business. The capital food chain is bewildering. Finding investors is difficult, but convincing them to invest is much more demanding.

This book will explain the sources of capital available for starting and growing businesses – from friends and family, angel investors and venture capitalists (VCs). But the particular emphasis will be on finding angels and convincing them to invest in your business. There is a substantial volume of information available on venture capitalists, who invest in about 1000 new companies annually, but very little on the elusive angels, who fund over 30,000 new companies every year.

Who are these angels and what motivates them to invest? – To successfully raise angel capital, it is important to understand angels. Are they, like VCs, full time professionals investing institutional money? Are they passive investors, or are they likely to want to help you grow your company? Will they threaten your ownership control of the company? I will describe angels and explain what inspires them to invest in seed and startup companies.

How do entrepreneurs find and engage angel investors? – Until the late '90s, angel investors were difficult to identify and engage. This book will provide you with information on locating solo angels and show you where to find a directory of angel organizations. And, once you find an angel, what then?

What are angels looking for in an investment? – Most angels don't invest in franchises or real estate deals. This book will describe in great detail the kind of ventures in which angels tend to invest. It helps to understand how investing in private companies fits into the investment strategy of angels, so this will be explained in detail. Angels invest in "businesses that will scale." Just what does that mean? Angels are investors (not bankers or donors) who are looking for a definitive exit strategy. This book will help you to thoroughly understand how angels will harvest their investment.

How do you pick the right angels for your business? – There are angel investors who will provide you with a "leg up" in starting your company. How do you identify angels who bring more than just money to your business?

What forms of business plans do you need to prepare? – Did you know you need multiple formats of your business plan to successfully attract capital? You will find descriptions of these business plans, definitions of their content and explanations of when to use (and not to use) each in this book.

How will angel investors assess the valuation of your business?

Valuation of early stage companies is a highly misunderstood topic. This book will demystify valuing pre-revenue companies, define the range of valuation to expect for your new venture and explain how angels determine where in that range is an appropriate fair valuation for your new company.

Identify important terms and conditions of your angel investment

Term sheets include a confusing array of terms and conditions that are important to entrepreneurs and investors alike. This book will define these important terms, suggest appropriate terms for most angel deals and describe where to get professional assistance for your deal.

How do you engage angels to help build your business?

Angels bring more than money to their portfolio companies. This book will describe the mentoring and coaching roles angels prefer to assume and suggest how to select angels from among your investors to serve in roles that can be critical to your success.

The care and feeding of angel investors

All investors expect regular feedback on the progress of their ventures.   What most angel investors anticipate from entrepreneurs will be described as will how to ascertain exactly what information your angel investors would like to see…and how frequently they want this information.

How can angels assist you in executing your exit strategy?

While selling your company may seem far in the future, harvesting the fruits of your labors is critical to achieving the goals of all shareholders. In this field, angels are experts and will step up to help you do the best deal possible for you, your family and your investors.

This book is NOT a template for writing a business plan, but will provide valuable insights into what information investors seek in business plans, with a list of dos and don'ts.

This book is NOT a worksheet for valuing your company, but will detail investor expectations regarding valuations and provide insights into what is likely to increase the pre-money valuation of your new company.

This book is NOT a set of legal documents to guide an angel investment round, but does defines the important terms entrepreneurs and investors negotiate in closing details and will show you where to get more information on specific terms and standard closing documents.

The author is confident that this book will provide entrepreneurs with priceless insights into starting and funding new companies!

2 Think Like an Angel

Who are these Angels?

Angel investors are usually entrepreneurs or retired businesspersons who have exited their businesses. They tend to enjoy working with entrepreneurs and view angel investing as "give-back," as appreciation to those who mentored them in their early days in business. Angels invest both their time (business acumen) and their money in new ventures. They have a variety of motivations and are not simply investing in early stage companies for return on investment. Most angels have many interests and view angel investing as a part-time activity. Angels enjoy mentoring and coaching entrepreneurs and especially assisting in the growth and success of their portfolio companies.

Who are Venture Capitalists?

Venture capitalists (VCs) invest other people's money in early-stage growth companies. VCs are smart businesspersons who raise substantial amounts of money from pension plans, university and foundation endowments, corporations and wealthy individuals and invest those monies in growth ventures. Venture capital funds are managed by these VCs as general partners, while the limited partners are passive investors. Venture capital funds range in size from a few million to hundreds of millions of dollars. A single venture fund is usually designed to have a life of ten years with the possibility of extending the fund life for a few years thereafter. Consequently, fund monies are invested in the first three years and investments are harvested three to ten years later. VC firms raise several funds over time and may have 2-4 active funds under management at any time, usually at different stages.

The general partners of venture capital firms have very little "skin in the game," that is, they usually invest only 1% of the capital under management with the rest coming from the limited partners. The general partners charge the funds raised an annual administrative fee of 2-3% to operate the fund (facilities, salaries, etc.) plus a 20% "carried interest." Carried interest is VCs' share of the earnings of the fund, after the capital is returned to the limited partners. With only 1% of monies invested, you can see that VCs have a huge upside potential for successful funds, splitting the earnings of the fund 20:80 with the limited partner investors, after the capital is returned to those investors.

How do VCs and Angels Differ?

Angels invest their own money, while VCs invest the monies of their limited partners. VCs are also full time investors with the opportunity to make substantial profits from their investments. VCs tend to have a fully staffed office while angels tend to work alone or with other angels and often have only modest administrative support. Angels invest in seed and startup (pre-revenue ventures) and early stage companies while VCs tend to invest in later stage, growth companies. VCs generally pick a few business segments in which the general partners have substantial experience and make all their investments in these verticals. Some angels follow this model, while others invest in a much broader portfolio of companies.

What do Angels do with their Time?

Most angels have sufficient wealth to engage in those activities that interest them. They normally do not have full time jobs or, if they are engaged in business, they have delegated operating responsibilities to others in their organizations. Angels choose to spend time with their families and pursue activities for which they have considerable passion, such as travel, woodworking, golf, tennis, bridge and investing in early stage companies. Angel investing is, at best, a part-time activity. Angels enjoy watching their grandchildren grow and thrive as they watch their invested companies become successful.

What Motivates Angels?

Return on investment motivates all investors, especially VCs who are investing other people's money. However, angels often have multiple motivations, both financial and altruistic. All enjoy working with entrepreneurs. Some feel that angel investing is a form of give-back to their community (economic development) or in appreciation to those who mentored them earlier in their careers. I enjoy working with entrepreneurs and feel that angel investing is a part-time activity that I can pursue into my 80s; one way for me to stay engaged in the business community after years of full-time involvement. All angels view return on investment (ROI) as important, but in many ways, view ROI as a metric of success in angel investing. Since most of us angels are only investing a small fraction of our net worth in our angel portfolio of companies, a high ROI from these ventures is not critical to our futures. Angel investing for me is one of many passions in my life. Regarding metrics, I hope to keep my golf handicap low and my angel investing ROI high☺

What is Active versus Passive Investing?

Active investing is defined as being engaged in the operations of the investment. Owning a franchise restaurant can be either active or passive. Active owners are operating the restaurant on a day-to-day basis. Passive investors hire managers to operate their businesses and review the financial reports of those managers on a regular basis.

Investing in a portfolio of companies on the New York Stock Exchange is viewed by most as a passive investing activity. Day trading, on the other hand, is very active investing. Limited partners in VC funds are passive investors, while the general partners are active investors.

There are many styles of investing in private companies. Many invest through funds, limited partnerships or private placement memoranda and are not engaged in the active management of these companies. Angel investors, on the other hand, are actively involved in their portfolio companies as coaches, mentors and serving on the Boards of portfolio companies.

Angel investing is considered active investing because of the level of engagement described above. Since an angel investor's portfolio many include as many as a dozen companies, an angel will not, however, choose to be active in each of their portfolio companies. Several angels usually invest in a startup company, and it is probably not reasonable to want each angel to be involved in some way with each company. It is usually clear that the angel or angels with the most experience in the business segment (or vertical) and/or the most compatibility with the entrepreneur(s) become actively involved with the company and represent all invested angels in the progress of the company.

Time and Money: Angels Invest Both in Portfolio Companies

Many entrepreneurs have expressed to me that the value of the time that angels invest in their companies exceeds the value of their money. Angels enjoy assisting entrepreneurs in growing successful companies. Angels have the means and are at a stage of life when they can do what they wish, yet some choose to spend substantial portions of their lives assisting entrepreneurs. This is obviously an activity that they enjoy and for which they bring great value. Most angel investors I know spend 10% to 50% of their time engaged with portfolio companies, mentoring the entrepreneur or key members of the management team and/or serving as active Directors. Those angels who are actively engaged with an invested company usually interact at least weekly with these entrepreneurs. The following are examples of the active engagement common for angels with their portfolio companies:

- Serving on the Board of Directors, perhaps as Chairman
- Mentoring the CEO on operational activities
- Interviewing candidates for key management positions
- Assisting the management team in the design and operation of sales channels
- Working with the controller in developing useful financial metrics
- Assisting in crisis management, working with the CEO and management team
- Serving as beta testers for new products
- Assisting management in selecting and using tools, such as accounting software.

Why do Angels Invest Only in Companies that will Scale?

"Investing in companies that will scale" means funding a venture that will grow very rapidly in the first five to seven years, providing an opportunity for the investors to exit with a high-multiple return on investment. For example, a pre-revenue company valued at $1 million at the time of an investment that grows to a highly-profitable company with $25 million in revenues that could be valued at $30 million in five years is a highly scaleable investment. This example would result in a 30X ROI (100% per year) for the investors for this company. If, on the other hand, the same company were only able to achieve a valuation of $3 million in five years at exit, the ROI to investors would be only 3X (or 25% per year) for this investment.

Angel investing is a risky opportunity. Of ten angel investments, the investor will lose all invested capital in about one-half and receive a fraction of capital returned or a small return on investment in most of the rest. Angels enjoy a highly successful exit in only about one in ten investments. For purposes of the example to follow, let's assume, for simplicity, that one in ten angel investments must provide all the ROI for the portfolio, while the other nine suffer complete lost of capital. (This is an extreme example, but provides a simple example of why angels invest only in companies that will scale.)

As a highly risky investment asset class, angel investors expect a 25% per year return on investment (compared to perhaps 10% per year for investing in Fortune 500 companies in public markets). If an angel investor has $1 million invested in a diversified portfolio of ten companies (assume $100,000 per company), his portfolio should be worth $3 million in five years. $1 million compounded at 25% per year will triple in five years ($1 million x 1.25 x 1.25 x 1.25 x 1.25 x 1.25 = $3.05 million, close enough).

If an angel investor's portfolio is to triple in value in five years, earning 25% per year ROI, and nine of ten companies fail, that single successful investment must be a "home run" to bring the value of the portfolio up to triple the value five years earlier. Since, in this scenario, we invested $100,000 in each company and the portfolio must be worth $3 million after five years and only one company must provide all the ROI, that single successful exit must be worth $3 million, or a 30X ROI for that investment (to achieve 25% for the portfolio).

Since we angels have no idea at the outset which of our investments will be produce that "home run" (or we would not invest in the other nine), each and every one of our investment must have the potential at the time we invest of achieving a huge ROI, 30X in this example. For this reason, a sound angel portfolio should not contain investments with the potential to only produce smaller returns on investment and should be limited to companies that will scale.

> This argument has been simplified for ease of explanation. It is unlikely that a carefully vetted angel portfolio will result in only one success and 9 failures. It is more likely that 3 to 5 companies will fail, a complete capital loss, while another 3-5 companies will return some capital or actually produce a small positive return on investment. It is reasonable then for angels to invest in companies where a 15X-20X ROI in five years can be expected and still enjoy a successful portfolio. However, a successful angel portfolio usually does not include investment for which the best anticipated exit might be a 3X or 5X ROI. Should one of these investments be the only highly positive exit in an angel's portfolio, the ROI for the portfolio over a span of years is likely to be negative.

Angel Asset Allocation: What Fraction of their Wealth is Invested in Angel Deals?

According to the Center for Venture Research at the University of New Hampshire, angels invest as little as 3% or as much as 50% of their net worth in angel deals. However, it is important to understand that most angel investors are not investing in new companies as their livelihood. They generally became wealthy through other business opportunities, often as entrepreneurs and are now investing a fraction of their net worth in startup companies. Most angels I know have most of their wealth invested in more conventional assets, such as real estate and the stock markets and a small fraction, say 5 to 10% of their assets, in this risky class of angel investments. These angels have the bulk of their investments in more conservative classes of assets, preserving capital and providing income for retirement. They have made their "nut" and it is being managed conservatively. Angels are investing their "mad money" in an activity that they enjoy - helping entrepreneurs build businesses.

What is “Mad Money”?

Mad money is cash that angels will not need for retirement and which may be spent imprudently, as in playing slot machines. We tend to view investing in startup companies as a good use of our mad money, that is, we are investing in a company that we believe we can help grow and be successful, but that we know is unlikely to thrive because of the risk involved in starting all companies. While recognized as very risky investments, we are motivated to invest in these companies because we have a passion for being involved with entrepreneurs and their early stage companies.

What is a Portfolio Strategy for Angel Investors?

What do we know about angel investing?

- It is highly risky – to reduce this risk, angels invest in several companies
- Angels tend to invest a small fraction of their net worth in angel deals
- Startup companies often require multiple rounds of investment to achieve success

Here are the assumptions for our simplistic angel portfolio strategy:

1. Our intrepid angel investor has a net worth of $10 million
2. This angel investor has decided to invest 10% this net worth in angel deals
3. This angel has decided to make 10 angel investment to reduce risk
4. And, our angel has decided to hold 100% of each investment in reserve for future rounds of investment in each company.
5. (Most angels would consider these to be reasonable assumptions.)

Based on these assumptions, what are the ramifications for an angel portfolio? Since the angel is investing in 10 companies, let’s assign $100,000 per company. But our angel is reserving 100% of invested capital for follow-on rounds, so each investment would be $50,000, with another $50,000 held in reserve for future round.

In practice, our angel may invest $25,000 each in some companies that he expects to make several follow-on investments and $50,000 in companies for which follow-on investing is unclear. But, an angel should always hold some capital in reserve for each investment. For every company that requires no additional capital there is one or more portfolio company that will require more than one additional round of investment.

A thoughtful angel always plans a diversified portfolio (that is, investments in 8 to 10 companies) and makes smaller initial investments in a larger number of companies. Furthermore, since angel investments are expected to exit in five to seven years, angels often invest in 2-3 new companies per year in the initial investing years and then 1-2 new companies and 1-2 follow-on investments in portfolio companies until their portfolio of 8 to 10 companies is complete.

What are Typical Angel Investments?

Angels typically invest in companies for which they have some familiarity with the industry segment (business vertical) where the companies operate. Angels are normally the first funding the company receives after monies from the entrepreneur's personal accounts, friends and family are exhausted. This seed and startup funding is usually invested by purchasing ownership in the company (equity) and is not a loan (or debt). Investors expect the value of their investment to increase with that of the entrepreneurs. Individual angels typically invest $25,000 to $100,000 per round of investment, with 6-15 or more angels, making up a round of investment of $200,000 to $1 million.

Seed rounds of investment are usually made in entrepreneurs and their companies at a stage when a product has been developed (or has been prototyped) and after a customer or two have been identified who will buy the product. The management team is usually incomplete and the companies are normally at the pre-revenue stage. However, angels do not tend to invest in technologies for which an entrepreneur has not been identified. Angels invest in companies, not technologies. (Angels do, of course, invest in technology companies.)

Do angels invest in multiple rounds with a single company?

Ask any entrepreneur or investor: It is very difficult to plan the startup of companies, consequently, entrepreneurs seldom if ever meet their financial expectations as described in their proforma (planned, anticipated) financial statements. Because revenues and earnings generally develop more slowly than planned, entrepreneurs often run out of cash prior to achieving positive cash flow in their businesses, or prior to expecting to need to raise more capital. Cash is the life stream of a company and running out of cash will shut down a company immediately. Consequently, experienced angel investors anticipate cash shortages by entrepreneurs and their companies and are ready, if appropriate, to put additional cash into their portfolio companies.

Many companies anticipate multiple rounds of investment by a series of investors during the life of the company. In these cases, it is also appropriate for angels to consider participating in multiple rounds of investment, to maintain their fraction of ownership in the company, precluding dilution of ownership as new investors fund subsequent rounds of investment.

However, angels are often faced with the dilemma: Is this company viable and just needs a bit more cash than originally anticipated, or am I throwing "good money after bad"? Consequently, prudent angel investors make a new decision prior to making follow-on investments in portfolio companies, that is, considering the current opportunity presented by the company. They ask, "Is this an investment I would make even if I did not invest earlier?" It is for just these company needs and investment opportunities that angel investors maintain "dry powder," that is, a reserve of funds to invest in existing portfolio companies beyond the funds set aside for investing in new companies.

Do angels invest locally, regionally or nationally?

Entrepreneurs often encounter angel investors who are away from home and are eager to "pitch" these angels to invest in their businesses. These entrepreneurs are disappointed to find that most angels are not interested in making angel investments more than 100 miles from their hometowns, even if the business plan is in the sweet-spot of the angel's interest. Why do most angels invest only locally?

Angels have typically traveled for all of their business careers, so more business travel is not particularly appealing. Furthermore, angels are often retired businesspersons and part-time investors, so attending Board meetings in the morning, leaving time for other activities in the afternoon, is attractive. Overnight trips to attend Board meetings and to engage with principals in portfolio companies are simply not as appealing as investing in and supporting local entrepreneurs.

Finally, the motivation for some angels to invest is to help the local economy and therefore local entrepreneurs. Appreciating this motivation helps the entrepreneur better understand the local investing style of angels.

How are active angels compensated for the roles they serve in portfolio companies?

As was described above, the time angels invest in portfolio companies is often more valuable than the money used to fund company startup and operations. I have also discussed that angels are very active in some of their companies and less so in others. In those companies in which an angel is rather passive, it is likely that other angels who invested in the same round are active, probably because they have more appropriate skills and experiences for this company.

Angel investors normally do not take an active management role in invested companies; rather they serve as mentors, coaches and Directors. Angels consider their mentoring and coaching engagements with entrepreneurs part of their investment and, furthermore, an opportunity to keep in close contact with their investment. Seldom are angels compensated for serving in mentoring roles. In extraordinary circumstances, angels will step in to assist the company in a temporary management role, and can be compensated for their efforts, but almost always in options or warrants for additional stock in the company, not for cash.

It is common, however, to compensate members of the Board of Directors for their role in the company, especially when the investor/Director is a very small shareholder. (VCs and other large investors with appreciable ownership of the company normally do not receive any form of compensation, except for reimbursement of travel expenses.) Compensation for Directors would normally be in options or warrants totaling no more than 1% of a startup company (vested over 3-4 years' service) and a lower percentage of ownership for a later stage company.

3 Control: Who Has It?

What is control?

Control of a company is vested in the Board of Directors, who sets the policy and direction of the company, furthermore, it is the Board's responsibility to hire and fire the management team, including the CEO. Many company founders are unwilling to share the control of their companies with outsiders; and because equity investors usually require some representation on the Board, these founders are reluctant to seek and accept outside investors. Frankly, this is an important decision that founders must make very early in the life of their companies. In many cases, the founder can bootstrap the company, that is, use personal funds plus funds raised from partners, friends and family, suppliers and customers to start and operate the company until cash generated from operations can be used to grow the company. In fact, capital from friends and family is the most widespread funding strategy for US startup companies.

In many cases, however, the capital required to start the company exceeds that which can be raised from friends and family. In other cases, the founder determines that larger amounts of capital will increase the chance of success of the company, by facilitating faster, earlier growth and market penetration. In each of these cases, the founder must get comfortable with the concept of sharing control in the company. The issue of controlling the company is an important decision for consideration by founders as they consider starting companies.

Who controls the company?

Control of a company is, in fact, vested in the shareholders, who elect the Board of Directors. The shareholders of the company elect the Directors and, depending on state law and the charter and by-laws of the company, a majority of the share ownership of the company can normally elect the majority of the Directors, hence controlling the company. And, in most startup companies the founder/CEO (and/or the founding team) have a majority of the ownership and hence control the Board. So, at the early stages of the company, control is circular question, that is, the Board controls the management team but the founders elect a majority of the Board. In a fight over control and depending on the by-laws of the organization, the shareholder majority generally determines the make-up of the Board and the direction of the company.

Does control equal independence?

100% control of the ownership of the company does, indeed, guarantee independence from interference in the management of a company. It puts the success or failure of the company squarely on the shoulders of the founder. But, is this level of independence really what you want as an entrepreneur? It is lonely at the top, especially for first time entrepreneurs. If you choose to maintain 100% ownership in your company, finding a support system of trusted advisors to help make difficult decisions and establish the policy and direction of the company is critical. Successful entrepreneurs, whether 100% owners or not, tend to surround themselves with competent advisors with whom they can share challenges and from whom they can solicit sage advice.

Is giving up some ownership equal to working for someone?

Bringing in outside investors results in working WITH those investors but not FOR those investors. This is an important distinction. By investing monies in your company, these investors are now shareholders (or partners) in the company with the founders. All ownership must share the objectives of building a successful company as well as sharing the objective of harvesting their investment in a reasonable period of time (an exit from the company usually within 5 to 10 years after investment is made).

Entrepreneurs must recognize that investors are not funding their company to help the entrepreneur build the company as fast and as far as the entrepreneur can build it. The investors' objective is to quickly scale the company to a size and level of profitability that a larger company will be interested in acquiring their company (with or without the entrepreneur at the helm as CEO). Investors are not interested in building a company that the entrepreneur can pass on to heirs or can operate until the entrepreneur's retirement. Investors are not interested in assisting in growing a company only to have their stock purchased back by the company, so that the entrepreneur can again own 100% of the company. The objective of investing in startup companies is to scale the company quickly and sell the company with huge capital gains for the entrepreneur and investors.

Savvy entrepreneurs quickly acknowledge that building a successful company is different that "building a successful entrepreneur." While some investors are more patient than others, all investors seek to build a successful company in a reasonable period of time. And, since first time entrepreneurs seldom have the skills to grow a company to sufficient size to justify a highly valuable exit, there will likely come a time when the founding CEO and the investors should agree to hire an experienced CEO to grow the company towards a harvest. Many entrepreneurs resist the transition to a "hired gun" as CEO. By insisting on remaining as CEO, they restrain the growth of the company to the level of growth they can personally manage.

Is giving up equity like getting married?

Since it is likely that investors will remain engaged in a successful company until exit, it is important to select investors wisely. Look for "smart money," that is, investors that also bring substantial business acumen and vertical experience into your company. Such investors will understand the problems of growing a company in your business segment and have many contacts in the industry to assist in completing the management team, as well as finding partners and customers. While we equate marriage to a life-long partnership, you will be working closely with investors in building the company for as much as a decade (sometimes more). So, in many ways, selecting investors is much like the process of getting married. Choose carefully!

Do angel investors want control? How much ownership?

As we have discussed, angels are part-time investors and are at a stage of life when they have a variety of engagements. Running your company on a day-to-day basis is not part of their plans. They have already "been there and done that" and do not want to go back to those 60 to 80 hour weeks managing a company. Angels will invest in your company and step to the plate to help you grow the company as rapidly as possible. The success you achieve will be jointly defined and executed by you, the entrepreneur, with the support of angel investors.

Single angel rounds of investment are typically $200,000 to $1 million in exchange for 20 to 40% ownership in the company. If the company has already demonstrated some success in startup and growth, the first round of investment may purchase less than 20% of the equity. Very seldom does a single angel round of investment result in 50% ownership in the company and hence control of the Board of Directors. Typically, the make-up of the five-Director Board after a seed angel round might be two Directors selected by the entrepreneur, two by the investors and one agreed-upon outsider.

What control will angels likely expect to exert?

As long as the company is growing according to plan, meeting milestones and not prematurely running out of cash, the investors are likely to provide the assistance requested by the CEO as well as complete financial and milestone oversight at Board meetings. Angels with busy lives outside their investing activities are unlikely to interfere in the operation of a successful company. Angels are, however, likely to step in when the company is not meeting milestones and especially if the company is unexpectedly running out of cash. This is what any entrepreneur should expect any investor to do when an investment seems to be at risk.

Do venture capitalists want control?

VCs are unlikely to acquire controlling interest in a company in their first round of investment. However, VCs (and many angels) will demand a voice in certain decisions the entrepreneur may address, such as seeking further investment, acquiring another company, pursuing bank debt, etc. In rapidly growing companies which require several large rounds of investment, it is unlikely the entrepreneur will maintain 50% ownership in the company after the second round of investment.

When the company is doing well, VCs also will provide only the agreed upon assistance and guidance to the entrepreneur and the company. VCs, however, are less patient than angels. VCs are full-time investors and usually have much more money invested in each portfolio company than do angels.   Consequently, VCs are likely to step in and exert control earlier than are most angels.

Can a minority interest exert control? If so, how?

An investor's minority interest generally has some negotiated influence (or control) and some informal control. By reserving some rights for the preferred class of stock in their negotiations as they make their investment, investors can require the CEO and the Board of Directors to get the approval of their preferred class of stock before undertaking certain specific activities, such as obtaining bank financing, making an acquisition, selling the company, etc.   So, in this case, a minority interest must approve certain transactions of the company.

Investors always exert substantial influence over subsequent rounds of investment. Prudent subsequent investors, as part of their due diligence, will poll earlier investors for their opinions on the progress of the company and the skills of the management team. New investors usually expect earlier investors to reinvest their pro rata share in subsequent rounds of investment to avoid dilution of ownership of those earlier investors. Reluctance by earlier investors to enthusiastically support the company is always a danger signal to new money.

Early investors often have access to deeper pockets, that is, these early investors know how to find larger investors who might be interested in investing in subsequent rounds. This is one mechanism of control that VCs in particular use with portfolio companies. Any unwillingness on the part of early investors to make introductions or cooperate with new investors will always dampen the interest of new money.

Does the CEO or the Chairman control the company?

The CEO is responsible for running the company, at the pleasure of the Board of Directors, who establishes the policy and direction of the organization. So, in theory, the CEO does not report to the Chairman, but to the Board as a whole. In many companies, the CEO and Chairman positions are held by the same person, making the question of control mute. But, the duties and responsibilities of the CEO and Chairman vary substantially from company to company.

It is my suggestion that the CEO/entrepreneur who is not the Chairman work closely with the new Chairman to negotiate the roles and responsibilities of each position. As will be described later, the appropriate division of duties can be of great assistance to the CEO/entrepreneur in preparing for Board meetings and generally managing the expectations of the Board of Directors.

Who should be Chairman of the company?

There is no consistency among early stage companies regarding who should be Chairman. It is often the entrepreneur/CEO and sometimes the lead of the investor group. It is best practice that the Chairman be the most qualified Director. This is likely a Director with substantial Board experience (often an investor) who works well with the entrepreneur/CEO. By selecting an experienced Director, the Board is removing a substantial burden from the shoulders of the CEO. This Chairman can work with the CEO and other Directors to establish the agenda for meetings and make assignments for preparing reports for the Board. An administrator within the company can be selected to collect and collate reports to be distributed with the agenda to Directors in advance of the meeting. This Chairman also moderates Board meetings to allocate appropriate time to the subjects of interest to the Board and assure that proper minutes are taken at the meeting and distributed later. Selecting such a Chairman leaves the CEO with more time to run the company without threatening the CEO with control issues related to the meetings of the Board of Directors.

What is an appropriate size and makeup of a Board of Directors?

Startup companies often have Boards of three to seven Directors. Smaller boards (3-5) are probably more appropriate at the earliest stages of starting a company, while larger boards (5-7) may be better for growing companies. As was mentioned above, an ideal five-director Board might consist of two "insiders" or Directors representing the entrepreneur, two investors and one Director with substantial experience in the business sector and in executing exits, agreed upon by both sides. It becomes appropriate to increase the size of the Board when added industry expertise would be valuable to grow the company. Maintaining an equal number of investor representatives and entrepreneur representatives can continue until subsequent rounds of investment are required. It is likely that the entrepreneur will then be diluted to less than 50% ownership in the company and that the Board, at that time, will add investors from the new group. Since it is responsibility of the Board is to work with the CEO in building and developing the management team, it is considered good practice for the entrepreneur/CEO to be the only employee on the Board.

Entrepreneurs can expect monthly Board meetings until the company achieves positive cash flow, when bimonthly or quarterly Board meetings may be sufficient. Telephonic meetings are appropriate for a portion but not a majority of meetings. Directors getting to know one another is important to the success of the venture and this can best be accomplished through face-to-face meetings. However, teleconferences between regular Board meetings, especially to deal with crises, are commonplace.

How can entrepreneur/CEOs manage investor control?

The keys to great investor relationships are communications and meeting milestones. Not surprisingly, investors thrive on information received regularly that report on the progress of financial and other company objectives. It is suggested that a portion of an early Board meeting be devoted to the specific expectations of each Director regarding communications and a group decision on progress reporting to other investors. Once these communication expectations are defined, the entrepreneur needs to meet those expectations. By not blindsiding investors and Directors with bad news, the entrepreneur is much more likely to gain investor trust and cooperation in resolving pressing issues.

What is founder vesting?

Founder vesting is used by investors to protect their interests by keeping the founder's "feet to the fire" in the tough times of starting and growing a company. Let me explain why investors may need founder vesting, through an exaggerated anecdote:

> *Professor Irvin has just received an investment of $500,000 in his new company from several angel investors. The angels now own 30% of the company and Professor Irvin owns 70% of the company. But, after a few months, the professor discovers to his surprise that he really doesn't like the pressures of being an entrepreneur, stops pursuing the milestones of the company and returns to his research in the company laboratories while on full salary. Unless this possibility has been anticipated, the investors can do little short of legal action to stop the professor from using their invested cash in the pursuit of his personal interests.*

Investors use founder vesting to protect themselves from such a disaster by temporarily reducing the founder's ownership of the company and then giving that ownership back over time, as the company meets the agreed upon milestones. While it is unlikely founder vesting would be structured exactly as is shown below, here is an illustrative example:

Time from Investment	Milestone	Ownership by Founder	Ownership by Investors
Before investment	---	100%	0%
Immediately after investment	---	20%*	30%
6 months after investment	prototype complete	25%	30%
12 months after investment	delivery of first order	29.9%	30%
18 months after investment	burn rate down to $5K/mo	35%	30%
24 months after investment	cash flow breakeven	50%	30%
30 months after investment	revenues >$1 mil annualized	70%	30%

*by one means or another, the reminder of the ownership of the founder is temporarily returned to the company

While this is a simple example and does not deal with required subsequent investment or the implications of not meeting the stated milestones, it at least provides the reader with an understanding of founder vesting and why it can be a very important term to investors in startup ventures.

4 Fundable Companies

What is the "capital food chain" for entrepreneurs?

There are many sources of capital for startup entrepreneurs, as are outlined below:

- Self: Perhaps the most important source of capital is your earnings and savings, including second mortgages on your home and other assets. Keep your "day job" until the startup company absolutely requires all of your time. The more capital you can provide, the less needs to be acquired elsewhere, allowing you to keep more equity in the company.
- The least expensive source of capital is research and development grants from government agencies. These funds can often be expended on critical research and product development related to commercialization of the company's technology. This cash is neither debt (need not be paid back) nor equity (cash in exchange for company ownership).
- A critical source of capital to startup entrepreneurs is internally generated cash (bootstrapping), that is, cash from profits in the early sale of products. Cash generation through profitable operations can minimize or eliminate outside investment, maximizing the ownership of the company by the entrepreneur. Entrepreneurs should consider selling equity only when no other sources of capital are available.
- According to a recent GEM* study, as much as $80 billion is annually invested in startup companies in the US by informal sources of capital, that is, friends and family. Self, friends and family provide over 80% of the startup capital in the US and are the first place to look for money when starting a company. It is important, however, that the entrepreneur and the source of capital clearly understand that this money is (a) a gift, (b) debt which must be paid back, or (c) an equity investment in the company.
- In recent years, angel investors provide about $20 billion per year to seed and startup entrepreneurs in the US annually. This investment is usually an equity investment or a debt instrument that the investors can convert into an equity security later. (While I have indicated above that angel investors normally do not invest in debt, convertible debt can provide an option for investors to convert to equity under favorable terms.)
- VCs are also investing about $20 billion in US companies, but only a tiny fraction of that is in seed and startup companies. VCs tend to invest at a later stage in company development.

What role do angels play in the capital food chain?

Since angels provide seed and startup capital to entrepreneurs, they are usually the first outside equity capital invested in the company. (Friends and family are generally considered insiders to the entrepreneur.) Angels are savvy businesspersons providing the first, independent, third-party investment in the company. Angels are excellent early stage investors because they bring substantial business acumen with their investment cash, a very useful asset to startup entrepreneurs.

* *Global Entrepreneurship Monitor* (Babson & London School of Business)

What types of companies do angels fund?

Angels make active (not passive) investments in companies that will scale.
Angels invest in retail companies, high-tech companies, life science companies, manufacturing companies and companies in many other business segments.
Since all angel investments are in the high-risk category, angels will only invest in companies that can provide a very high rate of return, as was discussed in Chapter 2.

Active investments are those in which the business experiences of some of the members of the angel investing group can bring special assistance to the entrepreneur in starting and growing the company. Angels serve as mentors, coaches and Directors to the entrepreneur and the company. While leveraged real estate limited partnerships can bring a very high rate of return to investors, a limited partnership by definition is a passive investment and not considered an angel investment.

In general, at what stage do angels seek to fund startup companies?

Prior to investing angels want to be able determine if the "dogs will eat the dog food." Will customers buy this product at price sufficient to enable high growth by the startup? Consequently, angels will not usually look at a company until the product development is sufficiently advanced to the point that the product or a prototype of the product has been shown to customers. The angels will then want to talk to those customers to determine if they will buy the product and at what price points.

Investors will generally not invest in technologies, that is, companies formed around interesting technology but for which products have not yet been identified. Angels are also unlike to pay for the writing of software code, meaning that the initial product release has to be sufficiently complete so that customers can begin to appraise the value of the product before angels will fund the company.

It is not uncommon for startups with exciting technology to develop a licensing business model - commercializing their technology through licenses to larger established firms. While a viable commercialization model, it is not a particularly interesting business model for investors. Generally, licensing companies grow slowly, dependent upon a royalty stream from revenue growth by licensees. And, selling a licensing company to exit can be a struggle when most possible acquirers are already licensees of the company.

There are many exceptions to these guidelines, such as angels investing in drug development or angels investing in exciting innovative technology. But, in many of these cases, a serial successful entrepreneur is involved, or a world-class laboratory is commercializing next generation technology, or a well-known scientist is staking his reputation on the science behind the venture. With these as exceptions, angels are normally looking for deals where customers have been identified and are also available to discuss the product with the investors.

What is a fundable CEO?

Angels love investing in serial entrepreneurs, who have had several successful startups on their resume, including a company which they "took public" [an initial public offering (IPO), a time consuming and expensive process of converting private securities into publicly tradable shares] as well as at least one company failure in their backgrounds - one usually learns more from a failure than a success. But, frankly, these investing opportunities are very rare.

Angels seek to invest in entrepreneurs who are highly-motivated, experienced businesspersons who are capable of making impressive presentations to investors, partners and customers. Integrity is critical – angels do background checks on entrepreneurs before investing. "Highly-motivated" implies a passion for success and "both feet in." Angels are not interested in funding entrepreneurs who "can always go back to their day jobs" if the going gets tough. Investors seek entrepreneurs with lots of business experience, especially in the business segment of the startup company.

Sounds good…but you don't score high on this list of qualifications. What should you do?

1. Be absolutely truthful in your dealing with investors.
2. Surround yourself with a first-class team, experienced businesspersons who do have the business acumen you lack. If you don't yet have the cash to put them on the payroll, have them waiting in the wings.
3. Surround yourself with a first-class team of business advisors…I mean top drawer! If you do a great job of recruiting them, they will agree to serve as advisors for a small piece of the equity (no more than 1%) in your company.
4. Finally, be prepared to step aside after the company has achieved a few milestones and help the investors hire a top-notch CEO for the company. Continue to support the company in a role consummate with your background. Investors expect a substantial return on investment in a reasonable period of time. It is in no one's best interest (including the entrepreneur's) that the growth of the company be limited by the skills and experiences of a first-time CEO.

First-time entrepreneurs often trip over their egos. It is almost always in the entrepreneur's best interest to congenially step aside and assist in hiring and ramping up a new CEO. By doing so and staying involved with the company, the entrepreneur optimizes his or her return on investment. After exiting, the entrepreneur can start another company…this time as a serial entrepreneur!

What are angels looking for in a CEO?

In interviewing entrepreneurs, investors are looking for many personal qualifications.

In fact, the investor will likely want to interview your management team and talk with your earlier investors (even friends and family) as part of the process. At the risk of repetition, here is a summary of the characteristics of fundable entrepreneurs:

Integrity – Truthfulness and honesty are a must. Angels will check into an entrepreneur's background. Be truthful from the start.

Interpersonal relationships – Are you a skilled manager? Do your customer, partners, earlier investors and family appreciate your personality? Do you carry yourself well in public (speaking, manners, etc.)?

Coachable – Do you listen? Do you seek the advice and counsel of others? Or, are you a "know it all"?

Passionate and committed – Is this just another activity for you, or is starting this business a self-consuming passion for you? Do you have "both feet in," that is, totally committed to the startup venture?

What is a fundable management team?

A critical component of the management team is the entrepreneur's willingness to surround him or herself with the most qualified management team available. Typically, "A" entrepreneurs hire "A+" managers, while "B" entrepreneurs hire "C" and "D" managers. Always be willing to hire executives who are smarter and have more experience that you do! Having prior experience with some of the members of your management team is a plus, but is not critical to success. (It is always nice to know that you work well with the rest of the team prior to starting a company.) Don't hire clones of yourself (same degree from the same school with the same experience since graduation). Develop an experienced, well-balanced team.

Must my management team be in place to seek funding?

Demonstrating the skills to attract highly qualified talent and your willingness to surround yourself with smart businesspersons is absolutely necessary. But, the entire team need not be in place at the time of funding. It is OK to have a few waiting in the wings for the company to be funded and even to tell the investors you need their help in filling a key position or two. It is a benefit to have a team member or two on board (or prepared to join the company). It is critical to make it clear to your investors that you intend to hire the most qualified team available and you would like to involve them in the process of building out the team.

What should an entrepreneur do when the company is not yet fundable?

There are several reasons why a good pre-seed company might not yet be fundable, but may be an excellent candidate for funding at a later date. One likely reason is that the entrepreneur has not yet addressed the critical issues necessary to complete a business plan. Examples: The intellectual property (IP) may not yet be under the control of the company. Or, the marketing channels have not yet been flushed out. Or, the proforma financials are not yet validated. An entrepreneur must have carefully thought through the business plan and be very well versed in the plan prior to approaching investors.

The product may not be defined sufficiently to interest investors. Remember, angels want to determine if the "dog will eat the dog food." If product development is insufficient to yet capture customer interest, more work needs to be done prior to approaching angels.

So what is an entrepreneur to do until the company is fundable? Remain patient, keep your "day job," seek grants and funding from friends and family to continue writing the business plan or complete product development. Stay the course…don't waste your time pursuing funding from angels or VCs until the company is fundable. Your time is much better spent working on the plan and the product.

Where else should I look for funding until angels will fund my company?

As have been mentioned, personal earnings and savings, grants, and friends and family are the principal sources of pre-seed capital. If necessary, entrepreneurs can also seek capital from wealthy local experts who understand the opportunity and may be particularly interested in the product or market. Solo angel investors often get involved with pre-seed companies long before groups of angels might actually fund a startup company. Many enjoy the startup process and will introduce the entrepreneur to groups of angels later, when the company is ready. But, be careful. Normally, these wealthy experts and solo angels will do so only when they have a deep understanding of this marketplace. They have likely invested in a similar fashion in other companies. They must be "right-minded" persons, truly interested in helping entrepreneurs start companies in specialized verticals. Check their references! Talk to other entrepreneurs whom they have helped start their companies. Be sure these are investors of integrity, for whom helping you is their primary motivation. And, if necessary, share some equity with them for their effort. They should invest some cash and a lot of time in assisting you in teeing up your company for investors. And, for that, you might consider sharing 3 to 10% of the company (common stock) with them, depending on their level of effort and expertise.

What if my idea is "perishable"?

"Perishable" opportunities are those which have no value unless commercialized in a limited window of time. Some experts in the new venture marketplace feel that the "first mover advantage," that is, the first company with a new product for a new application, has a large advantage over companies who enter the market later. Many of the rest of us feel that "first mover" advantage is over-rated, having seen the "first mover" make many mistakes and spend too much money making a market for which the second or third company in the space successfully dominates.

But, some ideas are truly perishable…software that is compatible with a totally new release of a dominant player's software upgrade may indeed have a limited shelf life before many competitors enter the market (or the "big guy" introduces the next version). There are many such opportunities.

My suggestions for those with "perishable" ideas are (1) make sure the idea is both scaleable and fundable; (2) hurry, with patience; and (3) consider shortcuts to the marketplace, such as development and/or marketing partners. It is always better to share a perishable idea and take a smaller piece of the pie than to see the window of opportunity disappear.

Will angels sign Non-disclosure Agreements (NDAs)?

It is quite shocking and disconcerting to first-time entrepreneurs to learn that neither angels nor VCs will sign a confidentiality agreement (or a non-disclosure agreement) to read the entrepreneur's precious business plan. This is a serous dilemma. Entrepreneurs have truly confidential information but investors cannot possibly sign several thousand NDAs in their investing lifetime. So, what is an entrepreneur to do?

Trust – Work only with investors whose integrity you can validate. This is actually easier to confirm than you might expect. Most investors value their good names and integrity far too much to ever intentionally steal an idea. There are simply too many good ideas and too many good business plans available to invest in to spend time attempting to steal ideas. Always do "due diligence" on your investors. Make sure they are really persons you would like to partner with in your company.

Non-confidential business plan – As an innovative entrepreneur with a "top secret" venture idea, you must learn to write a non-confidential business plan. Define the "secret sauce" and find a way to write the plan without revealing the confidential materials. And remember, with access made possible by the Internet, there are no secret customer lists and no new business models. Confidential technology is usually covered by patents, and a clever entrepreneur can write the plan around the confidentiality.

Investors do sign NDAs! – If you write a solid plan for a scaleable product without revealing the "secret sauce" and an investor finds your plan compelling, he may indeed sign a NDA during the "due diligence" prior to investing (but not prior to getting to know you and the plan). In this case, the investors or a designate may agree to sign a very narrow non-disclosure agreement in order to read and validate the critical 1000 lines of software code or the critical claims of a new process patent or the chemical formula for your newly discovered "secret sauce."

The trick is to write a great non-confidential business plan and then let the investors ask you to reveal the confidential information to them. At that point they will be willing to sign a limited NDA.

Who owns my Intellectual Property (IP)?

Entrepreneurs cannot license their technology to their company and keep ownership of the intellectual property for themselves. Investors will simply not invest in such companies. If you are an entrepreneur/inventor and you own rights to the intellectual property to be utilized by the company, the technology you own related to that venture must be included in your contribution to the company at startup or at least before investors will engage.

How can I protect my IP from investors?

Under the limitations I have described above, you may need to protect your truly confidential information from **potential** investors; however, you do not need to protect confidential information from your investors. After all, they are your partners. They succeed when you and the company succeed. As long as you have done reasonable background checks on your investors and validated their integrity, you have done all you can to protect yourself.

You will also be surprised to find that very few investors will care about the IP after the investment, except that the company owns it. Investors will primarily be interested in the quality of the company the entrepreneur is building to commercialize the technology, rather than in the technology itself. The exceptions are when ownership of the technology becomes an issue (legal challenges or infringement) or if the company has difficulty commercializing products utilizing the technology.

Who can assist me in managing my IP?

If the patent estate is critical to the success of the venture, it is incumbent upon the entrepreneur to secure the best possible team to assist in developing a technology strategy for the company. What technology should be patented? What technology should be protected as trade secrets? What technology should be acquired from others (such as a university or national laboratory) under what payment terms? Management of IP is expensive and most entrepreneurs have little money, so careful planning is necessary to optimize expenditures in designing a highly fundable company.

There is no rule of thumb for managing IP. Get some business advice from your local entrepreneurship center or from advisors on the best available legal counsel in your particular technology arena. Sometimes you can get excellent counsel to write fundamental patents at a reduced rate or payable over time until the company is funded, with a promise to use the same counsel for future work.

Patent attorneys are not necessarily the best sources of information on establishing a strategy for your patent estate. If you can find business experts familiar with the technology or market of interest, who are willing to advise the company (for cash or better yet, for a small piece of equity), engage them to develop a strategy and to negotiate licensing arrangements with university and laboratory sources of technology, if appropriate. In any case, it is suggested that you engage with an experienced business advisor as you negotiate technology rights with universities and laboratories.

5 Planning Growth and a Funding Strategy

Building a Scaleable Company

In Chapter 2, we described scaleable companies. These companies propose rapid growth and generally feature products for large niche markets. Entrepreneurs of scaleable companies propose sustainable models for their startup companies that can reasonably be expected to provide a substantial return on investment in five to seven years.

Do VCs look for larger opportunities than angels?

Angels tend to invest $200,000 to $1 million per round in seed/startup and early stage companies, many of which will require multiple investments to achieve positive cash flow through operations. Some angels fund rounds of investment sized between $1-2 million, however these deals are infrequent, probably less than 5% of angel deals. The average round of investment by angel investors in the past two decades has not changed substantially and remains at $250,000 to $400,000. A few companies have raised $5 million or more from angel investors (in multiple rounds of investment) but these are the exception, not the rule. Most companies raise less than a total of $2 million in angel capital. For these companies, an exit valuation of $10-20 million can be an exciting and profitable opportunity!

Venture capitalists, on the other hand, have raised huge amounts of capital in the past two decades from their limited partner investors. Consequently, each VC must invest more money per deal than in the past. In the early '90s, the average round of investment by VCs was $3 million or so, but as VCs raise much more money from their limited partners, the average VC round has steadily increased to $7-8 million, more than double the average investment round before the Internet bubble. As a general rule, later stage investments tend be much larger than earlier stage investments. Since VCs now invest larger amounts of money per deal, VCs are much more likely to invest in later stage deals than in the early '90s. VCs often invest $25 million or more in total (multiple rounds) in portfolio companies, and look to exit those ventures at valuations of $100 million or more.

If you think about it, the startup phase of a high-growth company will require relatively small amounts of funding, probably no more than $1 million. But, high-growth startup companies need to raise significant amounts of capital to sustain very high growth over several years. The management teams of these highly scalable companies will soon face a dilemma; how to raise the capital necessary for sustained growth? One option is to raise more money (probably from VCs) to sustain the maximum growth rate. The second is to grow more slowly and organically, that is, using cash generated by the business and later bank debt for growth. This is a complex decision and there is no standard answer to this quandary. It depends on the nature of the business and the appetites of the founders and early investors.

What is the funding gap?

Angels have been investing in rounds of investment between $200,000 and $1 million for decades, while VCs have tripled their average round size since the early '90s. Before the Internet bubble, successful angel deals could expect interested VCs to step to the plate and invest in follow-up $2-3 million rounds in exciting companies. This is no longer the case. With most VC monies being invested in much larger and later stage deals, there are very few investors interested in the $3 million deal size. This is not necessarily logical, but just a sign of the times. There are over 100,000 angel investors interested in rounds of investments less than $1 million in size and nearly 1000 venture capital firms interested investing in deals with capital requirements of $5 million and larger. Unfortunately, there are very few investors in the US interested in funding $1-5 million rounds of investment (The Gap) in early stage companies. The following chart shows this funding gap.

INVESTORS	Self Friends and Family Solo Angels	Angels & Angel Groups	THE GAP Very Few Investors	Venture Capital
INVESTMENT SIZE	$2,000 to $100,000 (rarely to $300,000)	$200,000 to $ 1 million (rarely to $2 million)	$1-5 million	$5 million and above (few $5 million)
ANNUAL US INVESTMENT	>$50 million	~$20 billion	~ $500 million (estimate)	~$20 billion

How do I avoid the funding gap?

We see over 100,000 angel investors funding 50,000 companies with first or later stage rounds of investments between $300,000 and $1 million.

We know that about 1000 VCs are making first-time investments of $5 million or more in as many as 1500 later stage companies per year, but making very few investments of $4 million or less.

Clearly, companies need to go where the money is. But, what does a company that needs $3 million to meet its objectives do to raise this capital? Good question! Entrepreneurs must adjust their funding needs to match the somewhat convoluted capital marketplace.

A naïve entrepreneur who needs to raise $2.5 million in capital for his company will waste a lot of time without success pursuing this amount of capital. There are very few players in The Gap and finding them is almost impossible.

A savvy entrepreneur who needs $2.5 million to reach positive cash flow (from profits) in commercializing a new product, will stage funding-raising efforts to match the capital markets. He or she might, for example, raise $500,000 and plan to raise two additional rounds of $1 million each as the company achieves milestones.

An entrepreneur who needs to raise $6 million to achieve positive cash flow might raise enough money to achieve an important milestone, say $750,000, and then seek $5.25 million from VCs interested in this business vertical.

The important message for entrepreneurs is (1) understand the capital markets and (2) design a funding strategy that matches nicely with those markets.

What are measurable milestones?

All startup companies can define milestones, the achievement of which will demonstrate progress in starting and growing the company. Some of those milestones are measurable (obtained signed license for technology) and some are not (customer shows interest in verbal description of the product). The important and measurable milestones for all startup companies are different, but here are some examples that might be helpful in defining important milestones for your company:

- licensed technology from university
- developed working prototype in laboratory
- hired qualified CFO
- received reasonable production quotes from three reputable Chinese firms
- hired super VP of Sales
- negotiated agreement with channel partners in five regions of US
- based on testing prototype, three potential customers provided letter of intent to purchase products at our price, assuming quality sufficient to meet their needs
- closed $450,000 round of angel investment
- received and tested first production runs from China
- delivered first product to US customer
- received working line of credit from local bank
- first customer paid first invoice
- achieved $100,000 per month in revenues
- cut burn rate to $5,000 per month

Each of these milestones is tangible and can be measured. The entrepreneur can demonstrate clearly that each goal has been achieved.

How do I match milestones to a funding plan?

The first task is to establish a list of the dozen or so key measurable milestones for your company. Generally this list is not confidential, so show the list to your colleagues and advisors. Work on the list until all agree it is a rather complete list.

With the list in hand, estimate how much money it will take to achieve each of these milestones. Be conservative…entrepreneurs tend to be overly optimistic about achieving these objectives.   Let's use the list in the previous section.   Let's further assume that from personal savings and a loan from Aunt Martha, you have raised $150,000 and in addition, that if pressed, you could probably raise another $50,000 from other friends and family.

Referring to the list of milestones above, you may determine that $150,000 to $200,000 will be required to develop the prototype. You will obviously run out of money before the $450,000 in angel capital can be raised and will be forced to seek the angel investment round much earlier than is shown in the list above.

The object of creating the milestone list is to plan when you will need to raise money for your business. The more milestones you can achieve before raising the next round of investment, the more likely you will be able to find investors to fund the company.

Use your milestone list and your new knowledge of capital markets to match milestones with your rounds of investment. You can then tell your early investors that their $450,000 of investment will be enough to get you to positive cash flow or, alternately, that you will need to raise another $1 million from angels (or $5 million from VCs) after you have achieved a specific milestone to scale the company sufficiently. Select these milestones carefully, because investors will expect you to meet these objectives prior to raising more money.

Are some deals only funded by angels?

Many companies require less than $1 million to achieve positive cash flow, that is, the companies mature to the point that further growth can be financed by internally generated cash (from profits). Software companies serving large niche markets are examples of companies that often require $1 million or less in capital investment to be successful. Such companies can either be bootstrapped by the entrepreneur or financed by angel investors.

On the other hand, hardware and life science companies, for example, may require $10s of millions to achieve positive cash flow or to execute a successful exit. These companies, because of the huge amount of investment necessary for success, will likely raise capital from angel investors and later from venture capitalists.

To provide some perspective, according to the Center for Venture Research, angels provide first-time capital to over 20,000 companies per year in the US. VCs invest their first capital in less than 1000 new companies per year. Clearly, angels invest in at least twenty times as many companies as do VCs and about 5% of angel-financed companies successfully raise venture capital.

Will angels fund multiple rounds, to enable me to eventually reach the VCs?

All angels and VCs put aside "dry powder" (extra cash) for their portfolio of companies because entrepreneurs frequently require multiple rounds of investment to achieve success.   Sometimes this additional infusion of cash is planned and sometimes it is not, but to preserve their investment in good companies, all startup investors reserve cash for multiple investment rounds in portfolio companies.

Sometimes those second and third rounds of investment are designed to "bridge" the company to VC rounds of investment. In other instances, the company simply needs multiple rounds of angel investment to achieve success. Remember the savvy entrepreneurs a few pages back who planned to raise $500,000 then two consecutive angel rounds of $1 million to achieve success? Multiple angel investment rounds are the norm, not the exception, in today's capital market climate.

Is VC funding desirable? Necessary?

I always advise entrepreneurs against raising money from either angels or VCs, if they can possibly bootstrap the company to positive cash flow. Why sell equity in your new company if you can keep all the ownership for yourself without bringing in outside investors? Raising money is very time-consuming and takes vital time away from the mainstream business. Don't do it, unless you must.

However, if your conservative estimates suggest it will take $10 million to build your company, they you have little choice. VCs are the primary source of capital for startup companies who need to raise between $5 and $100 million to be successful.

There are strategic investors who may be interested in investing with or instead of VCs. These are often venture arms of larger companies, such as Intel and Google, who invest in companies that are commercializing technology of core interest to the future of their businesses. If the technology of your business is obviously important to larger companies, and you learn that the target company has a venture arm, pursue investment from them. Strategic investors can be very useful to startup companies. Be careful, however, because the interest of strategic investors may be substantially narrower than yours. Furthermore, having taken investment from a corporate player may discourage their competitors from becoming partners or even potential acquirers of your company.

When should I seek my first angel round?

If you need to raise $300,000 to $1 million in your first or only round of investment, angel investors should be pursued. Put off raising money as long as possible, because the more milestones you can achieve prior to raising angel money, the more valuable the company will be to angels (and the more ownership you will be able to keep).

As a general rule of thumb, angels prefer to invest in companies who have completed their product development and have shown the product or a prototype of the product to potential customers. Most angel investors want to talk to customers to validate that the solution offered is, indeed, important to users.

Angels will invest at an earlier stage in the company's development, but will likely demand a greater ownership share of the company for their investment because there is more risk involved in earlier stage investments.

When should I seek more funding?

Assuming you created the milestone-driven funding plan described above; you will know approximately when you will need to raise more money. Most investors suggest that each round of investment should provide 12-18 months of "runway," that is, months of operations before you run out of cash. And, knowing that it takes 3-6 months to raise money, a prudent entrepreneur will begin raising cash 12 months before running out of cash. It should be becoming clear that fund-raising is a critical and time-consuming part of the entrepreneur's job. This is why all investors will suggest that entrepreneurs bootstrap their companies, rather than raising capital from angels and VCs.

Why is it important not to run out of cash?

The obvious answer is that if you run out of money, your company goes out of business. But, in fact, there is more to this question. Companies that are about to run out of money lose all their investment leverage. Regarding the terms of investment, investors are then in a position of "take it or leave it." "If we don't invest, you will go out of business anyway." Entrepreneurs who run out of cash are forced to give up a much greater percentage of the company versus entrepreneurs who can afford to say no to "bottom feeders" and continue to look for investors who will value the company reasonably.

What happens to my company if I run out of cash?

Winding down a company through the bankruptcy process is painful and time-consuming with little or no return of capital. Early investors, who invested in you and your company, will likely get nothing in return for their investment. Employees will be out of work. Vendors will get pennies on the dollar for the supplies they sold to you on terms. Customers will be disappointed. Since all of your personal assets are tied up in the company, you and your family will be financially strapped. Finally, closing a business is a depressing duty. Your ego will be as strapped as your finances. Don't run out of cash!

What is a down round? Is that a cram down?

A down round is a round of investment in a company in which the current valuation of the company is lower than at the time of the previous round of investment. The result of a down round is that earlier investors get "crammed down." That is, because new investment money came into the company at a lower valuation, the ownership percentage of the earlier investors is substantially reduced.

How does a down round impact my early investors?

Here is an example of a down round:

Earlier Investor Investment	Later Investor Investment	Pre-money Valuation	Post-money Valuation	Earlier Investor Ownership	Later Investor Ownership
$500,000	---	$4,500,000	$5,000,000	10%	---
---	$2,000,000	$2,000,000	$4,000,000	5%	50%

Let's assume the Earlier Investor agrees to fund the company with $500,000 and negotiates a $4.5 million pre-money valuation for the company. The pre-money valuation is the valuation of the company just before investment is made. The post-money valuation is the pre-money valuation ($4.5 million) plus the amount of the investment ($500,000) equals $5 million for the Earlier Investor. So, to explain the first line of the table, the Earlier Investors buys 10% of the $5,000,000 company with his/her $500,000 investment: $500,000 ÷ $5,000,000 = 10%.

To explain line number two in the table above, let's assume the entrepreneur has missed milestones and new competitor has entered this market. The company now needs a lot more money ($2 million) and the investment, at least in the eyes of the Later Investor, is much more risky. The Later Investor negotiates a lower pre-money valuation of $2 million and invests another $2 million, so the Later Investor owns 50% of the company: $2 million ÷ $4 million (the post-money valuation of the later investment round).

The Later Investor now owns 50% of the company, so the ownership percentage of both the entrepreneur and the Earlier Investor are "crammed down" or reduced by half, so the Earlier Investor now owns only 5% of the company.

In this case, this cram down of the Earlier Investor would have been avoided if the new investors had allowed the earlier investors to invest proportionally in the later investment.   While we cannot tell from the information above, the Later Investor may not have been willing to share the round with the Earlier Investor or the Earlier Investor may not have been willing or able to participate.

In fact, the example above is a mild down round. Imagine what might have happened if the Earlier Investor had invested at a valuation of $50 million and the down round was done at a valuation of $2 million. In this case the Earlier Investor would have been diluted by approximately 25X, such that their ownership position after the new funding would have been only about 4% of their earlier ownership position (or from 10% to ~0.4%)

How to avoid down rounds?

Some investors believe they can use onerous terms, such as liquidation preferences and anti-dilution provisions (both defined and discussed in Chapter 11) to avoid down rounds resulting in a cram down of their ownership. While these investor rights look good on paper, they only tend to drive away subsequent investors may be interested in investing, but want to avoid addressing such sticky issues.

The three key issues in avoiding down rounds are:

- Negotiate an appropriate low valuation on early rounds in startup companies. Seldom, if ever, can a pre-revenue company justify a pre-money valuation in excess of $2.5 million (see Chapter 12).
- Raise enough money in a seed and startup round of investment to give the company enough runway to meet sufficiently important milestones to then justify a higher valuation for the subsequent fund raising.   Meeting milestones is often fraught with fits and starts. Raise a little extra cash and reduce spending in the early days to provide a cushion for meeting those critical milestones.
- Startup valuation is always based on accomplishments and milestones. Identify goals that will, indeed, increase the value of the company in the eyes of investors and then meet those goals.

6 Exit Strategies

What is an exit strategy?

Exit strategies describe the planned harvest of the investment in startup companies. This is almost always accomplished by selling all of the shares of the startup company to a larger and preferably public company. Not all businesses need an exit strategy. Lifestyle companies which are intended to provide income to the entrepreneur and take no investment from outsiders may not need an exit strategy. The entrepreneur operates the company during his or her working career and then sells the company for a modest price to an employee or another practitioner, who continues to operate the business to provide for family income. Family businesses do succession planning, rather than exit strategies, since passing the business along to heirs is the objective.

Why is an exit strategy important to investors?

As has been explained earlier, angels make high-risk equity investments in startup companies. Angels are investors not lenders, hence they expect more that simply to get paid back with interest by entrepreneurs. The intended exit strategy for angel investments is to liquidate the investment via a sale of the company to a much larger company. As will be explained later, exits defined by an initial public offering are unlikely for angel funded companies.

Why is an exit strategy important to me?

Defining an exit strategy is important for entrepreneurs who are seeking equity investors because those investors will expect the entrepreneur to be able to articulate a well-defined harvest for their investment. Furthermore, having a fleshed-out exit strategy is important to the entrepreneur and his or her family. As an entrepreneur, you are setting out on a journey of a decade or so to build a valuable company. But, as part of accepting equity investors, you are agreeing in advance to "sell your baby." While it is not evident at the beginning, this may be a difficult transition for the entrepreneur. A clear understanding by all parties, the entrepreneur, his or her family, and the investors of the intended outcome of accepting investor cash is critical to the success of the venture.

Should I engage my investors, partners and family in defining my exit strategy?

Clarity of purpose is useful in all relationships. Harmony at home and at the office is important to your success as an entrepreneur. Building alignment with partners and investors by defining the objectives of the venture is a necessary component of team building. A highly successful exit is the ultimate success and should be well understood by all on the team.

Building a company is hard work and requires years of commitment. Sacrifice of finances and time with family is standard for entrepreneurs, especially in the early days of a startup venture. Sitting down with the family and explaining the venture from beginning to end is an important component of maintaining a harmonious relationship at home while you are building a successful venture at work.

Why can't I buy out investors and give the company to my kids?

It is surprising to me how many times I hear this from first-time entrepreneurs. As was explained in Chapter 2, angels are expecting a very high return (perhaps 20-30X) on their invested capital. Angels (and other investors) often own between 20 and 70% of highly scaleable companies, after several rounds of investment. Even assuming the company is very successful, it is quite unlikely that the company will be able to afford (have the cash flow necessary) to repurchase investor shares at an independently appraised valuation. It should be the assumption of entrepreneurs and investors alike that a sale of the company is the intended and likely exit for successful angel funded companies.

Why is matching my exit strategy to that of my investors important?

Entrepreneurs must wear two hats, one as a founder/employee and a second as an owner of startup companies. The founder/employee hat dominates the activity of the entrepreneur during the startup and operations of the company. But, the ownership hat is, in fact, more important to the entrepreneur, because a successful exit will have a lasting impact on the entrepreneur and his or her family. Successful entrepreneurs create wealth for their families; consequently, adequate attention to their ownership position in their companies is a critical but often overlooked responsibility of entrepreneurs.

Harvesting their ownership position is, in fact, their final and perhaps most important act as entrepreneurs. And, executing the exit strategy is vital to the success of the investors. Consequently, a compatible exit strategy and harmonious execution of the harvest is in the best interest of both parties.

What is an IPO and why is an IPO really not an exit strategy?

An initial public offering of the shares of a private company (or "going public") is a financing event, not an exit. Going public allows a private company to sell shares in the public markets to generate cash for the company's growth. It is an expensive and time-consuming process. Very seldom is the company permitted to sell the shares of owners of the private company in the initial offering. The assumption is that the company needs cash for growth, consequently the entrepreneurs and investors shares are neither sold nor made available for public sale by the IPO process.

While an IPO is a financing strategy, it can and often does define the exit strategy for the investors, and can provide for future partial liquidation by the entrepreneur. Assuming the continued success of the company, investors' and entrepreneurs' shares can gradually be registered to be sold in public markets over a period of years. Since public companies are often valued somewhat higher than their private counterparts, selling investors' shares through public markets can eventually be a very attractive exit for entrepreneurs and investors.

Do you really want to go public?

While this may seem a frivolous question before the startup of the company, understanding the "trials and tribulations" of being the CEO of a public company should be thoroughly understood by startup entrepreneurs. It has always been more difficult to be the CEO of a public company than that of a private company. Because the officers and Directors of public companies are, by definition, managing an entity owned by public shareholders, the federal government has had strict financial and management reporting regulations in place for years. And, because of recent management scandals within very large public companies, substantial new legislation (such as Sarbanes Oxley) are now in place for public companies and beginning to impact the management of private companies.

As an entrepreneur, I remember the joy of developing and selling new products for delighted customers. The cycle of innovation to product to happy customers is the essence of entrepreneurship. Unfortunately, the jobs of CEOs of public companies are often far removed from innovation, products and customers in today's highly regulated corporate environment. Unless an entrepreneur knows that he or she can thrive in this environment, striving to take the enterprise public may not be such an attractive accomplishment. A good angel friend of mine says, "Let me know if you hear of an entrepreneur who wants to take his company public. I want to attempt to talk him or her out of it!"

What is the likelihood of an exit via an IPO or an acquisition event?

Business plans usually define the exit strategy as either selling the company to a larger company or taking the company public. While these are the two possible options, it is much more likely that the successful startup will be sold than go public. It is our estimate that perhaps 1% of the exits of angel invested companies will be via a public issue of shares; while less than 10% of venture capital funded companies may go public, depending on the marketplace.

Why is this? Twenty years ago, the dominant exit for venture capital invested companies was via public markets. Venture capitalists still prefer using IPOs to define their exit strategy. But, public markets can only assimilate a limited number of companies per year. And, the process for an initial public offering is both daunting and expensive. On the other side of the issue, larger public companies look to entrepreneurs for innovation and new products. More than ever before, large corporations are acquiring smaller companies to expand their core businesses. With the explosive grow in venture capital in the past decade, the predominant exit strategy has become via mergers and acquisitions. It is my impressions that the dominate exit strategy for angel invested companies has always been a sale of the startup to a larger public company.

What is an exit via a Mergers and Acquisition (M&A) event?

The expected exit for an angel funded company is to sell the company to a larger public corporation in exchange for either cash or shares of publicly tradable stock of the acquiring company, through merger or acquisition (M&A). All-cash exits are preferred, because the liquidation is instantaneous with no strings attached. The only downside to a cash liquidation is that all taxes on the sale are due in the year of the sale. Selling (actually a tax-free exchange) for shares in a blue chip public company can also be attractive, because it allows the recipient of the shares to sell the shares (and pay their taxes) on a planned schedule over several years. The disadvantage of receiving publicly tradable shares is that public markets are volatile and the price of the acquired security may go down resulting in a reduction in the return on investment of the exit. Selling for shares in another private company is not really an exit, because the received shares are likely no more liquid than those sold. It is, however, used to exit a troubled company, rolling the dice that the merged entity will have a greater chance of success than the stand-alone startup company.

Entrepreneurs should also be aware that selling the startup company to a larger public company is often subject to a market standoff (or lock-up), which precludes owners of newly registered shares from selling for restricted period (usually 180 days). This lock-up of acquired shares is regulated by the Securities and Exchange Commission. The purpose of the regulations is to avoid a flooding of the market with shares from acquired shareholders on the days immediately following closing and the consequential reduction in share prices resulting from more sellers than buyers making the market. While the lock-up is common in most tax-free exchanges of the shares of private companies for those of public companies, the lock-up period can be avoided in certain states and under certain conditions.

What do investors expect in my defining an exit?

Investors expect startup entrepreneurs to have anticipated that a thoughtful exit strategy is important to all owners of the company. Simply including a section in the business plan that states that you expect to exit the company in 3-5 years by selling the company or going public is not enough.

If the entrepreneur honestly believes an IPO is possible for his or her startup company, it is important to demonstrate why this unlikely exit makes sense for this company. What companies in the same business vertical or using the same business model have recently gone public? Why is it as likely or even more likely that the startup company will enjoy the level of success as the comparable companies? What other companies in the same vertical were unsuccessful in their bid to go public and why does the startup company have a greater chance of success than did they?

If the entrepreneur believes an exit via the sale to a larger public company can reasonably be expected as an exit strategy, the entrepreneur needs to explain why such a company would buy the startup. Define the available target companies and define why each might be interested in buying the startup. Show examples of other strategic acquisitions made by the target companies and compare and contrast the potential of the startup to those comparable acquisitions. Convince the investors that you understand the dynamics of your business vertical and a “home run” exit via strategic acquisition is really possible for your company.

Are their different types of M&A targets?

There are three types of acquiring companies for startup ventures. The first, a **strategic acquirer**, would consider buying startup companies whose products and customers will allow the acquiring company to grow and succeed faster than the in-house team can grow their business without the acquired venture. Strategic buyers often pay top dollar for acquisitions, especially if they fear one of their competitors is likely to buy the startup venture.

The second variety of acquirer is a **financial buyer**. They are looking for a successful company to purchase, planning to use their cash resources and portfolio companies to grow the acquired company very rapidly. Their objective is either to operate the company profitably, spinning off cash to the buyers or possibly selling the company after several years to an even larger company. Financial buyers tend to buy companies based solely on the numbers and pay lower amounts than might strategic buyers.

The third acquirer type is the **roll-up specialist**. Their objective is to acquire several companies in a related industry to build a much larger, highly successful venture from a set of smaller companies. A few have been highly successful, but most are not. The currency these roll-up acquirers use is often the stock of the roll-up company; and they tend to be stingy with valuation, expecting the investors in the startup company to make most of their return upon the eventual exit of the rolled-up company. This exit type is not appealing to investors.

So we are agreed…we want to define an exit by selling to a strategic acquirer, right?

How do I define an M&A target for exit?

Who are these strategic buyers? They understand your product, technology or market. They are suppliers, competitors, customers or co-vendors. Co-vendors supply your customers with products that are complementary to yours. As an example, a customer buys two different, non-competitive raw materials, one from you and the other from a co-vendor. To best define all the targets for your eventual exit strategy, it is important to develop a complete and thorough understanding of your marketplace, including the competitive landscape for your suppliers, your customers and sometimes your customers' customers. Finally, spend enough time in the appropriate R&D institutions in your vertical to understand the future threats and opportunities in your business segment. Will changes in your customers' environment make your products even more attractive in the future? Or, might technology among your suppliers (and their competitors) make your product less attractive soon?

How do entrepreneurs gather a complete competitive analysis that will help identify all potential strategic acquirers? The answer is networking. Go to trade shows. Talk to your customers and your vendors. Talk to your customers' customers. Spend time doing competitive analysis on the Internet. Look off-shore to see how the competitive landscape differs from local markets. Spend time with the researchers at universities and laboratories to better understand changes in the technology which will impact your success. From a complete understanding of the competitive landscape, it will become clear which companies would benefit most from acquiring your startup company.

What should I consider in identifying companies that might acquire my startup company?

From the competitive analysis above, you will be able to identify a rather large list of candidates.

- You can eliminate (for now) those companies that are small, struggling startup companies who could never afford to acquire your successful venture.
- You may wish to give a low priority to larger private companies, based on the analysis above. But keep these companies on the list, because

they may be acquired by attractive companies in the future.

- You will find some companies whose cultures do not match that of your company. Give these companies a lower priority, but leave them on the list because the situation may change in the next decade.
- Give a high priority to those public companies in your environment that could best benefit from acquiring your new venture in five years or so.
- Try to create a list of multiple candidates to acquire you. Why? All investors know that you will get a better price for selling your company when several large companies compete in an auction for the right to buy your company.

Who can help me define my exit strategy?

There are two sets of advisors who might help you define your exit strategy: The first is the experts in your business segment, who can help you define the vertical and how it may change in the next decade. Understanding the competitive landscape is critical to defining potential acquiring companies for your new venture. Where can you find these experts? Consultants will talk to you because they want to cultivate a relationship with you. Your company might be a potential client for them. Vendors will talk to you because you are a possible customer. You potential customers may talk to you, if you flatter them as experts in the competitive landscape.

The second set of experts is those who can help you articulate your exit strategy. The entrepreneurship center in your region should be able to provide some guidance in defining your exit strategy. If you know angel investors, ask them for advice. Finally look in references at the end of this book for help in writing business plans. You will find those references quite useful.

7 Why write a business plan?

What is a business plan?

General contractors need blueprints. Blueprints are necessary for two reasons; (1) to make sure they do not forget something important and (2) to be able to communicate the plan with others. Entrepreneurs need business plans for the same two reasons. A business plan is a comprehensive review of the venture, covering all aspects of the opportunity. Without a business plan, the entrepreneur cannot easily convince partners, investors, employees and others that he or she has a carefully crafted plan for success of the business.

Are there several versions of a business plan?

Because there are a variety of uses and needs for a business plan, at least five versions of the business plan must be prepared. Furthermore, the entrepreneur must be prepared to effortlessly deliver each. Here is a description of each adaptation of the plan with an example of when it might be used:

Full plan: This version must be written first because all others are adaptations of the full plan. It is by reading and studying the complete plan that investors will be able to make a decision to fund your company. But...no one will read your full business plan until they are very seriously considering investing in your business. Entrepreneurs consistently make the serious mistake of thinking that investors will read their plan to decide if they might be interested in investing. It is only after they have read shorter versions and spoken with the entrepreneur at some length that they will dedicate the time necessary to reading the full business plan.

Executive Summary: The executive summary is a 2-4 page summary of the business plan, covering the highlights of all aspects of the business. It is a complete and stand-alone synopsis of the full plan. This document is frequently the first introduction that investors and others have to the plan. It must be written after the plan is complete and summarize the full plan.

Elevator Pitch: As could be expected from the name, the entrepreneur must be able to flawlessly deliver this version of the plan in two minutes or less, the time one generally spends in the elevator. Entrepreneurs tend to unexpectedly bump into potential investors at every networking event they attend. In order to attract the attention of these busy investors, the entrepreneur must be able to present this short summation of the product and the market opportunity very quickly. This version must be simple and straight-forward. I suggest you practice by delivering your elevator pitch to your grandmother. If she gets it in two minutes, you have done a good job. The elevator pitch is not the version that contains chemical formulas and highly detailed descriptions of technology.

Video Pitch: This version is similar to the **elevator pitch**, except deliver via a video file. Video pitches are useful when applying online to angel groups or to online investment posting services. Investors are interested in your innovation, the market opportunity for the product and how you plan to attack the competitive environment. Video pitches are usually about two minutes in length. Entrepreneurs are encouraged to take advantage of the media, that is, don't just be a "talking head." Show investors your product or use visual aids to demonstrate why yours is an opportunity investors should pursue.

PowerPoint Presentation: If the entrepreneur's **elevator pitch** or **executive summary** has attracted the attention of potential investors, he or she will be invited to deliver a verbal presentation to an interested group. As Garage.com's Guy Kawasaki explains in his book, **The Art of the Start**, this version of the business plan should follow his 10:20:30 rule. Ten slides which can be delivered in no more than 20 minutes. Each slide must have a brief description of one aspect of the business in at least 30-size font (because investors tend to have older eyes than entrepreneurs, and because reading detailed slides defeats the purpose of a verbal presentation. Like the executive summary, the PowerPoint presentation must be developed after the complete business plan has been written to assure the completeness of the presentation. Finally, it is critical that the PowerPoint be delivered in a practiced and articulate manner without reading the slides. The PowerPoint presentation is the first real look that most investors will have at your business plan. Be prepared to wow them!

Why is a business plan important to me (and to my partners)?

Writing the business plan is the first opportunity that most entrepreneurs have to really think through the plan and to drill down into the details. Most entrepreneurs have a good concept of their product prior to writing a plan, but other phases of the business are much less clearly defined. It is important to understand the sales channels that will be utilized to reach customers. It is critical to develop an appreciation for the amount of funding that will be required to commercialize this product and to develop a sustainable business. Without a complete business plan, the entrepreneur cannot demonstrate he or she has a viable investment opportunity.

Comprehensive plans are vital to successful business partnerships. Clarity of purpose and direction are essential for establishing a lasting partnership. Potential partners need to pour over business plans to make sure they are in agreement on the level of commitment in their relationship which may last a decade or so.

Is the business plan important to others?

Seldom does the entrepreneur launch a business in a vacuum. Important vendors need to be convinced that the business is viable, sustainable and can grow to a sufficient size to become an important customer to them. Vendors can offer customized sources of raw materials or special payment terms for new entrepreneurs, if they are convinced you are "for real."

You will be asking key employees to leave their current employers and help you grow the business. It is important that you can concisely explain your business and their important role in its success to them.

Customers need to be convinced that your company is viable and that your product or service resolves an important problem for their companies. Customers must be persuaded that they should make the commitment of time and resources to evaluate and implement your products.

While banks and other lenders may not be important sources of capital at the outset of the business, eventually you will likely choose to use borrowed funds to grow the business (debt is always cheaper capital than is equity). A well-crafted business plan is important to bankers. They are conservative and like to have substantial back-up documentation of their loan portfolios.

You may not need a complete business plan for each of these examples. But, you will be surprised to find how important your plan will become to a variety of outsiders as you start and grow your business. Do it right at the beginning.

What are the components of a business plan?

In Chapter 8, we will provide a detailed description of the written business plan. As we have discussed, there are various versions of the business plan. Let's take a quick look at a shorter version of the business plan: the PowerPoint presentation. I mentioned above that Guy Kawasaki suggests entrepreneurs use ten slides to describe their investing opportunity. Well….I prefer eleven slides! Here they are:

Market Need: While you may not believe me at this stage, this is the single most important part of a business plan. Investors want to know that the product is a "pain killer not a vitamin pill," that is, your product solves important problems for customers. It is also critical that you explain that yours is a sizeable opportunity and that your business model will accommodate the scale required for success.

Industry Overview: Provide the investors with a comprehensive review of the industry and marketplace. You need to convince investors that you understand the needs of your customers and the importance of your solution.

Product Overview: Entrepreneurs tend to make this section of their business plans way too long. The description of the product needs to be concise and is only one of several critical components of the plan.

Technology (Current & Future): Explain the technology in a concise manner with a focus on your rights to use the technology and your freedom to operate within the space. (Do larger competitors have you boxed in? That is, do their patents preclude you from making important improvements to the product?)

Competition: Frequently, entrepreneurs suggest that "there is no competition for my product." Don't fall into this naïve trap. For every product or service there is an alternative. Develop a comprehensive description of the competitive landscape, present and future, in your plan.

Barriers to Entry: Describe a complete list of the features and benefits of products in your vertical and explain how your product stacks up against the competition. Make the list comprehensive, even if your product has some shortcomings against the competition. This becomes a "truth test" for investors.

Strategic Partners and Customers: Describe the partners that will be key to the success of the business. Early, committed customers can, in fact, be strategic partners. Early adopters, especially name-brand players, can be critical to the early success of the business.

The Team: Describe the background of the players on your team and, if possible, those waiting in the wings. If you have holes in the team, that is OK, at this stage. Describe for investors how you plan to fill those holes.

Milestones for Growth and Funding: Provide details on the key milestones that you and the investors will use to measure your success. Describe milestones that can be reached with this round of funding and any additional funding that you anticipate might be needed later.

Use of Funds: Explain how much funding is necessary in this round and to what purposes you will apply those funds. Do not describe the valuation of your company or how much of the ownership of the company you expect to sell for this equity investment. This subject is highly negotiable. Do not paint yourself in a corner with an unreasonably high or low valuation, as you write the business plan. Valuing the business is not a critical ingredient to the business plan. (Nonetheless, it is important to have a rough idea of an appropriate valuation for your business. Be ready for verbal questions on valuation and to give the impression that valuation is negotiable.)

Proforma Financials: Complete financial projections are a vital part of your plan. Financial projections are required information in deciding how much money you need to raise from investors to achieve positive cash flow in the business. I suggest you develop income statements, balance sheets and cash flow projections on a monthly basis for two years and quarterly projections for the following three years. Most investors would like to see how large you anticipate building the business in five years, and the reasonableness of your projections to get there.

What is the desired length of a business plan?

Investors don't generally agree on the ideal length of a written business plan, because businesses, products and the competitive landscape are so different among new ventures. However, most investors believe that less than 20 pages is probably too short and more than 50 pages is likely too long. In general, I would suggest that entrepreneurs shoot for 20-25 pages in the body of the plan, plus appendices. What should be in each appendix varies from business to business, except that the detail financials be among the appendices and that summary financials be in the body of the report.

Who should write my business plan?

I can't tell you how many entrepreneurs have come to me saying that they are not good writers and need someone else to write their plan. My advice is "get over it!" Learn by doing. The entrepreneur must own the business plan. The business plan reflects the passion and vision of the entrepreneur. This cannot be done by others. Writing a business plan demonstrates you have a comprehensive understanding of all aspects of what it takes to be successful with this venture. Feel free to bounce your ideas and your written plan off your advisors and knowledgeable friends. Use an editor to correct errors in spelling and grammar. But do all the drafting yourself.

Having others write your plan is a slippery slope. Sooner or later, an investor will ask you a question about the plan, and you won't remember that part of the plan because you didn't write it. Don't allow yourself to be blind-sided by potential investors. Write the plan yourself.

What is a business broker?

Many business brokers offer their services to assist entrepreneurs in writing their business plans and in finding investors to fund those plans. There are reputable business brokers and there are shady business brokers. Unfortunately, there are far too many of the latter. Among the latter are those who will claim to have many investors within their networks just waiting to fund your business. However, to convince them to invest, you will need a much improved business plan (no matter how good or bad your plan already is). They will then offer to rewrite your plan for a fixed fee, of say, $10,000, and then promise they will show it to their investors, when, in fact, they do not know any investors who might be interested in your specific business. They then circulate your plan to known investors in the community, something you might have been able to accomplish on your own.

Please do not misunderstand me. There are many knowledgeable and reputable business brokers who have been successful at assisting entrepreneurs in raising money, but, how will you be able to choose among them?

How should entrepreneurs work with business brokers?

If, after this diatribe, you are convinced you need a business broker to find funding for your company, pick one who will work on contingency. Their only compensation from you is perhaps 5% of the funds they raise for your company. This compensation scheme should assist you in avoiding those who are unlikely to really help you raise money.

> Caveat: *Most angel organizations are unwilling to fund companies where a "finder's fee" will come out of the proceeds of their financing. Why? Two reasons: (1) angels want to see all the monies used to grow the business and (2) angel groups believe they are easy to find and an enterprising entrepreneur should not need a business broker to find their organization. Conclusion: If you choose to use a business broker, do not do so until after you have approached the angel organizations in your area. We will discuss how to find angels and angel organizations later.*

When should I write my plan?

It is my suggestion that entrepreneurs write their business plans early, before leaving their regular jobs. Writing a plan is a time-consuming project, because of the research that entrepreneurs must do to complete the project. Starting a company is always a major strain on personal finances. Write the plan in your spare time while doing the best job you can for your current employer.

What if I am not a good writer?

Writing skills are important to being successful as an entrepreneur, and not just for writing a business plan. Improving your writing skills is important for a variety of reasons. You don't have to be a good writer to write the draft of a business plan. But, you do need a well-written business plan. Use the creation of a written business plan as a step towards substantially improving your writing skills. Find a tutor and use the tutor to assist you in improving your skills as you complete the plan. If appropriate, also seek an editor to hone the final product into a quality written plan.
A poorly written plan detracts for an otherwise good investment opportunity. Bad grammar, difficult-to-understand passages and misspelled words do, indeed, matter. Make sure the investors that read your plan finish thinking about the opportunity, not the poor quality of the writing.

Creating an excellent business plan takes much more than writing skills. The market research and competitive analysis can require lots of time talking to experts, in the library and on the Internet. Crafting a quality plan does require a substantial commitment to putting the words on the page. My advice is to do it yourself and use the experience to significantly advance your skills in this important art.

Where can I get help in writing my plan?

An effective business plan consists of excellent content organized in an effective manner. You can enhance your skills and experience in assembling content with quality and breadth through networking with advisors with deep vertical experience and by contacting suppliers, competitors and customers in the space. You can also learn a lot by surfing the Internet.

For help in organizing the materials, the Small Business Administration website at www.sba.gov has an excellent section on starting businesses with substantial content devoted to writing business plans. I often find this site helpful. There are many books and publications available on writing business plans. Look at those in your local library. One product in particular that I recommend is **The Business Mentor**, produced by the Ewing Marion Kauffman Foundation. This product can be purchased at www.fasttrac.org. It is available as a CD for about $35. Your local entrepreneurship center is an additional source of information on writing your business plan. Perhaps experts in the center would be willing to review of an early draft of your plan.

What mistakes do entrepreneurs make in writing plans?

I have read thousands of business plans. The biggest mistakes I have seen are (1) too much focus on the product or service and (2) lack of balance, that is, a plan which does not adequately cover all the components of the plan described above. We entrepreneurs are passionate about our products, but need to recognize that investors are looking for a broad understanding of how the venture will use the equity investment to make money and grow by leaps and bounds into a scaled business. Don't make the mistake of concentrating only on the description of your product in the various versions of your business plan. Make your presentations well rounded, covering all the important components of a plan.

Why shouldn't I focus all my energies in describing my product?

I realize this section duplicates my warnings above, but this is important. The description of your product or service should take 10 to 15% of the text or slides of your plan. I would guess that, of the plans I have read, a solid majority put too much emphasis on the product or service and not enough content devoted to the many other aspects of a successful business. Do not fall into this trap! Create a balanced business plan.

How important are the numbers? How do I create the proformas?

It is not possible to determine how much capital the startup stage of your company will require without developing a thorough set of quality proforma financial statements. Some business plans can generate cash from operations in two months and others require five years. All businesses have expenses from the outset. Knowing how much cash you need and making sure you do not run out of cash are absolutely paramount to your success as an entrepreneur. Spend the time necessary to do this right.

Creating the proforma financial statements for one who is not familiar with financial statements can be daunting. Fortunately, proforma financials are rather standard fare. Business plan tutorials, such as The Business Mentor (mentioned above), ease the pain. I would also suggest spending time with experienced small business persons in your region as you develop your plan. Ask them to help you understand what reasonable expenses will be for your business in your locale. Coupling a good tutorial with sound advice from a small business expert in your region can help you create very effective proforma statements. Use these tools and experts to help you create the financial statements, but don't have someone do them for you. Your investors will have many questions about your proforma financial statements and you need to know what assumptions were made in developing the statements and how to explain the idiosyncrasies of the finances of your business.

Finally, build your financial statements from the bottom up. Don't simply assume you can capture 1% or 10% market share. Your investors will want to know who your customers will be and at what price they will be eager to buy your product. Your investors will appreciate quality financial proforma, which will, in fact, lead to good budgeting after the business is launched.

8 The Business Plan

The Written Plan: Covering all aspects of the business

In the last chapter, we briefly described the components of a condensed version of the business plan, the PowerPoint presentation. In this chapter, we shall describe in detail the various components of the complete written business plan. In looking at section headings, don't become confused by the titles of the sections or the number of sections. For example: Some business plan references use the expression "Competitive Advantage" while others call that section "Barriers to Entry." They are essentially the same. Sometimes it makes sense to merge a discussion of the product and the intellectual property and for other ventures, the separation of these two sections is important. While we will be describing a generic written business plan here, it is appropriate to adjust the titles of the sections and the content to meet the needs of your venture. However, this is not to suggest that you can ignore the Competition or Marketing and Branding sections. Each business plan must be a complete document that brings clarity to the founders and their team while describing the opportunity for investors.

As stated earlier, do not consider this book as the "be all, end all" for writing your business plan. There are many outlines for successful business plans and those outlines change somewhat for different business types. An outline that works well for a software company may look quite different from the outline of the plan for a life sciences company. In designing your plan, study other business planning presentations, such as those products described in the previous chapter and those you can find in your local library or on the World Wide Web.

Executive Summary

The executive summary is a 2-4 page summary of the business plan, a stand-alone document that is used as a "teaser" to attract the interest of investors to the investment opportunity. It must very briefly cover all the aspects of the business. No investor will make an investment decision based solely on the Executive Summary. This document is used to introduce the venture to investors and to encourage them to begin to engage in the due diligence process of validating the investment opportunity.

Entrepreneurs often make the mistake of attempting to write the Executive Summary and begin distributing it to investors prior to writing the full business plan. In most cases, this is a mistake because the entrepreneur will not have given adequate consideration to all aspects of starting and growing the company by simply writing the Executive Summary. Only when all aspects of the venture have been studied in detail and completely described can one begin to consider the content of the Executive Summary. Don't fall into this trap. Resist the urge to write the Executive Summary until you have completed the entire written business plan.

Introduction

While business plans start with the Executive Summary, most readers will either read the Executive Summary only, or after they have become engaged in investment discussions with the entrepreneur, sit down and read the entire plan. When they take the time to read the entire plan, the introduction is the start of the full written business plan.

The introduction should detail the value proposition offered by this venture. A company has three major stakeholder groups: customers, employees and shareholders (investors). How will the business use its resources to deliver superior value to its customers? How will the founder build a world-class management team and a stable, motivated workforce? And, most importantly, how will the founder and management team delight the investors in the company?

The Opportunity

This section introduces the reader to the industry segment (or business vertical). Often the specific market to be addressed by the product or service offered by the venture is only a fraction of the total industry segment. It is important that the entrepreneur describes in detail the "addressable market," that is, the precise market and customers that will purchase the product. The key issues to be described in this section are:

- Define the niche,
- Describe the size of the market, and
- Detail the growth rate of this niche, now and in the future.

As an example of a description of the niche, if you plan to enter the sheep-skin, bucket-seat, seat cover business, do not provide your readers with the size of the worldwide automotive marketplace. (It may come as a surprise, but I have read many plans that make just this mistake.) The addressable market is only the aftermarket (these seat covers are not usually purchased installed at the factory by new car manufacturers) for people who prefer sheep skin seat covers and have a vehicle with bucket seats, not bench seats.

In technology businesses, the marketplace is constantly changing. It is often necessary to describe the convergence of the needs of the market and technology advancements two years hence when your product will be ready for early adopters.

In defining market size and growth rates, finding and quoting recognized authorities in your market niche can be very helpful in providing investors with referenced data. In any case, it is critical that sources of market data be referenced for plan readers. You can be sure that interested investors will seek independent validation of market size and growth rate, so use quality data in describing the market niche you plan to pursue.

The Product and the Intellectual Property

This could be one section or two. This is a choice you need to make, depending on complexity of the technology environment. If the technology is a minor component and easily explained, include IP as part of the product description. If the technology is complex and/or the intellectual property landscape is complex with many apparently overlapping patents and limited room to operate, then separate the sections.

Entrepreneurs are generally comfortable writing a description of their product and technology, but descriptions of their products are far too long. Find concise language to describe your product. Be brief and to the point. As we said before, be able to describe your product in a way that your grandmother will understand it! Investors are not impressed with twenty-page product descriptions. Make sure this section is balanced with the rest of the written plan.

Investors are not only interested in understanding the product but also in the production of the product. Clearly define the manufacturing methodology and, in particular, the problems involved in manufacturing the product. Is the manufacturing well-defined or is substantial development necessary to make the product? Can this product be outsourced? Are there trade secrets and intellectual property involved in the manufacturing process?

Are raw materials an issue in manufacturing this product? Are their substantial environmental challenges related to the product or the manufacturing of this product?

Intellectual property descriptions vary substantially from business to business, so it is difficult to generalize descriptions of this important part of the plan. Some of the key issues are as follows:

- Who owns the technology? If licenses are involved, describe them.
- Describe the intellectual property landscape. Who owns the technology in the environment your business must operate?
- Describe the exclusivity that your patents provide for your business.
- Define your freedom to operate. Will the patents of others impact the advancement of the business?

Barriers to entry (competitive advantage)

What makes your product unique? Describe the features and benefits that differentiate yours from competitive products. Does a patent create barriers to entry by your competitors? What lead time do you have over the competition? Can you extend those patents to lengthen advantage in the marketplace? What is the likelihood that well-funded competition could "reverse engineer" your product and introduce a similar product without violating your IP?

Competition

Describing the competitive landscape is a critical component of your business plan. Who are the major players in this market? Describe the strengths and weaknesses of these competitors and their product offerings in this market. Describe how you, as a smaller company with lesser resources, will address their strengths in the market.

If no direct competitors exist prior to the introduction of your product, what are your potential customers doing to satisfy this need? (There is no product or market without competitors or potential competitors.) If your introduction of this product is highly successful, what reaction do you expect from larger potential competitors? How quickly could these potential competitors react and what impact on the market would you expect?

Often, describing the market today is insufficient. Technology advances and demographic changes alter market direction. Describe how you expect the market to change over the life of your product or products and how you will manage your business to take advantage of these changes over time.

Sales

Many entrepreneurs have little or no understanding of how products or services are sold. First of all, investors want to make sure you have a good understanding of the selling processes in your industry. What are your sales strategies? Who are your target clients? Will you be focusing on larger clients or smaller users? Will that focus change over time? What are the unique characteristics of your target accounts? What sales channels will you utilize to sell to your target accounts? Describe your sales channel options and detail why you have selected specific channels. Will you address accounts that are not within your target list? If so, how? What are your pricing strategies and what considerations have you made in establishing pricing? What compensation schemes have you considered for motivating sales people? What tactics do you plan for customer retention?

Marketing

What strategies will you use to make your customers aware of your product (and your company) and eager to buy from you? How will you find customers or enable them to find you? How will you brand your products and strengthen your branding over the life of the business? Marketing, in particular advertising, can be very expensive. What marketing techniques will enable you to reach your potential customers without "breaking the bank"?

Management Team

Provide your business background and that of each of your management team. Integrity is critical for investors, so be totally honest in your resumes. Dishonest mistakes uncovered by investors in background checks will almost always terminate investor interest. If some members of the management team are waiting in the wings, make it possible for investors to do background checks on these team members without, if appropriate, revealing their intentions to current employers. Describe holes in the management team and discuss the skills and experiences needed to complete the team. Describe when you plan to fill these vacancies.

Know that investors will plan multiple interviews with you and key team members. This knowledge sometime affects the information you include in bios in the business plan.

Keep the biographical information in the body of the plan rather brief, approximately 1/3 of a page. Feel free to add complete biographical information in the appendix.

Funding Required

Complete the proforma financials (described below) prior to completing this section. Use the cash flow analysis in the proforma financials (plus a substantial safety margin) to determine how much cash will be required from investors for the company to achieve positive cash flow, enabling the company to grow on its internally generated cash.

Then carefully select measurable milestones that can be achieved with specific amounts of funding. Remembering the funding gap described in Chapter 5, decide how much cash should be raised in the first and subsequent rounds of investment, and what milestones can be achieved with this cash. (Note: More than 95% of angel rounds of investment total between $250,000 and $1 million.) Define for investors what can be accomplished with this round and what funding will be required in future rounds
.
Part of this analysis is to determine to what uses the cash raised in this round will be put. Define, as precisely as possible, the 5-7 categories of expenses to which the funds raised in this round of investment will be applied.

Note: Some companies become profitable but continue to raise money because their growth plans dictate the need for more cash than can be generated from internal cash flow. How can that be? Rapid growth requires lots of cash. To sell lots of products often requires huge inventories, which require cash. Selling large volumes of product often requires offering special terms, such as payment in 90 days. Funding large accounts receivable requires cash. Growing a business often requires a steady stream of new products, which may require extraordinary R&D expenses, which again require cash. The assumptions made prior to this paragraph were that the requirements for invested cash will cease, once positive cash flow is accomplished for the company. This may not be the case for some very rapidly growing companies.

There is no rule of thumb that suggests that investors will only fund companies until they can achieve positive cash flow from operations. This decision depends entirely on the growth rate that the entrepreneur can demonstrate is necessary to develop a highly successful company.

Exit Strategy

The options for entrepreneurs and investors to harvest their investment in startup companies have been described in detail in Chapter 6.

Suffice to add here that investors expect entrepreneurs to articulate a carefully crafted exit strategy in their business plans. Simply indicating that you expect to exit via an IPO or the acquisition by a larger company is not sufficient. In the case of the more likely M&A exit, the entrepreneur needs to identify candidate acquirers, why these companies might be interested in purchasing the startup company and how the startup company can be positioned to sell at the most attractive return on investment.

Proforma financials

Using tools such as The Business Mentor (see Chapter 7); entrepreneurs need to forecast complete income statement, balance sheets and cash flow statements for the first five years of the venture. The financials are expected to be carefully completed with reasonable expectations. Assumptions need to be detailed and, in fact, it is those assumptions that investors really study.

Entrepreneurs must realize that the numbers are important and that investors expect entrepreneurs to have a great grasp of the financial metrics necessary to manage the business. Yes, the business will eventually have bookkeepers and controllers to manage the accounts. But, in some ways, the proforma financials are a "rite of passage" for entrepreneurs. If you are unable to assemble reasonable financial statements for a startup company, numbers that you really understand, then you are unlikely to attract the investment needed to start the company.

It is my suggestion that entrepreneurs develop monthly statements for the balance sheet, income statements and cash flow statements for the first two years and then quarterly statements for the same three statements for the next three years, a total of five years of financial statements. These statements should be reasonably detailed; however, only summary statements should be included in the body of the business plan. Include all the detailed statements in the appendices to the plan.

Appendices

The business plan should be rather easy to read. Excessive detail detracts from the value of the body of the report, because the reader can easily become bogged down with excessive facts and numbers. For this reason, I have suggested that lengthy resumes and detailed financials be summarized in the body of the report, but included intact as appendices.

Entrepreneurs often include marketing materials, detailed production schematics, technology briefs, market surveys and other useful supplemental documents in the Appendix to their business plans. I caution entrepreneurs not to include too much information in the Appendix, because frankly it may never be reviewed. But, the Appendix is a useful place to include important information that is simply too detailed and involved to be in the body of the report.

All materials in the Appendix should be referenced in the body of the report (such as "see detailed resume as Appendix C"). As a rule of thumb, if the materials cannot be easily referenced in the body of the report, this information should not be included in the Appendix.

Format for the Written Business Plan

Investors seek plans that are well-written, neat and attractive, but without the "expensive look." Entrepreneurs who distribute "slick plans" tend to be viewed as extravagant. No investor will read a plan because of the cover. What is in the plan is much more important than the graphics design. That said, a messy, error-filled plan is also a major turn off.

Business plans must be available in both printed and electronic format. My suggestion is that entrepreneurs design a plan for electronic distribution and then print out copies, as needed. Making spiral bound copies is easy and inexpensive at business service centers.
Monitor the file size of electronic business plans and limit them to about 2 MB. Text and spreadsheets require little file size but graphics and pictures can rapidly expand file size. Minimize the file size for the graphics that must be included in the plan.

Confidentiality

Your business plan and executive summary must be non-confidential documents. Do not include a confidentiality agreement or non-disclosure agreement as the opening page of your business plan. Upon seeing such a page, most serious investors will

simply return the plan unread.
It is not necessary to reveal your secrets to investors to interest them in your plan. In fact, most investors do not want to know the formula for the "secret sauce," or want to read the claims of your patent still languishing in the US Patent Office. We investors do not consider potential customer lists as confidential and are not particularly interested in seeing new business models. Find a way to write your plan extolling the virtues of your business opportunity without revealing confidential information.

That said, if angels feel they must validate patent claims or trade secrets by reviewing them with experts and/or your patent counsel, at least one of the interested investors will sign a non-disclosure agreement during the due diligence period just before investment, but not before reading the executive summary or the business plan.

Distributing your business plan

I recommend against broadly distributing your business plan, for two reasons:

- Individual angels and VCs never read unsolicited business plans
- A broadly distributed business plan quickly become "shop worn," that is, viewed as a plan that has been around for a while and not funded. Therefore, something must be wrong with it.

There are several ways to reach angel investors and venture capitalists, and we will discuss this in greater detail in Chapter 10. While angel groups will accept unsolicited plans, individual angel investors and venture capitalists really only fund referenced deals, that is, deals that are referred to them by trusted sources. When you are introduced to a venture capitalist or angel investor, be ready with your "elevator pitch" or send them your executive summary. Remember: Your full business plan need only be distributed upon demand. You must create interest for your full business plan using other abbreviated versions of the plan.

Over the transom

Only organized angel organizations accept unsolicited business plans. Do not mail your plan indiscriminately to other investors unknown to you personally without an introduction.

Finding angels and VCs

Finding solo angels and angels in groups will be covered in Chapter 10 – Your Angel Investors.

Before approaching VCs, develop a plan of attack. Start by defining the universe of venture capital. There are several lists of the more than 1000 venture capital firms in the US. Probably the best reference is available for sale from the National Venture Capital Association. Look on their website at www.nvca.org. Pull down Membership | Services and then click on Publications and Products. State and regional venture capital associations also have directories available. You can likely find other VC directories available at your local library.

Each venture capital firm tends to invest in a few narrow business sectors. You need to find those firms investing in your business vertical and carefully study each firm. In addition to the lists of VCs, knowledgeable people in your region will be able to name the most likely VCs to invest in your vertical (another good test of your networking skills). The best source of information on VC firms is available on their websites. Look at the companies in their portfolios. Read what each says about their business sectors of interest and their intentions for the future. This will allow you to narrow your search to a few firms. Like angels, VCs tend to invest regionally. So if 35 VCs are investing in your vertical but only 5 are in your region, concentrate on those five. Next step: Get an introduction. I know this sounds difficult, but most venture capitalists invest in referred deals only. Solicit the assistance of your service provider. Network at the local entrepreneurship center. Getting an introduction to a VC is critical to soliciting their funding.

9 The Form and Style of the Business Plan

Why several versions of the plan?

In Chapter 7 we described the five versions of the business plan: the elevator pitch, the video pitch, the executive summary, the PowerPoint presentation and the full business plan. Each must be a stand-alone plan, that is, as complete as possible considering the recommended length and scope. Each is used at a different stage of introducing your venture to investors. The video pitch is an online introduction to your company. The elevator pitch is a quick verbal presentation, while the executive summary is an easily-read introduction to the plan. These three versions are usually the first look that investors have at your plan. Once investors indicate some interest in the plan, you will have an opportunity for extended "face time" and be invited to use your PowerPoint, a longer and more complete verbal presentation. Finally, serious investors may read your whole business plan, as they begin the due diligence that precedes investment in your company.

Why are the verbal and video deliveries so important?

As we will discuss later, the key consideration for investors is YOU. Angel investors invest in ***entrepreneurs*** and their businesses. One measure of your potential success is your verbal presentation skills. Is your delivery stiff or smooth? Are you prepared, or is your delivery punctuated with pauses, "hems and haws," and glances at your notes? Do you appear to be comfortable in front of this audience? Do you have a good grasp of all aspects of your business? Can you do a good job handling questions? Are you obviously "winging it," or are you honestly answering that you do not know the answer to some questions? Honesty and integrity are key tests for investors. An entrepreneur who seems to be making up responses on the fly will not retain the interest of potential investors.

Why are investors so tough on entrepreneurs at this stage of their relationship? After all, shouldn't first-time entrepreneurs be "cut a little slack"? Sorry, that is not the way it works. Entrepreneurs are expected to be able to make a polished presentation to investors because their verbal skills reflect their future success in closing deals with customers, motivating employees, negotiating relationships with partners and securing additional funding at later stages of the business. Being comfortable in front of audiences of all kinds is a critical skill for entrepreneurs.

> Practical Tip: *Practice both your elevator pitch and your PowerPoint presentation until you can deliver them in your sleep. Be sure your video pitch represents you and your company in the best possible way. Quality delivery is key to your success in raising money for your business.*

When will investors read my business plan?

Trust me on this one: No investors will EVER read your complete written business plan to learn a little about your venture. You will need to use your elevator pitch and executive summary to get their attention. If you are pitching a group of angels and have attracted their attention, you will then be invited to make your PowerPoint presentation. Only then may interested angels spend the time necessary to read your plan.

When do I use the Executive Summary?

Send your executive summary to any investor who has indicated an interest in learning something about your business. Carry printed copies in your briefcase wherever you go. But the primary delivery vehicle is email. If you find potential investors, ask for their email addresses so you can send them your executive summary. Even if you are carrying a printed copy, potential investors will often ask that you send them an electronic copy so they can forward it to other investors or file it on their computer. When you email your executive summary to investors, attach it to a cordial email reminding the investors where you met and thanking them in advance for their consideration. Investors often are pitched by several entrepreneurs at a single networking event. The reminder will be appreciated. Do not simply attach your executive summary to an email with no message included in the body of the email.

Don't send your full business plan upon first meeting angel investors (unless they specifically ask for it). They won't read it at this stage, so you are simply wasting your time and theirs! If investors are interested, they will follow up with you and ask for a copy of your full plan.

When are investors interested in reading the Executive Summary?

Your executive summary is the first written exposure that investors will have to your business. This is a key document, because it is your opportunity to convert "mildly interested investors" into potential champions for your cause.

In Chapter 7, it was suggested that the executive summary of your business plan be written LAST, not first. This is worth repeating. We investors can tell when an executive summary is written prior to completing the work to develop and write the entire business plan. Unprepared entrepreneurs describe only their product in their executive summaries, while a great executive summary covers all aspect of the business.

> Reminder: *Write your executive summary AFTER you have completed the development and writing of your business plan.*

What is the "elevator pitch?"

Expert opinions vary on the best content for an elevator pitch. Obviously, you cannot delivery your whole business plan in two minutes. So, what should you include? I suggest you consider the following: Angels invest in "pain killers not vitamin pills."

The implications of this are that you describe why your customer will demand that you sell this product to them. What can your product do for your customers that the competition simply cannot supply? What really important problem does your product resolve for your customers?

Don't focus on your product and you really don't have time to even mention your intellectual property. Describe your product, but from your customers' perspective. How will your product be a "pain killer" for your customers?

What else? As you are describing the "pain killer" aspect of your product, describe the size of the opportunity. A tiny patented component which must be included on all automobiles five years into the future could be a huge opportunity. Investors are not interest in small niche opportunities...they are interested in huge niche opportunities.

When do I use the elevator pitch?

The beauty of a well-practiced elevator pitch is that it can be used anywhere. A networking event sponsored by the local entrepreneurship center, or during the social after church, or at a political rally, or while waiting for the PTA meeting to start at your local school! An elevator pitch can be effective at any time, and often when you least expect it. Practice, practice, practice...and then deliver it to all who will listen.

When are investors interested in hearing the Elevator Pitch?

Frankly, the answer is always and never! You use your well-rehearsed elevator pitch anytime you might catch the attention of a potential investor or customer. This is the classic example of "carpe diem": You suddenly find yourself on an elevator with a well-known angel investor in your community. S/he was not planning to listen to your pitch, but has nothing better to do for the next two minutes. Tell him or her about your business and the investment opportunity.

Busy people will usually give new entrepreneurs two minutes of their time. This is especially true at networking events. If they then indicate they are not interested in your business, politely thank them for their time and ask them if they know angel investors who might be interested in this opportunity. Angels tend to invest in narrow business verticals and only within their communities. Your plan may be outside their investing parameters, but they may know other angels for whom your plan may be a great fit. It never hurts to ask.

What are the Do's and Don'ts of the elevator pitch?

Practice, practice, and practice your elevator pitch. Make sure you can deliver your polished pitch in two minutes...not five minutes, not ten minutes. End your pitch with a question, such as, "Is this a business plan you would be willing to explore for its investment opportunity?" If the answer is yes, ask the investor for the next steps in the process. If the answer is no, ask if the investor knows of others who may be interested. Always be ready to leave your business card with the investor, even if s/he indicates little interest. Under all circumstances, remain polite and grateful for the time allocated to you by these busy investors. Leave a good impression. You never know when an investor might suddenly remember an investor who might be interested in your plan and refer them to you.

Don't be pushy, that is, demanding more than two minutes which most investors will allow you. Don't be ungrateful...no investors is obligated to invest in your plan or refer you to others.

What is the "video pitch"?

The video pitch is an online version of your elevator pitch. Both are two-minute versions of your business plan and the content should be similar to that mentioned above for elevator pitches. There are two important differences between these two pitches:

- Since the video pitch is recorded, you can practice, rehearse, shoot and re-shoot until it is perfect. You generally get only one shot with elevator pitches. Make sure your video pitch delivers exactly the right message as professionally as possible.
- Video is a unique media. Take advantage of the "show and tell" benefits of video. Show your product. Use graphics. Don't just be a "talking head."

David Rose, Chair of the New York Angels and Gust is a major user and proponent of video pitches, and has blogged on this subject. See his "Video Pitches are So Important" at http://www.gust.com/blog/2008/05/04/videos-are-so-important-heres-whyand-heres-how/

What is the "PowerPoint" presentation?

As was described in Chapter 7, the PowerPoint presentation is a 20-minute verbal presentation usually delivered to several interested investors, often members of the same angel organization. The Microsoft PowerPoint format is by far the most common software format for delivering the slides accompanying your talk. This verbal presentation should be made by the CEO/entrepreneur. It is critical that all aspects of the business be covered in this short, verbal presentation. While involving multiple presenters can be effective, the change over between presenters tend to take valuable time from the presentation and is not generally recommended. Have important team members in the audience, if you like, and refer appropriate questions to them during the Q&A time following your formal remarks.

What are the components of the PowerPoint Presentation?

As was mentioned in Chapter 7, the Art of the Start by Guy Kawasaki is recommended reading in the preparation of PowerPoint Presentations. My suggestions for the content of each of your 10-12 slides are covered in some detail in the same chapter.

When do I use the PowerPoint presentations?

You will use your PowerPoint presentation almost always at the invitation of an investor or a group of investors. You can deliver it from your laptop monitor for one or two investors or projected for groups of investors.

Delivery of this presentation will almost always be scheduled, and very seldom an impromptu presentation. After reading your executive summary or hearing your elevator pitch, investors will invite you to come to their offices or to a meeting of their angel organization to make your presentation. I suggest you bring along copies of your slides for each attendee, which you can leave with each interested investor.

It has been my experience that versions of your PowerPoint presentation can be useful for other purposes, for example, in introducing your company to larger customers, strategic partners, Director and advisor candidates, and bankers. A well-practiced, quickly delivered PowerPoint presentation is a great way to introduce yourself and your company to influential players in your industry.

When will investors want to view my PowerPoint Presentation?

Angel organizations or other investors groups will invite you to make this presentation to their groups at meetings scheduled for that purpose. The purpose of these meetings is to develop broader interest in the opportunity to invest in your company. No one will invest in your company immediately after hearing your presentation. Your objective is to develop interest among one or more champions within the group in leading a group of investors to fund your company. Pay particular attention to those in the audience asking knowledgeable questions about your company. They are the attendees most likely to have deep understanding of the business vertical in which you plan to operate.

What can I expect to happen during a face-to-face meeting?

Group meetings of investors often review the PowerPoint presentation of several entrepreneurs in a single meeting (2-4 presentations in a single meeting). To stay on schedule, a moderator will be appointed who will make sure the meeting moves along. To accomplish this, moderators will often insist that presenters complete their presentation on time, even if the presenter is not finished. It is very important that you complete your presentation in the allotted time.

Most groups will make it clear what you should expect. If not, ask the person that invited you to the meeting for details.   Here is one scenario: You will be brought into the room after the meeting has begun and asked to set up for your presentation. (It is really convenient if the group has your presentation "teed up" on their computer projector in advance, so check this out prior to the meeting.) You will be given a fixed amount of time for your delivery, often 20 minutes. To keep the meeting running smoothly, most groups will allow you to deliver your talk without interruption.

Most groups will then allow a fixed time for Q&A. I would plan short, concise answers to all questions. Do not elaborate. Then, ask the questioner if your answer was sufficient. If not, provide additional information. The objective is to answer as many questions as possible in the allotted time.

It is not uncommon for investor groups to ask you to leave after the Q&A session, to allow the members to discuss your plan. The groups will tell you whether you should wait outside to hear from them, or whether they intend to contact you later with next steps.

Some groups prefer less discipline in their presentation meetings. You may be interrupted with questions, which you need to deal with as they come up. Again, I would suggest short, concise answers ending by your asking if that answer is sufficient. Be prepared for such interruptions, because they cause you to lose your train of thought in your presentation. Quickly get back to the presentation, if possible, without losing your place in the talk.

What are the Do's and Don'ts of PowerPoint presentations?

- Understand what is expected of you in your presentation and the time limits dictated by the group. Gather this information by talking to the group contact.
- Practice, practice, practice your presentation before the meeting. Your ease with the materials is key to success.
- Do not spend all your time talking about your product or service, which is only one ingredient to a successful plan. THIS IS THE LARGEST MISTAKE MADE BY ENTREPRENEURS.
- Get through your presentation quickly, being sure to cover all the material in the allotted time. Do not get bogged down. Complete your presentation.
- Answer questions briefly and concisely, allowing time for more questions.
- Do not be afraid to say you do not know the answer to questions. Don't bluff. Someone in the audience will recognize your "made up" answer. Integrity is important to investors.
- Dress neatly. I would suggest wearing a jacket and tie, unless your group contact suggests otherwise. Get a haircut, if you need it. If you are an engineer like me, leave your pocket protector at home ☺

10 Your Angel Investors

Where do I find angel investors?

Angel investors use three distinct approaches in searching for startup investment opportunities: as solo angels networking locally, as solo angels looking online, and by participating as members of angel groups. Some angels prefer operating alone and will only look locally (or regionally) or on their preferred websites. Others exclusively utilize the deal flow offered through their membership in angel groups. Many operate as solo angels and have also joined angel groups.

Angels are most comfortable investing in deals in familiar business sectors, that is, in technology or markets in which they have substantial experience. But angel investors come from all walks of life, so you can find angels with interest and expertise in virtually all business sectors. Some prefer high-tech deals, others are more interested in life science and medical startups and many are more comfortable with low technology and retail companies.

Most angels prefer investing locally, especially if they intend to be actively engaged with the entrepreneur and the startup company. Other angels prefer deals in a narrow business sectors (enterprise software, clean tech, green deals, etc.) and are willing to broaden their search regionally or nationally to find interested companies. A few angels are willing to invest internationally, but most such investing takes place cross-border in adjacent cities, such as Seattle, WA and Vancouver, BC. Only a tiny fraction of angel investors seek deals in other countries not close to home.

Why do most angels prefer local deals?

This is actually quite simple: Angels are part-time investors with many interests who don't relish climbing on an airplane to attend a board meeting.

Furthermore, many angels have a propensity to assist their local neighborhoods, mentoring local entrepreneurs as "give back" to the community and helping creating jobs to support local economic development.

How do I find solo angels networking locally?

Solo angels who do not use online services are very difficult to find, and getting their attention is even more difficult. These angels often attend networking events but they never put "angel investor" on their badges. You could find them if you only knew their names. The best way to meet these local solo angels is by attending the same meetings they attend, such as venture fairs, MIT Forum meetings, venture clubs and entrepreneur pitching events. Get your elevator pitch ready and tell as many people as will listen about your new business. Ask each person you meet if they know angel investors who might be interested in your business. Service providers (lawyers, accountants, financial advisors and bankers) tend to know angel investor and may be willing to introduce you. When you find angels who are not interested in your plan, ask them to refer you to other angels in the room or who are local but not attending the meeting. Have several of your Executive Summaries ready for interested investors. Be sure to include your contact information on anything you pass on to investors.

Do not overlook business plan competitions in your region as access points for investors. TechCrunch Disrupt, DEMO and VentureLabs are three of the more well-known opportunities, but there are many all over the country. And, if you are fortunate to have an incubator, such as Y-Combinator, DreamIT and TechStars nearby, these are great avenues to reputable investors.

In spite of the difficulties in finding local solo angels, there are many highly qualified investors helping to build successful ventures around the country. If you can find and enlist the support of a solo angel with experience in your business vertical, sign them up!

Should I choose angel groups over solo angels?

Members of angel organizations are not necessarily better angel investors than are solo angel investors. But, angel organizations are much easier to find than are solo angels. Angel groups have a one-stop shopping feature – the opportunity to pitch to 30-50 angels at one time. Think about the difficulties of finding, soliciting and closing deals with a dozen or so unaffiliated solo angels. Entrepreneurs need to spend their time executing their business plans, not raising money. Angel groups ease the pain substantially.

Where do I find these angel groups?

Angels have been forming and joining organizations of angel investors rather rapidly since the middle '90s. These angel organizations are generally easy to find because of the public relations they do to promote deal flow in their local area. To find an angel organization in your region, look in the comprehensive investor search engine located at gust.com. Gust is the official platform of the Angel Capital Association in the United States, the National Angel Capital Organization in Canada, and their equivalents in many other countries, including Australia, New Zealand, Ireland, France, Portugal, and Turkey

What are angel groups?

Angel groups are membership organizations of accredited* investors who have adopted a robust process for managing deal flow and investing in seed and startup companies. Because deal flow is important to the organization, they tend to promote their group within the entrepreneurship community and make the process for applying for funding straight-forward, usually through their website. Angel groups provide "one stop shopping" for entrepreneurs, that is, most angel organizations are large enough to fund seed and startup rounds of investment from $250,000 to $1 million. Furthermore, smaller angel groups can syndicate larger rounds of investment with neighboring angel groups, assuring that qualified entrepreneur get adequate funding.

Why are angel groups important?

Angel groups offer many advantages to accredited investors who wish to band together to make angel investments. They are organized to manage deal flow and utilize robust processes for evaluating investment opportunities. Furthermore, angel groups bring together angels with a variety of experiences, enabling quality due diligence for a variety of business opportunities.

But, angel organizations also offer many important advantages to entrepreneurs, as follows:

- Angel organizations are easy to find – access by entrepreneurs is straight-forward.

  ** The Securities and Exchange Commission defines an accredited investor as a person with a net worth of at least $1 million, (excluding the equity in their primary residence), individual annual income of $200,000 or family income of $300,000 per year.*

- Most angel organizations can fund an entire round of investment (or syndicate with neighboring angel groups), making one-stop angel shopping possible for entrepreneurs.
- Angel groups can apply substantial business acumen to solve complex problems for entrepreneurs, even bringing in non-investors to help.
- Angel groups tend to develop relationships with venture capitalists and other partners who can bring important resources to help companies grow.

How much money can I expect angels to invest?

Based on the statistics of a large angel organization of which I am a member, most angel rounds of investment are between $250,000 and $1 million. Very few are larger and some are smaller. The sweet spot is probably between $300,000 and $500,000 for a first round, seed or startup deal. The average angel round of investment in the US is just over $300,000.

While individual angels invest as little as $5,000 and as much as $1 million, most members of angel networks invest $25,000 to $100,000 per round of investment. Individual US angel investors average about $30,000 per round per company.

Will angels provide more than one round of investment?

Angels typically invest in multiple rounds of investment in their portfolio companies. They do so for two reasons: (1) their portfolio companies tend to need more money than they think they will and (2) angels often invest in subsequent rounds to prevent dilutions of their ownership percentage.

Wise angels reserve at least 50% of their available funds for follow-on investing, that is, for every dollar invested, angels will put another dollar in reserve for future investment in portfolio companies. Not all companies will need follow-on investment, but other will require multiple subsequent rounds of investment.

Some angel financed companies raise angel money in three to five rounds of investment totaling perhaps as much as $5 million. However, most companies who need as much as $5 million will raise perhaps $500,000 from angels and then $5 million from venture capitalists.

A key for entrepreneurs in raising subsequent rounds of investment from angels or venture capitalists is to establish and meet milestones and timelines. A track record of success in meeting target objectives is important to investors.

How much ownership of the company will angels require for their investment?

While this will be covered in much greater detail in Chapter 12, angels often receive 20 to 40% of the shares of a company for an investment of $300,000 to $500,000. Here are a couple of examples:

- The agreed upon valuation of the company prior to investment is $1.5 million (pre-money valuation). The angels invest a total of $500,000. The post-money valuation is then $2 million ($1.5 million pre-money valuation plus the money invested). For their investment, the angels receive 25% of the company ($500,000/$2 million).
- The angels invest $300,000 in a company with a negotiated pre-money valuation of $1.2 million. (The post-money valuation is then $1.2 million plus $0.3 million = $1.5 million). For their investment, the angels receive 20% of the company ($0.3/$1.5 = 20%).

How to pick the right angel investors?

There is a tendency on the part of entrepreneurs to accept the first money offered, perhaps out of gratitude for the offer or maybe because raising money is difficult and entrepreneurs just want to get this complicated fund-raising phase behind them. I believe this is a mistake.

Angels should bring more than money to the table. Entrepreneurs should then pick only "smart money" to invest in their company, that is, investors who bring value beside their money to the company. What kind of value? How about....experience in the business vertical, great networks of additional investors, valuable Board experience, extensive marketing or finance experience, and/or, especially important, M&A experience in selling startup ventures!

How should an entrepreneur determine compatibility with these angels and the extent of their experience? I would suggest due diligence on each investor, especially those who will be in regular and direct contact with the company as Board members, etc. Check their backgrounds with other entrepreneurs in whose companies they have invested. Interview each investor, especially those who might represent this angel round of investment on your new Board of Directors. Be sure not only that you can work with these angels but that they bring value to the company.

What is the angel investing process?

The process for closing a deal with an angel organization consists of several steps of increased engagement with the entrepreneur and the company. These steps are:

Pre-screening A quick check to make sure the entrepreneur has supplied all the requested information and that the company meets the criteria for investment of the group.

Screening	The first look at the company – a spot check to see if angels familiar with the industry might be interested in this deal.
Due Diligence	In depth validation of the business plan and the investment opportunity by a team of investors.
Term Sheet	Negotiating the terms of the investment deal, including the valuation of the company which determines the percentage of ownership for the investors.
Investment Meeting	After the due diligence is satisfactorily completed, investors gather at this meeting to consider investment in the company, or, in the case of an angel fund, to vote on investing pooled monies in the company.

What is a Gatekeeper and what does s/he do?

The Gatekeeper is the first contact an entrepreneur has with an angel group. This person may be an experienced member or a paid staff person. The Gatekeeper often heads the pre-screening efforts of the group, making sure the applicant meets the criteria for investment of the group and is within the areas of interest of the group. The Gatekeeper may, for example, return the application to the entrepreneur for more information. The Gatekeeper is often the primary point of contact with the organization, at least until the angel organization enters into the due diligence stage with the company.

What are Criteria for Investment?

Angel groups usually post their criteria for investment on their websites to clarify for entrepreneurs the characteristics of deals in which they invest. The criteria for investment might be a limit on the amount of money a group will invest in a single round (for example, few groups invest above $1 million in a single round of investment). The criteria might also dictate the areas of interest of a group, for example, some groups only invest in software or life science deals. The criteria will probably define the geographical area in which a company must be headquartered to receive investment. Most groups only invest within perhaps 50 miles of the offices. Other groups may exclude certain kinds of deals, such as retail, restaurants and/or real estate deals.

What is deal screening?

Screening is the first serious look an angel group will take at an applicant company. The entrepreneur is usually invited to make a 20-minute PowerPoint presentation, followed by a short Q&A period, to a group, which may consist of staffers and experienced members of the angel organization. The meeting will usually be at a site determined by the angel group. The purpose of this meeting is for the angel organization to decide if there is sufficient interest in their group to enter into due diligence with the company and to find a champion among the angel members interested in leading the due diligence on this deal.

What is "due diligence?"

Due diligence is the process of validating the investing opportunity. Due diligence is different for every deal, so it is difficult to provide a general description. Here are just a few key points that might be checked on any deal:

- Is the ownership of the intellectual property clearly with the company? Do other patents in the area restrict the freedom to operate of the company?
- Did background checks on the entrepreneur reveal anything untold?
- Is the size of the opportunity compelling?
- Are there lawsuits, violations of regulations or other conflicts that might impede the company?
- Will the customer buy the product?
- Are the proforma financials sufficiently predictive? Is the amount of money the company is attempting to raise sufficient to achieve the necessary milestones?

This is only a miniscule list of possible questions that might be addressed by the due diligence team. Suffice it to say due diligence is a time-consuming chore that often requires 100 person-hours of angel time and usually requires 30-60 days to complete.

What is an investment meeting?

The investment meeting, for many angel organizations, is the meeting at which angel members are asked to seriously consider investing in the company. This meeting usually follows the successful completion of due diligence and, in the case of angel networks, agreement by one or two members to invest in the company. The entrepreneur is often introduced by a champion or the lead of the due diligence effort, who can now validate the investment opportunity. The presentation is similar to that of the screening meeting, but the length of the Q&A period may be extended to allow members to get answers to as many of their questions as possible.

Will angels write checks at an investment meeting?

In the case of angel funds, the entrepreneur will be excused and a vote will be taken on investing in the company. Assuming a positive vote and that the term sheet has been successfully and completely negotiated, a check can follow quickly.

In the case of angel networks, additional meetings are usually scheduled at the facilities of the entrepreneur with all interested angels to cover all the details of the investment. Usually one or more angels will have written checks prior to the investment meeting and individual checks of interested members will drift in after each has had a chance to meet individually or in smaller groups with the entrepreneur. It is often the responsibility of the champion (or group manager) to work with the entrepreneur to gather checks and get the deal closed.

How long will it take to get angel money?

From start to finish, it usually takes 3 to 6 months to close an angel investment round. This is dependent on the timing of the application (just before the December holidays is not a good time), the complexity of the technology and the deal, the availability of busy, part-time angels to attend meetings and complete due diligence, the ease of negotiating valuation and other deal terms and the compelling nature of the opportunity. If several angels write checks early, there will be some pressure on the rest of the group to join before the deal is closed. If angels are waiting for one angel well-versed in the technology or business vertical to make up his or her mind, it may take longer to close the deal.

Due diligence takes significant time for both angel networks and angel funds. Often angel funds can make a decision faster, because they are simply voting “up or down,” not writing individual checks. On the other hand, it may take longer to close the entire round with an angel network, but some angels will write checks early, indicating at least some of the round will be filled by the angel network (i.e., not an up or down decision by the group).

While it may seem to take a long time for individual angels to make this decision, remember that angels are investing for the long haul with each company. They expect their engagement with each company may be seven or even ten years in length. Taking time to make this decision should be expected.

11 Terms of the Deal

What is the most important term to entrepreneurs?

For most entrepreneurs, valuation is the most important term to negotiate. While I acknowledge that valuation is important, smart angels and entrepreneurs acknowledge that seed and startup angel deals will have a pre-money valuation in the range of $1-2.5 million, depending on many factors described in Chapter 12. I believe entrepreneurs waste too much time trying to move angel investors to valuations above this range, while compromising on other terms that ultimately impact management of the business and/or their return on investment. It is critical for entrepreneurs to learn the important terms of venture deals and how these terms ultimately impact them.

Disclaimer

The author of this book is NOT an attorney and is not qualified to advise entrepreneurs on the legal terms related to seed and startup deals. In this chapter, we will discuss terms of the deal in layman's language. For more complete descriptions of these terms, I suggest reading **Term Sheets & Valuation** by Alex Wilmerding, available from Amazon. Furthermore, you can find a sample term sheet and useful examples of standard investment agreements on the website of the National Venture Capital Association. Go to www.nvca.org and look in Resources for Model Legal Documents. For specific recommendations related to **your** business, I urge you to consult with your attorney.

When should I get my attorney involved?

First time entrepreneurs should spend time networking and develop a list of the best attorneys in their region for assistance in starting companies in which equity investment is anticipated. (These are not patent attorneys.) I urge you as an entrepreneur to interview several such attorneys to find the attorney best suited to work with you in your company. Include a candid discussion of fees in your interview. Lawyers familiar with starting companies realize that entrepreneurs do not have a lot of money for legal fees at the outset and many are willing to forgo some or all of their legal fees until the company closes its first round of funding.

I encourage first time entrepreneurs to engage a quality attorney early in the process of setting up the company and especially when engaging with investors. Angels have usually invested in companies before and understand the terms and conditions of the investment. Have a strong team on your side when you begin seeking investors.

Should I insist all investors be accredited?

Accredited investors, as defined by the SEC, are sufficiently wealthy and sophisticated to make investment decisions without studying exhaustive filings by entrepreneurs with our state and federal governments. Having stipulated that an investor is accredited in the closing documents of an investment round in a private company precludes that investor from claiming s/he did not have adequate information to

make the investment deal. Since accredited investors are able to withstand the loss of the money without substantially impacting their lifestyle, the courts have given them few legal grounds for claiming their investment monies should be returned by the company or other investors in the company.
Given the choice, I would always recommend to entrepreneurs that they only accept investment monies from accredited investors. Not only are they precluded in most cases from legal pursuit of the company or entrepreneur over this investment, they are generally more sophisticated investors anyway. Why take money from naïve investors or lenders, when they may not know enough about the risk and may need the money back at a later date?

I make the same recommendation to angel investors. Investing in a company with many unaccredited (and unsophisticated) investors is only inviting problems with these shareholders (or lien holders) later. Non-accredited investors may have a claim against the company or the entrepreneur at a later date. Why risk investing in companies with such a liability?

The law in many jurisdictions has many exceptions to the above limitations on accredited investors and many advisors may suggest entrepreneurs can accept funding from some or a few non-accredited investors. Check with your attorney for local rules, but as a general rule, I am suggest taking as little money as possible from non-accredited investors.

What are the securities options for structuring the deal?

There are several ways you can structure your company in preparation for accepting equity investment from angel investors. For simplicity, I am going to describe three options and suggest that one option is probably best for a high growth company which will likely require multiple rounds of investment. All of the structures generally satisfy the concern of investors for personal liability, that is, the company can provide a "corporate liability shield" for all owners (meaning that in most cases, successful lawsuits against the company cannot penetrate the corporation, creating liability for individual shareholders).

Limited Liability Company – LLCs are very flexible corporate structures available almost everywhere. These can be designed as "pass thru" entities for tax purposes, that is, the company is not a tax-paying entity. All tax deductions and liabilities are passed directly through the corporation directly to the owners, much like that of a partnership. While this structure may be interesting to some angel investors, an LLC is not a structure in which venture capitalist would invest. Furthermore, conversion to another corporate structure after angels have invested but before VCs invest is expensive and impractical. Therefore, it is recommended that entrepreneurs not use an LLC structure for investments in which VC investment is a possibility.

Common Stock in a "C" Corporation – Setting up a standard "C" corporation and selling common shares to angel investors is not an unusual transaction. It is a rather straight-forward legal transaction and not particularly expensive (legal fees). Many angel investors have invested in common stock, right along side entrepreneurs, who also own common stock. There are disadvantages to investors (which will become clear in the next section on preferred stock transactions), but none to entrepreneurs, with the following exception. If the company must raise more money later from sophisticated angels or from venture capitalists, then I encourage entrepreneurs to use the preferred structure for the first round of investment, rather than common stock. More sophisticated angels may (and venture capitalists will) only be willing to invest in preferred stock in a subsequent round. Under this scenario, your earlier angel investors who accepted common stock will be at a disadvantage to subsequent investors, which is not a comfortable position for entrepreneurs. If you expect multiple rounds of investment from increasingly sophisticated investors, don't use common stock in the Series A round.

Preferred Stock in a "C" Corporation – This is the classic structure for entrepreneurs seeking multiple rounds of investment to grow companies. Preferred stock, as a separate class of stock, allows certain rights to be granted to that class of stock, such as:

- Dividends – this class of shareholders may be eligible for dividends not available to common shareholders.
- Liquidation preferences – the right to receive all invested capital back prior to the distribution of the proceeds of a sale. In adverse situations, the return to investors may be a multiple of invested capital.
- Electing Directors – shareholders in this class may reserve the right to elect a specified number of Directors (usually a minority).
- Approving transactions – approval of a majority of a class may be required to sell the company, buy another company, solicit additional investors and/or close on bank financing.
- And other rights.

Sophisticated angel investors and all venture capitalists will insist on purchasing preferred shares in your company. As was mentioned above, if you expect to pursue venture capital, I strongly recommend you set up a preferred structure for the first equity invested capital.

Why is a Preferred A round often chosen?

In addition to the special rights possible (but not required and therefore negotiable) for the preferred class of stock, there is one particular advantage to using preferred stock for invested capital. High growth companies requiring substantial amounts of angel and VC capital must build exceptional management teams. Awesome management teams often utilize stock options as incentives for new additions to the team (after the founder shareholders).

Because preferred shareholders have special rights, including being ahead of common shareholders in the case of a liquidation, preferred shares can be priced higher than common shares in the early, high-risk stages of company development. As an example, if preferred investors buy shares in a pre-revenue company at $1 per share, it might be possible to value common stock at $0.10-$0.20 per share in the early days of the company. This allows the Board of Directors to establish a stock option plan for officers and Directors for very attractively priced common stock, thus allowing the Board to build a great management team, with incentive driven by low priced stock, at least early in the life of the company.

What are the implications of multiple classes of stock?

As has been shown for a high growth company, there are many complementary reasons for establishing a preferred class of stock for investors. Investors are interested in the advantages that preferred stock offers to common in case of an unanticipated liquidation and in the special rights related to return on investment and control. Furthermore, all shareholders are interested in establishing a desirable option pool to assist in building an awesome management team. Establishing multiple classes of stock facilitates these corporate advantages.

Will investors want a Board seat?

In most cases, angels will want to participate as Directors on the Board of portfolio companies. Angels can be very effective Directors, contributing to the growth of the company and communicating progress of fellow investors. But, there are advantages and disadvantages for investors serving as Directors. The Board controls the company, but in these litigious times, members of the Board of Directors can, under certain circumstances, be exposed to personal liability for this service. Since angel investors are generally wealthy, they may not willing to agree to this additional personal exposure to litigation without liability protection.

Established companies purchase Directors and Officers Insurance to protect Directors from such exposure to litigation. However, policies for this insurance often cost the company as much as $10,000 per year, an unreasonable expense for a startup company with limited cash assets. I think you can understand the dilemma for investors - active participation as Directors accompanied by personal liability exposure

The exposure to litigation is different for every company. So, often angels will, indeed, decide to accept a Board seat even when D&O Insurance is not a reasonable expectation. However, in my experience, it is unlikely that angel investors would ever want control of the Board of Directors. Angels are generally looking for representation on the Board and access to all the records and current financial statements of the company.

Venture capitalists, however, will insist on D&O Insurance coverage for Directors. Once VCs have invested in the company, expect to purchase this coverage.

Because of their business acumen, angels tend to be very useful Directors in the early stages of company development. However, as the company matures, it may be appropriate for angels to step aside to make room for later stage investors with much more capital at stake and for industry specialists who can facilitate rapid growth in the company.

What is a liquidation preference?

It has become common for angel investors and venture capitalists to insist on liquidation preferences as part of the terms and conditions of closing rounds of investment.

A liquidation preference means that, in the case of any liquidation or sale, the investors get their investment back prior to distribution to any other shareholders.

In distressed investment situations, investors sometimes require multiple liquidation preferences, that is, (in the case of a 2X liquidation preference) the investors get twice their money returned prior to distributions to other shareholders. (This is not common in very early rounds, but often the case when the company has not met its milestones and runs out of money.)

There is another twist. Liquidation preferences can be participating or non-participating. In non-participating, the investors must choose between receiving the liquidation or converting to common stock and sharing the return on a par basis with common shareholders. In the case of a participating liquidation preference, the investors can take the liquidation preference and then convert to common and participate again as a common shareholder.

Here is an example for your consideration:

Liquidation Preference	Investment	Selling Price	Proceeds Investors (30%)	Proceeds Entrepreneur (70%)
0	$1 million	$3 million	$0.9 million	$2.1 million
1X (non participating)	$1 million	$3 million	$1.0 million	$2.0 million
1X (participating)	$1 million	$3 million	$1.6 million	$1.4 million

In this simple example, an investor buys 30% of a company for $1 million. The company later sells for $3 million (probably much less than the entrepreneur and investor initially expected). With no liquidation preference, the investor's proceeds of the sale are 30% of $3 million = $0.9 million. Note: The investor lost money on this sale! With a 1X liquidation preference (non participating), the investor chooses to have the investment returned ($1 million). In the case of a 1X participating liquidation preference, the investor gets the $1 million plus 30% of the remaining $2 million, or a total of $1.6 million.

In the case of a disappointing return, a liquidation preference provide for the return of investment to investors. In the case of a wildly successful selling price, the difference in return to both the investor and the entrepreneur is inconsequential.

Just to prepare entrepreneurs for "sticker shock," many investors today require a participating 1X liquidation preference as one of the terms of investment in their deals.

Can I expect all the money at once?

- Investor have two choices, giving all of the money raised in a round of investment to the entrepreneur at once or parceling the money out to the entrepreneur in "tranches," that is, giving the entrepreneur the money as milestones are met. *(Tranche in French means a portion, as in a piece of pie.)*

In most cases, investors (both angels and VCs) will give all the money to the company at the outset. In some cases (usually where huge investment rounds have been raised), investors tranche the money to the entrepreneur. If investors suggest providing funds to you, as an entrepreneur, in tranches, carefully review the milestones. Unfortunately, milestones change over time, indeed, product and business plans change over the early life of many companies. So, the problem for entrepreneurs is that when the milestones change, negotiations must take place regarding new milestones.

What reports will investors expect?

As has been mentioned above, entrepreneurs and their investors are married, generally for seven to ten years. As in any partnership, communications are vital. Corporate law gives investors the right to see almost any reports, financial or otherwise, they would like to see. But, requiring investors to demand reports by legal recourse is inappropriate. My suggestion to all entrepreneurs is simply: Ask investor groups what reports they would like and how often they would like them, and then do your best to deliver those reports on time. (I would not ask individual investors this question, because then you end up creating customized reports for each investor.) Provide frequent and complete reports to your investors on a regular basis.

What is "founder vesting?"

Founder vesting is described at the end of Chapter 3. While angels have not used founder vesting frequently in the past, venture capitalists do. My expectation for the future is that angel investors will begin using this term with greater frequency. My advice to entrepreneurs is to learn as much as you can about founder vesting and get comfortable with the concept. Learn the various terms and conditions of founder vesting and negotiate the best deal you can, when confronted with this somewhat onerous term.

Founder vesting is only bad when the progress of the company is slower than anticipated. When the company hits all its milestones and is showing impressive numbers, founder vesting will not be an issue. But, in bad times, founder vesting can be quite a problem for entrepreneurs.

What is "redemption?"

Redemption is the repurchase by the company (or the entrepreneur) of the investment made by angels and venture capitalists after an agreed upon period of time (often five years). This is another intimidating term, because it requires the entrepreneur to buy back the investment (sometimes at a premium) from investors at a later date.

While intimidating, this term seldom, if ever, will come into play. Why? Because five years hence, it is unlikely that the entrepreneur will have the resources necessary to repurchase the investor stock as required by this term.

The worst fear of any investor is that the entrepreneur will convert a rapidly growing company into a lifestyle company, that is, the entrepreneur is earning a nice salary and becomes less willing to push hard for growth. In this case, the company is doing OK, but is simply going sideways…not growing, not increasing the value to investors.

Redemption is designed to make entrepreneurs uncomfortable and to remain hungry for success. Entrepreneurs who become comfortable will see their investors attempt to invoke the redemption rights and, since the company and the entrepreneur cannot afford to repurchase the investor stock, the investors may, indeed, become 100% owners of the company.

No investor insists on redemption rights because s/he wants to own 100% of the company. The opposite, in fact, is true. The investor wants the entrepreneur constantly striving to grow the company for a successful exit. But, the threat of redemption is necessary to keep some entrepreneurs' feet to the fire.

What are "anti-dilution rights?"

Anti-dilution rights (or privileges) preclude an investor from seeing his ownership in the company diluted by the sale of shares in the company at a valuation less than the valuation at the time the investor's funds were invested in the company. There are somewhat complex formulae describing the two basic anti-dilution methodologies. I suggest you refer to detailed definitions on the Internet or in Wilmerding's book on term sheets (see Chapter 14), but simple definitions follow:

Full ratchet anti-dilution – If a subsequent investor is sold one or more shares of stock at a lower price than the price paid by investors with full ratchet rights, the earlier investors are immediately granted an additional number of shares that s/he would have purchased at that price with his or her original investment.

Weighted average anti-dilution – In this case, depending on the volume of shares sold at the lower price, a proportional number of additional shares are granted the original investor(s). In other words, if only a few shares are sold at a lower price, the original investors are only eligible to receive proportionally more shares based on the extent of their dilution.

What are "registration rights?"

Registration rights are important for those very few companies that eventually go public. These provide early investors the rights to register their private shares for sale in public markets at some reasonable time after the company goes public. There are several kinds of registration rights, but suffice to say that in seed and startup stage deals, standard registration rights are appropriate and unusual and/or onerous registration rights are not. Consult with your attorney and insist on "vanilla" registration rights.

There are many other terms not described here, but these are some of the more important ones faced by entrepreneurs seeking seed and startup funding. Consult Wilmerding's book and your attorney for a more complete explanation of deal terms.

12 Valuing Your Business

What is valuation and why is it important?

I have mentioned valuation a few times earlier in this book, but let's review
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Pre-money valuation – The value of the company at a time immediately before closing a new round of investment in the company. For a company which has not raised any significant money in the past, to what assets are we attempting to assign a value?

- The idea for the business
- The "sweat equity" of the assembled management team
- The proprietary technology driving the business
- Product and/or service development
- Relationships established by the team – with customers and partners

In short, the pre-money valuation represents the value of the opportunity to build a substantial business. What would an independent third party pay for this opportunity, if all owners wanted to sell without taking investment? Probably not much. Investors are paying for passion, commitment and unproven ideas – a high-risk opportunity to build something of value in the future.

Post-money valuation – This is easy. Pre-money valuation plus the amount of money invested in this round equals post-money valuation. Simple, huh? It may be simple, but it is very important that entrepreneurs stipulate whether you are talking about pre or post-money valuation when talking to investors.

A comment about risk that I mentioned in Chapter 2 when discussing why angels invest only in companies that will scale: It is important to understand that the pre-money valuations of seed and startup companies would be much higher if the odds were greater than about 1 in 10 that invested companies would exceed investors' and entrepreneurs' expectations. But, over the decades we have only found that about 10% of fundable startup companies, which are good enough to secure angel financing, actually achieve the kinds of scale to which both investors and entrepreneurs aspire. These statistics, well-understood by investors but not necessarily acknowledged by entrepreneurs, usually explain differences in opinion of pre-money valuation between the two groups.

What is the typical range of Pre-money Valuations for Seed and Startup Companies?

A fair valuation is the pre-money valuation upon which independent entrepreneurs and investors can agree. Investors and entrepreneurs typically agree upon valuations for seed and startup companies (usually pre-revenue) in the range of $1-2.5 million. As was explained with a couple of examples in Chapter 10, angels typically buy 20-40% for their investment of $300,000-$1 million.

During the craziness of Internet boom (1998 – 2001), inappropriately high valuations were negotiated by foolish and greedy investors and entrepreneurs alike. (I should know...I was one of them!) However, except for that period of idiocy, seed and startup valuations have been relatively stable for the past thirty years. Pre-money valuations between $1-2.5 million have dominated the landscape.

Note: This discussion of valuation is limited to companies in the seed and startup stage of development. Seed and startup companies are, according to a definition created for PricewaterhouseCoopers' MoneyTree database, defined as follows***:***

> *Seed and startup - the initial stage. The company has a concept or product under development, but is probably not fully operational. Usually in existence less than 18 months. (definitely a pre-revenue stage).*

How are pre-revenue companies valued?

On-going companies are often valued based on multiples of earnings or cash flow. The methodologies generally involve crunching numbers based on financial statements. But, pre-revenue companies have no proven financial statements, only proforma (or planned) financials.

Let's start with the tried and true assumption that most seed and startup companies have a negotiated pre-money valuation of $1-2.5 million. So, the question becomes where in this range should your company be valued? We can apply subjective considerations to assist in determining where within this range is a fair pre-money valuation for your company. Investors consider the skills and experiences of the management team...the size of the opportunity...and the strength of the technology portfolio, among other factors.

While this may be surprise to most entrepreneurs, here is a table that describes how some angels attempt to quantify the value of pre-revenue companies:

Management Team	*30%*
Size of Opportunity	*25%*
Product/Service and Technology	*15%*
Marketing and Sales Channels	*10%*
Competitive Environment	*10%*
Other factors	*10%*

I am only going to cover the first three in the discussions which follow.

Management Team (30%) – The management team is the most important consideration in valuing an early stage enterprise. An experienced CEO will necessarily command a higher valuation for the company. But, a CEO/founder who is clearly capable of achieving certain milestones, such as completing product development and closing the first few sales, AND is willing to step aside in favor of an experienced CEO to be hired later is also valuable. An inexperienced CEO/founder who is unwilling to consider stepping aside upon the achievement of certain milestones is a danger sign to investors and may not get funded at all.

It is not critical that the management team be complete, although some key players should be on-board or at least identified and in the wings. What is important is that the founder recognize the key team members that need to be in place and when.

Investors bet on an A+ team with a B product idea every time over a B team with an A+ product. Why? Because A+ teams will find A+ products and build a business, while sometimes B teams cannot commercialize A+ products. This is why the quality of the management team so critical to investors.

Size of the Opportunity (25%) – As I have mentioned on numerous occasions, investors seek to fund companies that will scale quickly to $20-50 million in revenues or more. The importance of this factor in valuing pre-revenue companies demonstrates the criticality of scale to investors.

Product or Service (15%) – It comes as a shock to all first-time entrepreneurs that their product or service represents such a small piece of the pre-money valuation. And, for high technology companies (with a valuable patent portfolio) this 15% number is low and would be perhaps 20%. In no case would the importance of the product or service exceed that of the management team or the scalability of the company. The product is important, but only as it defines the domination of a large marketplace that the company can achieve.
The components of the remaining 30% of the pre-money valuation are important, but described in the business plan section in Chapter 8.

> *The key issue to acknowledge is that a super product with super technology will not radically improve a company's pre-money valuation, while an excellent management team with a product that can command a huge future business will substantially increase the valuation of pre-revenue companies.*

The Benchmark Method of valuing pre-revenue companies first looks at the average valuation of similar companies in the region in recent transactions. Let's say that average pre-money valuation is $1.5 million. The investor then considers each of the factors listed above for the target company and may conclude that the target company is 20% more valuable than the average comparable company, perhaps due a very strong management team and solid product intellectual property. An appropriate pre-money valuation of the target company would then be $1.5 million X 1.2 = $1.8 million.

How are on-going companies valued?

Often angel investors have an opportunity to invest in small ongoing companies that have uncovered a new, large opportunity and need capital to take advantage of the new business. These cases tend to represent somewhat lower risk investments for angels for two reasons: (1) the founder/CEO has already demonstrated the skills to run at least a smaller business and (2) the downside risk can be lower, because the company already has revenues and earnings.

Some angels value these opportunities by estimating the value of the ongoing business and then adding to that the valuation of the pre-revenue component of the new business. Methodologies for valuing ongoing businesses are well-documented elsewhere and will only be covered briefly here. Appraisers of ongoing businesses tend to use multiple methods and then use a weighted average of the results to come up with a final valuation of the ongoing business (or the ongoing component of an angel investment opportunity). Here are the descriptions of three such methods that might be used in such a weighted average:

- Transactional method – If stock has recently changed hands between independent third parties, the valuation at the time of such transactions is appropriate for consideration.
- Comparable method – By comparing the price/earnings ratios (and other appropriate data) of comparable public companies to the target company, reasonable assumptions of value can be obtained.
- Discounted cash flow – By discounting the cash flow (or earnings) from reasonable projections of future performance (based on past performance), the appraiser can obtain a third important valuation to be averaged with the rest.

These methodologies do not apply to pre-revenue companies, but only to ongoing companies.

How are the CEO and the management team appraised?

Investors do deep background checks on the founder and the management team as part of the due diligence process. In rating the key team members, three sets of criteria are critical:

- Skills and experiences: How many years of experience does each team member have in the role s/he is expected to play? How was each team member rated in these roles by previous employers and employees? How comparable were these roles to the expected roles in the new company? Were these experiences in the same business verticals as the new company?
- Integrity, passion, work ethic: Investors are entrusting large sums of cash with this management team, so integrity is of utmost importance. Background checks focus on integrity. But a passion for the new venture is also important as is the work ethic of each team member. Starting a new company requires huge time commitments by team members. Is this team ready to step up to the plate? Finally, does this team have "both feet in," that is, fully committed to the success of the venture?
- Prior success in business is an important criterion for measuring team members. Team members with no previous business experience are difficult to evaluate and generally receive low marks.

Why is the size of the opportunity important and how is it determined?

The size of the opportunity is used by investors to determine the likelihood that a company, if successful, will scale to a very high valuation and therefore a home run exit. For companies that need only a round or two of angel funding to achieve optimum growth, achieving a valuation of $20-50 million in five years is viewed as highly scaleable. For a company that requires venture capital investment of as much as $10 million, the company must show the opportunity to grow to at least $100 million or more in revenues.

In measuring the size of the opportunity, the key issue for investors is to carefully define the niche. Too many entrepreneurs, in describing the size of the opportunity, as in the previously described example for sheepskin seat covers, show investors the size of the automobile industry as a whole. In this example, we want to know the size of the seat cover after-market, what share sheepskin seat covers have of that market and what competitive advantages the proposed venture is to capture a substantial share of that market.

Another mistake entrepreneurs make is to suggest that the demonstrated market size for their niche is $1 billion and they need only capture 5% to be a $50 million company. That logic is unconvincing. Why should we assume 5% versus 0.05%? We investors want a bottoms-up analysis, that is, we want to know the compelling reasons that specifically-identified customers will purchase how much annually and in what colors!

By using web searches followed up by phone calls, we angels have found that this analysis is substantially easier than it was a decade ago.

How is the intellectual property valued?

Proprietary intellectual property (IP) is an important competitive advantage to entrepreneurs. Investors first want to know that (1) the company actually owns the IP, (2) the IP gives the company a competitive advantage and (3) that the company has room to operate, that is, that competitors have not hemmed in the IP with other patents that limit the operating space of the company.

IP is not usually valued per se. Investors credit the value of the IP into the likelihood that the IP will allow the company to grow more rapidly in market share, because the competition will not be able to respond quickly with "me-too" products.

However, sometimes IP has substantial value in business sectors outside the interest of the investors and can produce license fees and royalty income for the company. If real, this can offset the amount of capital that must be raised and increase the valuation of the company, allowing the entrepreneur to keep larger ownership in the venture.

The competitive advantage provided by strong IP can bring significant value to the company at exit. Once the business model has been proven and value proposition to customers is validated, potential buyers will view strong IP as important differentiation when considering the possible acquisition of your company. Value at exit may be the most important contribution for intellectual property.

Why doesn't the product receive more attention in valuation?

I think by now you may be tiring of me harping on this same point. The product is a critical ingredient in the success of the business, because it describes the size of the opportunity, competitive advantage, etc. Taken as a whole, these are huge pieces of the valuation. But, as I said early in this chapter, a great management team with an average product has a much greater chance of success than an average team with a great product. Great management teams can innovate and execute. The product is only one piece of the puzzle.

Bill Hewlett and Dave Packard got together to build a great company (HP in 1939) and built the management team before they ever sat down to think about what products they might make. Many of us think theirs may have been the right approach.

Why is competitive analysis important? What if I have no competitors?

Let's deal with the second question first. Never tell investors you have no competitors. If your product is going to be used by a customer, those same customers somehow got the problem solved yesterday using some product or technique. That is your competitor today. If you introduce a product today, your potential competitors will know about it tomorrow. Which ones have the capabilities, resources and interest in competing with you in this marketplace? These are your competitors.

Competitive analysis is critical because it provides some answers for investors to the question of what kind of head start you will have in the business vertical and how long that lead will last. Furthermore, this analysis will define which competitors are likely to enter the market with competitive products and when. Well-funded competitors who only have to tweak their products to chase you into a new market are intimidating because they are established in the marketplace with plenty of money and resources.

An interesting competitive analysis fully defines the marketplace and explains why you can maintain a sustainable advantage over your competitors.

Why are investors concerned with sales and marketing?
In spite of what you may have heard, nobody beats a path to your door to buy your new product. Once we know that the "dogs will eat the dog food," we now need to determine how customers in this marketplace normally buy their products. Do they buy from direct sales persons or sales representatives or through distributors? (These are different sales channels.) If you have customers in different markets (selling paint for furniture and automobiles), do customers in those different markets buy products via different channels? And, how will online sales contribute to the success of the company?
Often entrepreneurs understand products, technology or finance, but have no understanding of sales and marketing. Investors need to confirm that entrepreneurs both understand the importance of sales and marketing and have important management team members focused on making sure those dogs are fed!

Why are investors (and entrepreneurs) concerned about dilution?

Dilution is normal for angels and entrepreneurs in companies that need to raise multiple rounds of investment. When the valuation is steadily increasing, the ownership percentage of early investors and the entrepreneur tends to decrease (unless they invest cash along with new investors), but the value of their investment increases because the price per share continues to increase. (As an extreme example, the early angel investors in Amazon were eventually diluted to a miniscule fraction of ownership of the company, yet they enjoyed a 4000X return on their invested money.) In some instances, angel will invest in several rounds at higher and higher valuations because they continue to believe in the return on investment opportunity even at higher valuations. But, many angels simply make one or two early investments and allow themselves to be diluted as the valuation and investment increases.

Why is it important to come to an early agreement on valuation?

Contentious negotiations on valuation create hard feelings that can last through the duration of the "marriage" and are really unnecessary. If your valuation expectations are above a pre-money valuation of $2.5 million, I urge you to seek local advisors who can help you justify the proper valuation. If your expectations are in the typical range, but the angel investors are proposing a valuation below the typical range, suggest they seek advice elsewhere. (Better yet, suggest they contact us!) If you, the entrepreneur, and the angel investors are both in the range but separated by a significant number, split the difference and get on with building a company. If your company eventually sells for $50 million, everyone wins. If your company goes out of business, the original valuation was not important. If your company eventually liquidates for a number less than everyone anticipated it might, you were unsuccessful in executing the business plan proposed to investors and probably deserve a bit lower return on investment. The important thing to recognize is than in the case of a wild success, the original valuation was not particularly important.

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Using Angels to Build Your Business

Wise entrepreneurs choose "smart money" as angel investors in their companies. Smart money brings more than cash to the investment; that is, business acumen, valuable networks and a willingness to assist in growing the startup venture. After surveying hundreds of startup companies seeking angel capital, Professor Josh Lerner of Harvard Business School reported in 2010 that mentoring and business contacts from angels seemed to be even more important that the capital angels provide.

If you raise $500,000 in your Series A angel round, it is likely to come from ten or more individual angels. (Remember: The average individual angel investment in any round is $30,000.) You can't possibly be expected to actively engage with a dozen smart, inquisitive angels – and you should not. You and the lead investor (or the manager of the angel organization) should sit down before closing the deal and define roles for the key investors who will initially assist the company, serving as Directors on the Board and mentoring or coaching you and your key management team. I would suggest initial active relationships with one or two of the angels in the Series A round is the right number.

This is not to suggest that these roles cannot change, depending on the needs of the company and the availability of individual angel investors. Periodically review those actively involved and consider making changes, irregularly and on an as needed basis. This is also not to suggest that only one or two angels will be involved with your company. You will regularly come across special issues where the expertise of other investors (or even other members of the angel organization who did not invest) can be applied. For example, as you begin to export off-shore, you may encounter technical problems or corporate structure issues that a specialist in the group might help resolve. As another example, you may need assistance with special employee benefits or an employee stock ownership plan and find that others in the angel organization may have special knowledge in this area. I would routinely look to your investors and the organization of which they are members for such special assistance.

What do angel investors expect from entrepreneurs? (the care and feeding of angels)

As a group, your angel investors expect timely information on the financial and non-financial progress of the company. Some of this reporting may be covered in the term sheet for the deal and other investor reporting obligations are covered by state law. Nonetheless, I would suggest that, shortly after closing the investment round, the entrepreneur meet with the lead investor (or the investors selected to serve on the Board as members or observers) and discuss regular reporting to investors. I would suggest that quarterly financials in an abbreviated format (one or two pages each for income statement, balance sheet and cash flow statement) be sent to investors with a cover letter describing progress related to non-financial milestones. The letter should come from the CEO or the Chairman of the company (or both).

I would also suggest that all investors be encouraged to attend the annual shareholders' meeting. Announce the meeting date and place with plenty of notice and provide a meaningful agenda, encouraging an open discussion with investors. My experience with such open shareholder meetings is that investors always make positive contributions, volunteering to make introductions and help open doors to customers and partners, etc. Angel investors usually enjoy attending shareholder meetings, especially if the meeting is designed to solicit suggestions and assistance from these investors.

How do entrepreneurs determine what reporting investors want?

As we discussed earlier, this is easy. Ask your Chairman, the lead investor and/or the manager of the angel organization the question "What progress reports and at what intervals does this set of angel investors want?" Come to an agreement on what makes sense to investors and the company, and then live up to your commitments regarding the information your investors would like to receive. In fact, I suggest entrepreneurs exceed the reporting expectations of their investors.

What is the makeup of an effective Board?
In Chapter 3, I described an effective Board. In general, smaller Boards of Directors are probably better for seed and startup companies. Perhaps the founder/CEO, an angel representative and an agreed upon experienced, outside Director would be appropriate for starting the company. Somewhat more established companies should consider five to seven persons Boards, using the models described in Chapter 3.

I strongly urge new entrepreneurs to avoid the temptation to promise minority partners/employees and/or key management team members a seat on the Board of Directors. Boards function most effectively when the CEO/founder is the only employee represented on the Board. Founders feel more comfortable when key management partners, such as the CFO or the founding partner are on the Board, but this can create unnecessary problems down the road. The Board of Directors can provide useful counsel to the CEO/founder in evaluating and managing key members of the management team, but these discussions cannot take place if those team members are also members of the Board of Directors. It is also reasonable to invite key members of the management team to regularly or irregularly attend Board meetings. However, the involvement of management team members should be limited to the "open" portion of the meeting. Only Directors should be present during the "closed" portion of meetings and during these periods, frank discussions of all members of the management team are easily facilitated if only the CEO is present. Recommendation: Don't fall into the trap of promising early key employees a seat on the Board of Directors. It is very difficult to "go back" on such promises. Here is a useful excuse: Tell early partners and employees that you and the early financial investors are reserving the right to select an independent, experienced Board of Directors from the business community.

Should I use angels to assist in building a Board?

I think it is quite appropriate for the entrepreneur to enlist the assistance of the lead investor in a Series A round to help define an effective Board of Directors. Angel leaders are usually well-connected in the community and can be very helpful in suggesting possible candidates and in recruiting those candidates for the Board. There are two questions to be answered: (1) what is the appropriate make-up of the Board of Directors (how many Directors? how many representing the angels?… how many representing the founder?… how many independent, to be selected upon the agreement of both parties?), then (2) who should represent the CEO, angels and who would be appropriate independent Directors? I would suggest that the founder/CEO carefully interview several independent candidates before agreeing to specific candidates.

How do I recruit awesome Board members?

I suggest that the founder/CEO objectively list his/her strengths and weakness. (If you have trouble with this assignment, your spouse or your mother can surely help☺) The Board of Directors should consist of a balance of generalists and specialists, but I suggest the entrepreneur focus on bringing in experienced Board members with specific strengths which balance the weaknesses of the entrepreneur.

Once you create the list of strengths and weaknesses, sit down with your advisors and make a list of the best candidates in your community who might fill these positions. If you have three areas of weakness that would really benefit from substantial expertise, include three or four candidates to fill each spot. (Your angel investors can and should be among those on the list.) Prioritize each list and, working with your advisors and angels, determine how you can get introduced to the strongest candidates on your list.
Some, of course, will turn you down. But, most of these candidates will be flattered that you asked, and, even if they say no, they will likely be available for special counseling in the future. And…surprise, surprise…some will actually accept your offer. Using these techniques and calling in all your resources, you can build a truly awesome Board of Directors.

I suggested above that your first formal Board of Directors should be made up of people in your community. Most experts agree that Boards need to meet monthly until a company achieves the critical milestone of positive cash flow. Depending on the company, this might take six months, three years or, in some life science companies, a decade. It is reasonable to expect local Directors to show up in person for monthly Board meetings. On the other hand, in-person attendance by busy, non-investor Directors who must fly into town for meetings is much less likely. Experience suggests that the most effective Board meetings are when all Directors are present and not when a Director or two is present by teleconference. Board meetings by telephone can be effective for special meetings or in an emergency, but are not good regular practice. The personal relationship that Directors establish by meeting regularly together, in person, is very valuable to the company. For these reasons, I urge new entrepreneurs to build a Board using local expertise.

Should Directors be compensated for their service?

As a general rule, large investors who serve as Directors should not be compensated.

You will find that these Directors are normally representing their interest (in spite of the fiduciary responsibility to represent all shareholders). Venture capitalists, with substantial investment in the company seldom require compensation, except, perhaps, for reimbursement for travel expenses.

Local experts, who are not investors, recruited by the entrepreneur to serve as Directors should definitely be compensated for their service and have all travel expenses related to attending Board functions reimbursed. For very early stage companies, I would suggest compensating these experts, non-investor Directors with stock options only, not cash. An appropriate amount might be ¼% of the company per year, vesting immediately. For a four-year commitment (not an unreasonable expectation), options for 1% of the shares of the company vesting 25% per year would seem appropriate.

For minor investors who have agreed to serve as Directors, it is not unreasonable to compensate them as you do local experts with no investment in the company. As an example, if you raise $750,000 from angels in your Series A round and one angel investor stands out as an awesome potential Director, but s/he has only invested $25,000 in this round, it seems an inappropriate work load to expect this angel to commit to a multi-year Director's position without compensation, when s/he has only a tiny fraction of angel capital investing in this round. I suggest treating such angel Directors as if they were non-investor experts.

Who should be Chairman of the Board?

There is no definitive answer to this question. Many founder/CEOs insist on being Chairman, fearing perhaps losing the power of the office of Chairman. Some investors would prefer the founder/CEO be Chairman. My answer to this question is that the most qualified member of the Board of Directors should be Chairman. By that, I mean that the Director with the most experience in serving as Chairman and with the time necessary to serve should be elected Chairman.

First-time entrepreneurs seldom have any experience as a Director and find serving as Chairman a steep and time-consuming learning curve. An experienced Director serving as Chairman, working with the founder/CEO can take a substantial load off the founder/CEO by suggesting agendas, formats for Board books, and appropriate resolutions for consideration. A non-executive Chairman releases the founder/CEO from Board administrivia, allowing him/her to focus on the important tasks of running the company and executing the plan.

The position of Chairman (without also serving as CEO) has little power and much responsibility attached. I believe that first-time entrepreneurs are best served by working closely with an experienced Chairman recruiting and managing a startup Board of Directors.

Who should set the agenda of the Board?

I believe that neither the CEO nor the Chairman should use their positions to control the agenda of Board meetings. I suggest that the CEO and the Chairman draft a proposed agenda and circulate it to all Directors a week or so before meetings, soliciting comments and suggestions from all Directors. All Directors should have substantial input into the agendas of Board meetings.

How often should a Board meet?

As was suggested above, while the company is burning cash, that is, before achieving positive cash flow, best practice dictates that Board meeting monthly, and in some cases even more frequently. As companies mature and the Board begins to transition into less frequent meetings, a common first step is to continue to meet monthly with alternate meetings by telephone with abbreviated agendas. Once a company is operating with appropriate safety margins of cash and the management team is performing efficiently, Boards often choose to meet less frequently, usually quarterly.

Should the Board meet frequently in executive session?
It is good Board practice to schedule a portion of every meeting, usually at the end, when no employee, including the CEO, is present. This gives the Board a brief time to execute their fiduciary responsibility to evaluate the performance of the entire management team, including the CEO. Founder/CEOs will find this uncomfortable at first, but founder/CEOs are shareholders, too! It is appropriate and demonstrates confidence by the founder/CEO to provide this meeting time to non-employee Directors at every meeting of the Board.

Using Angels to raise more capital

A key advantage of using angel capital, especially angels who are part of an active angel organization, to fund your Series A round is that these investors can provide substantial assistance in raising more money. Furthermore, experienced angel investors can advise entrepreneurs on the timing and sources of new capital. Here are just a few scenarios as examples:

- The company is burning through cash and while the opportunity remains exciting, the venture is slow in meeting milestones due to technical difficulties. In these circumstances, it is unlikely that the valuation will have appreciated much since the last round of funding, so the angels might recommend raising a small round from existing shareholders at the same valuation as the last round. The investors will be sure to help the entrepreneur raise enough money to meet sufficient important milestones so that the valuation will increase before new money is gone. If the original funding was raised as a Series A round, this may be considered an extension of that round at the same valuation, a Series A-1 round.
- Why not bring in new investors? New investors, sensing the company is low on cash and recognizing that the entrepreneurs did not achieve the anticipated milestones with the Series A monies, may only invest in a down round, which may not be the best decision for the company at this stage of development.
- The company is using Series A cash expeditiously and meeting the planned milestone as planned. The Board recognized at the outset that the cash raised in the first investment round was insufficient to achieve positive cash flow (based on revenues and earnings). The Board has selected a key milestone of achievement as a trigger to raising an additional $1 million in capital, while the company still has sufficient cash in the bank to survive for several months without cutting back on expenses or running out of cash. Since the amount

of money to be raised is within the "sweet spot" for angel investors, the Board decides to raise a Series B angel round from existing and new angels at a higher valuation than that of the Series A closing. Since angels know where to find more angels, the entrepreneur revises the business plan appropriately and makes presentations to existing and new angels, but is introduced by an angel investor who serves on the Board at each meeting. This Director makes the point that most of the Board members and investors in the Series A round are investing again in the Series B round. This testament is very helpful in convincing new investors to step up to the plate.

- As in the immediately preceding example, the company is using Series A cash expeditiously and meeting milestones as planned. In this example, however, the Board recognizes that the company must now raise $6 million to meet anticipated milestones over the next 18-24 months. This round size exceeds the capabilities of angels, dictating the need to raise capital from venture capitalists.
- The angels on the Board will have recognized this need for some time and will have been courting appropriate venture capitalists, probably since before the closing of the Series A round. When the timing is appropriate, the Board will make a decision. Do they raise another smaller angel round or is the company sufficiently mature to raise a venture capital round?
- Based on this decision, the angels will work with the entrepreneur every step of the way to assure the round is closed efficiently.

Why do angels provide this assistance to portfolio entrepreneurs? This is simply part of the job of helping entrepreneurs build their companies. In most cases, the angels are more experienced at raising capital than are first-time entrepreneurs. Raising money is key to the success of their investment, and experienced angels know when they need to jump in and help.

Angels as Mentors and Advisors

Angels are effective mentors because they have accumulated years of experience in the business environment, often in starting their own companies. My advice to startup entrepreneurs is to find an angel among your early investors whose counsel, style and personality are most compatible with yours. Engage this angel investor as your personal mentor, at least during the early stages of starting the company.

And, don't forget the rest of your team! Your VP of Sales or COO may benefit from a mentoring relationship with an angel investor. While I would advise against "forcing this to happen," angels enjoy being engaged with portfolio companies and can be very helpful in jump-starting business functions, such as sales or product development.

A key issue in seeking mentors is knowing your angels. In an earlier chapter, it was suggested that entrepreneurs interview prospective investors and even complete due diligence on each investor. This process reveals much about an angel's background and personality. Keep mentoring in mind as you complete this due diligence and discuss possible mentoring relationships with both key team members and angels as the company moves forward.

How can mentors and advisors help?

While often used interchangeably, I think of mentors as personal coaches and supporters on a variety of subjects over a longer period of time. Advisors, on the other hand, may be experts in a specific subject and provide counsel on that topic as needed.

In these roles, here is just a sampling of how angel investors can assist in growing a company:

Keeping the team focused – Very early stage entrepreneurial ventures tend to be opportunistic as a necessity. They seek revenues and income from all sources – consulting, non-strategic revenues, products unrelated to the business plan. This is quite understandable, since the company is as yet unfunded and scrambling for survival. In fact, chasing opportunistic revenues can become a culture for entrepreneurs and their teams. However, once entrepreneurs have raised capital from investors, it is necessary to **focus** on executing the plan. Often this transition is very difficult for the team. Investors, especially those serving as Directors, will be very effective at reinforcing the new mantra – stay focused on the plan.

Recruiting and retaining an awesome team -- Angels have large Rolodexes which can be effectively utilized to find candidates to fill out the management team. As importantly, angel Directors are very effective at helping in the interview and selection processes, to assure hiring the best candidates. It is often difficult for first-time entrepreneurs, who have no experience in sales, for example, to select among qualified candidates for the VP of Sales position. The investor group can provide valuable assistance in this task.

It is not enough to hire key people. The company must design effective programs for retaining key personnel. While a stock option plan is usually a key issue, other benefits and programs play an important role in retention. Use your new Board of Directors to develop a retention program for the new management team.

Identifying and approaching large customers and partners – Angels can also use their Rolodexes and networks to identify appropriate customers and partners. More importantly, they can find key decision-makers within those important companies and often arrange introductions for the CEO and/or key team members. Networking broadly is the key to finding introductions, so use your entire set of investors to find and meet important new customers and partners.

Using Angels in executing your exit strategy

Angels engage with seed and startup companies to help build high growth ventures. Return on investment is an important motivation in this process. Effecting a successful exit is a high priority for angel investors and one with which most have substantial experience. Angel investors, especially angel Directors, can be quite useful in assisting the entrepreneur in the "harvest," that is, selling the company. Here are a few ways angel investors can effectively assist the entrepreneur in this process:

Retaining an investment banker – Investment bankers and business brokers are experts in selling companies and can be of great assistance in this process. Most first-time entrepreneurs have never sold a company or retained an investment banker. Experienced angel investors can be very useful in selecting a banker and in negotiating a fair fee for services.

Identifying target acquirers – With substantial experience in the process, investors can assist in identifying potential buyers of the company. And, using their networks, investors often can make introductions within those potential buyers to quickly gain access to decision-makers.

Evaluating offers – Selling your company is an emotional exercise. After all, this company is your baby! Investors can provide valuable assistance in objectively reacting to offers from potential buyers and optimizing the eventual outcome of the transaction.

Acting as the Bad Guy – In exit negotiations, the selling team often needs a bad guy to take a hard nosed stand with the opposition, even if the outcome may impact the relationship between that individual and the buyers. This person cannot be the entrepreneur, because the entrepreneur almost always will be working for the buying company for some period of time after closing. Use your angels as bad guys in negotiations.

14 Where to go from here?

In this book, I have....

Defined angel investing and how it may fit into your funding plans - It is important for entrepreneurs to understand angel investors, their expected involvement when funding entrepreneurs' companies and how they can help entrepreneurs grow their businesses. Both angels and venture capitalists are considered "smart money" and are only interested in investing in scaleable businesses. Angels tend to invest earlier than VCs, and invest lesser amounts of money in entrepreneurial ventures. Angels are part-time investors but can bring great value to entrepreneurs, serving as mentors, advisors and Directors of their invested companies.

Shown you how and where to find angel investors - Finding solo angel investors can be difficult, because they don't generally promote their angel investing avocation. Solo angels can be important investors, if entrepreneurs can locate them and interest them in investing. That said, the best sources of introductions to local angels are regional entrepreneurship centers and knowledgeable service providers. Active networking at appropriate events can also bear fruit.

Many online sources offer introductions to angel investors, however, entrepreneurs are urged to seek out only those web solutions with a solid reputation, good functionality and security and great investor access. Gust, located at www.gust.com is the solution of choice.

Finding angel organizations, if there is an active group in your region, is rather easy. They make themselves known to the entrepreneurial community. They accept executive summaries from local entrepreneurs through their websites and are quite responsive, because they are looking for deal flow. To assist in finding local angel groups, I suggested that entrepreneurs refer to the Directory of Angel Organizations on the www.angelcapitalassociation.org website.

Explained what to expect from the angel investing process – It is not as easy as writing a brief description on the back on an envelope! Angels have a defined screening processes which for successful entrepreneurs results in a substantial validation of the business plan, called "due diligence." Entrepreneurs passing muster are then invited to present to angel group investment meetings and are likely to receive funding.

Given you some tips on writing your business plans – You now know the difference between an elevator pitch, an executive summary, a PowerPoint presentation and a full written business plan. Each serves a specific purpose and, most importantly, you now know when to use each. You only get one shot at most investors, so practice your delivery and use the right version of the plan at the right time!

Provided an introduction on valuing your business – Seed and startup companies, eligible for funding, normally deserve a pre-money valuation of $1-2.5 million. The book discussed what factors determine where in this range is the appropriate pre-money valuation for your company. I have also discussed how excessive valuation in early rounds sets the company up for down rounds later, which is quite harmful to entrepreneurs and investors, alike.

Shown you what to expect from the due diligence process – Due diligence is the process of validating the investment opportunity through verifying the credentials of the management team, quantifying the size of the opportunity, confirming the ownership and value of the intellectual property and assuring that customers are truly interested in buying the product at a price which provides substantial profitability to the company. Due diligence will also study the competitive environment and substantiate the competitive advantage of the company. This tends to be a somewhat arduous process, often requiring more than 100 person-hours of angel investors' commitment.

Finally, the book has given you some tips on using angels to help build your business – Angels are savvy businesspersons who can leverage their equity investment by helping to build and grow the business using their business savvy and prior Board experience. The key for the entrepreneur is to engage with those angels who are the most personally compatible with the founder/CEO and management team and can provide the most effective mentoring and Board leadership. A good balance of engaged angels has complementary skills and experiences, deep vertical exposure and a number of years as Directors of new ventures. Angels also provide most effective support to entrepreneurs when executing the exit strategy.

Other references for engaging with angels in starting your business

Many useful sources of information are available for entrepreneurs starting their businesses, writing business plans and for soliciting funding from angel and VC investors, but to keep it simple, I recommend that entrepreneurs initially look at four rich sources:

The ***Ewing Marion Kauffman Foundation*** *(Kansas City)* is recognized as having assembled the most complete knowledge base on starting high-growth ventures in the world. Much of this content is captured on Kauffman's Resource Center at www.entrepreneurship.org. It is suggested that entrepreneurs who wish to drill down on specific issues visit this website. Searching for key words will lead to a wealth of information on a very broad range of entrepreneurial topics.

Guy Kawasaki's book ***The Art of the Start*** *(2004)* is a pithy commentary on the do's and don'ts for starting companies, especially those seeking equity investment from angels and VCs. This book is rather short, full of great ideas and, at the same time, quite entertaining.

The Small Business Administration's website contains volumes of useful information on starting and growing a business and on writing a business plan. See www.sba.gov. Click on the custom view "Starting" (a business). There you will find useful information on "Finding a niche," "Buying a franchise," "Forms of ownership," "Business plan basics," "Writing a business plan," and a host of other useful subjects. In particular, you will find the business plan sections to be quite useful.

The Business Mentor, developed by the Kauffman Foundation and available as a CD, is perhaps the most effective template for writing a business plan. I urge entrepreneurs to use this model as they begin the process of writing their business plan. This product is available for about $35 and can be ordered by visit www.fasttrac.org and searching for "The Business Mentor."

Finally, Alex Wilmerding's book, ***Term Sheets & Valuations - A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations***, as referenced in several places in this book, is an excellent primer on terms and term sheets (but not valuation). This book can be purchased at Amazon.

BillPayne.com is a great resource for entrepreneurs seeking capital. It is easy to search this website for blog and articles of a myriad of topics related to funding sources. Visit us at www.billpayne.com.

This book, ***The Definitive Guide to Raising Money from Angels,*** is one of many resources available on our website to assist entrepreneurs in starting their companies and raising equity capital. Entrepreneurs encounter many unique business challenges not addressed by professionals in other walks of life. Successful entrepreneurs agree that the most reliable sources of solutions to entrepreneurial problems are other entrepreneurs, people who have "been there and done that." At our website, we have assembled just the information that is only available from one entrepreneur to another.

Writing a business plan is a daunting challenge. Entrepreneurs should know, before starting to write their plan, if their venture idea is a reasonable business opportunity and what resources might need to be marshaled for success. We are skilled at appraising venture proposals and will examine your Venture Analysis and promptly respond with a detailed analysis of the pros and cons of your proposal.

Once you have written your plan, we can provide you with skilled Business Plan Review, making suggestions for improvement and recommending specific sources of capital and other resources which will assist you in starting and growing your business.

Visit our website for more information on these and other services available to entrepreneurs starting their businesses.

Starting your own business

Entrepreneurs start businesses for many reasons:

- To be their own bosses
- To demonstrate their business skills unfettered by a large corporate bureaucracy
- To create good jobs in their community
- To create wealth for their family
- To enjoy great personal satisfaction

Entrepreneurial success requires dedication and a willingness to continuously climb a steep learning curve. But the fruits of your diligence will be most gratifying. Don't put off any longer your desire to become an entrepreneur - start your business. Begin the process today!

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