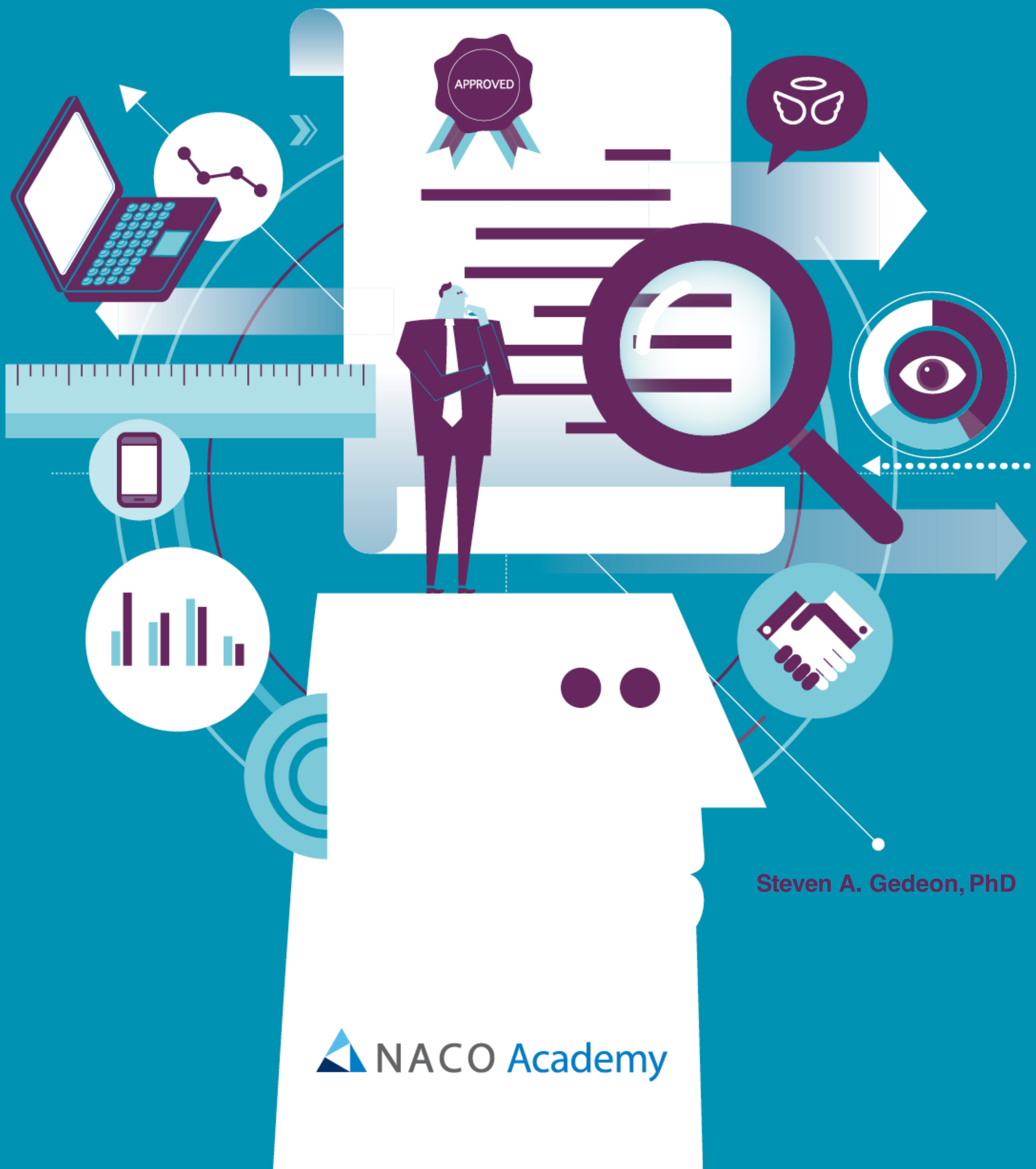
Introduction to Angel Investing

How to Start



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NACO Academy

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How to Start

Introduction to Angel Investing
How to Start

What is Angel Investing?

Once an individual has financial independence through sufficient income, real estate, mutual funds, publicly- traded stocks, bonds, T-bills and other public financial investments, they are called “Accredited Investors” and are eligible to make direct investments into Private Companies OUTSIDE of the normal Public Stock Market (such as Private Equity and other financial instruments open to High Net Worth Individuals making significant investments).

Angel Investors are Accredited Investors that make their own direct investments (usually in a group) into a private company (usually a “startup”) in exchange for equity (common shares or preference shares), debt or other terms.

Why be an Angel Investor?

Job Creation from Startups

537
currently active companies
invested in since 2010 created
6,856 jobs
as of 2016

$490 million
in investment from **Angel Groups** resulted in
$1.7 billion
in revenues

Angel investing creates jobs and builds the economy. 98.2% of all businesses have fewer than 100 employees. When you add in medium-sized businesses (100 to 499 employees), the percentage rises to 99.8%. They are the engine of the economy and their success is vital to Canada’s prosperity (Government of Canada, nd).

Angels invest in 27 times more startups than VC investors (NACO Academy Module 101). The total size of the Angel asset class is now as large as the entire VC industry in Canada.

What Angels Do

Angels spend time assessing:

- ✓ the quality of the business,
- ✓ the market opportunity,
- ✓ the character of the entrepreneur(s) while structuring the deal.

Angels may spend years helping the company grow before achieving a Liquidity Event when the Angels (and normally the Founders) convert their equity or debt back into cash with, hopefully, a good Return on Investment (ROI).

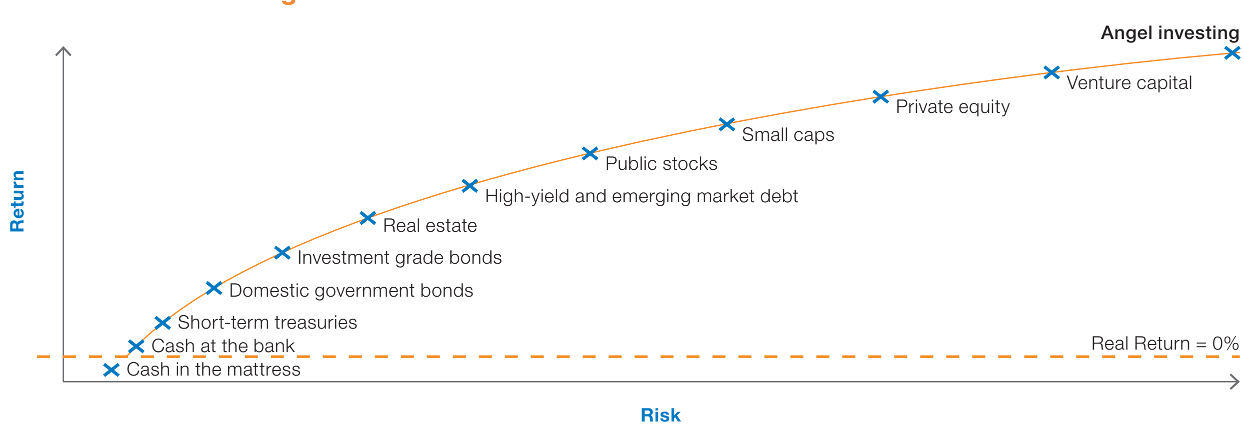
Why be an Angel Investor?

Angels once invested in Broadway theatre productions. Just as these patrons of the arts invested due to love of the theatre, Business Angels invest in companies because of their love of entrepreneurs and business. Their reasons include:

- Potential for significant financial returns
- Personal interest or expertise in the company or industry
- Mentorship with the entrepreneur
- “Paying it forward” by sharing their expertise with those who need it
- Contributing to the economic growth of their region or country Giving back to the community
- Enjoying the social aspects of networking with other Angels

Angel Investors participating with an Angel Group can achieve significant financial returns. The Angel investment asset class has a 27% average IRR (Internal Rate of Return) – the “average” Angel exit is 2.6X the investment in 3.5 years (Wiltbank).

Risk vs Return for Angels



However, since 1 in 10 investments will create 90% of total returns, successful Angel investors take a portfolio approach.

So to have a good chance of achieving those 27% returns, most Angels plan to invest in multiple companies and multiple rounds within companies. It's better to invest $15k in 20 companies than to invest $100k in 3 companies.

Who can be an Angel Investor?

Many Angels are retired executives or "cashed-out" former entrepreneurs. They want to continue doing what they love without the daily stress of running a company. So they invest less than 20% of their assets in companies with whom they can have a long term relationship, add value and generate superior rates of returns.

Getting Involved in a local Angel Group List of Resources

Most Angels in Canada invest alongside other Angels and Angel Groups. The Canadian Angel investment eco-system is one of the most advanced in the world with Angel groups across the country that provide a wide range of activities for their members, including:

- Providing a public face to attract deal flow while enabling individual members to maintain their privacy
- Marketing actively to solicit and manage deal flow
- Meeting with entrepreneurs and screening potential opportunities
- Providing standardized information sheets that allow Angels to quickly assess interest
- Organizing investment presentations by prospective investee companies
- Organizing, collaborating and tracking due diligence and successful deal closing
- Providing software systems to manage deal flow and co-investment
- Organizing regular meetings that provide a social network to facilitate camaraderie and sharing of common goals
- Obtaining matching funding from government sources

AngelONE
Building the Canadian Economy One Deal at a Time

An Example of How Angel Groups Can Work Productively

Angel One Investor Network, based in Burlington, Ontario, has helped close over $28 million in 72 deals with an additional $27 million in government matching funds. Active participation is expected of Angel One members, with average investments of over $200,000.

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Set Goals

How to Start!

Step 1: Set Goals

Set a Limit to the total amount of money and time you want to invest in Angel investments:

- Speak with your spouse and financial advisors
- No more than 10-15% of your total portfolio is recommended, but that varies widely (see the NACO Guidebook, A Practical Guide to Angel Investing)

Set a **Target Number** of Companies

- 15+ is recommended or perhaps 2-5 investments per year
- NOTE: You may want to start off by investing in an Angel Fund to gain diversity while you get more involved individually in a smaller number of companies (see Section 2.4 in NACO Guidebook, A Practical Guide to Angel Investing)

Set your **Average Investment Amount per Company**

- Many recommend starting at $10-25k per investment round
- Don't put all your money into an investment at once – save some for future rounds ("keep your powder dry")

Set your **Level of Involvement**

- Assess your Interests and Value Add
- Decide what role you want to play in the selection of companies, due diligence, deal-making, corporate governance, and post-investment involvement

Find Other People to Collaborate and Share Risk

- Go to Events in your local entrepreneurial ecosystem
- Participate in an Angel Group
- Take NACO Angel Academy Educational Modules
- Go to Investment Summits

Visit **www.nacocanada.com** for more information.

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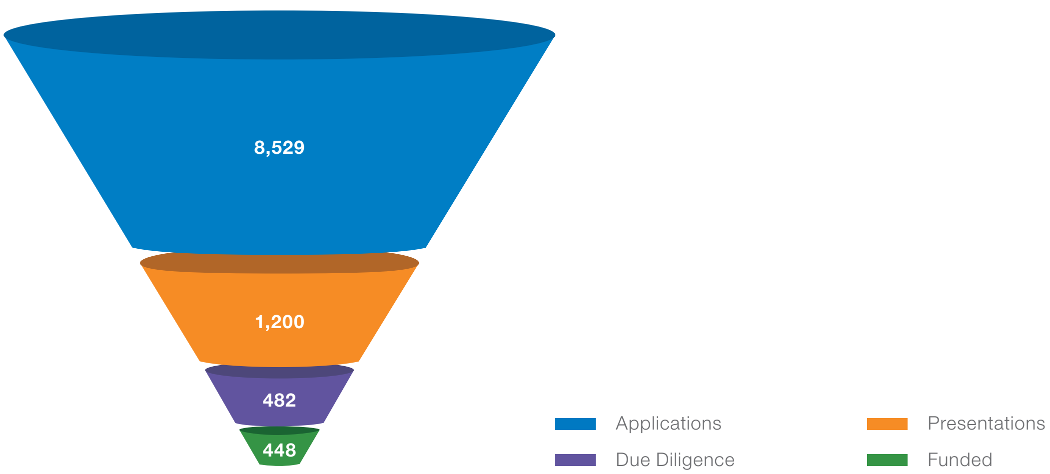
Pick Good Companies

Step 2: Pick Good Companies

Venture Capital firms (VCs) look at well over 100 companies before they pick one to invest in. That's their job. But Angel investing is not a job. In most cases, an Angel will piggy-back on someone else's deal flow who spends a lot of time working in the startup eco-system. Hence the role of Angel Groups.

In 2017, 43 Canadian Angel Groups pro-actively received and reviewed 8,529 formal applications of which 1,200 were selected to make a presentation to the Angel Group Members.

The Funding Success Funnel

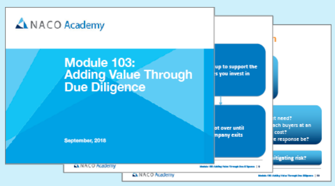


Source: **Mason & Tjahjakartana**, *2016 Report on Angel Investing Activity in Canada*

After each presentation, Angels in the room are asked if they are interested in working together to potentially invest in that company. In 2017, at least 482 of these pre-screened companies moved forward into the Due Diligence phase.

Due Diligence:

Time spent in Due Diligence matters! On average, Angel investors should spend around 20 hours on Due Diligence to achieve 2.6X ROI. Spending 20-60 hours dramatically increases this to 5.9X! Nearly all Due Diligence teams follow a comprehensive checklist to ensure they don't miss anything. See NACO online resource Sample Due Diligence Checklist. https://www.nacocanada.com/cpages/angel-resources



Adding Value Through Due Diligence is the most popular NACO Angel Academy Course – Module 103

During Due Diligence, Angels seek to understand the character of the entrepreneur and gain insight into how the company works and what it needs to be successful. They also check for good hygiene – to make sure the company doesn't suffer from any fatal flaws. The goals of Due Diligence include:

- Helps each investor make a Go – No Go decision
- Leads to negotiation of the specific investment terms
- Builds a foundation for the future relationship between the parties
- Identifies the coachability of the entrepreneur
- Identifies if and how the Angels can add value to the company (in addition to the amount invested)

Angel Resource Institute Scorecard to Evaluate the Deal


Management Team – 30%


Sales Channels – 10%


Size of Opportunity – 25%


Need for More Funding – 5%


Product & Technology – 15%


Other – 5%

Source: **Angel Resource Institute**, *Angel Investing Basics for the Startup Community*

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Make Good Deals

Step 3: Make Good Deals

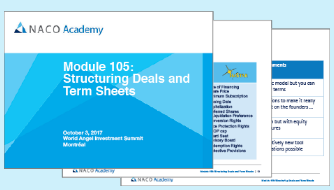
Eventually you will need legal documents to sign before you transfer your funds to the company (or your lawyer).

In some cases, the Angel may be "getting in on a hot deal" and sign agreements set by others. These Momentum Investors are normally in or out of a larger deal controlled by others.

Value Investor Angels set the deal terms and normally have more experience in doing investments than the entrepreneurs they are investing in.

There are three primary aspects of any deal:

1. Deal Structure
2. Valuation of Company
3. Term Sheet Conditions

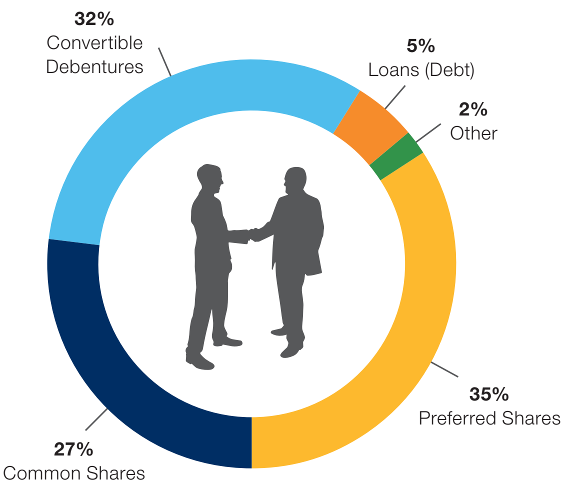


NACO Angel Academy Module 105: Structuring Deals and Term Sheets

Deal Structure
What Exactly are you Buying?

Are you buying newly issued Common Shares, Preferred Shares, Debt, or some hybrid (like a Convertible Debenture with an Option or Warrant)?

Deal Structure



Source: **Mason & Tjahjakartana**, *2016 Report on Angel Investing Activity in Canada*

Common shares – Founders' and investors' shares are treated equally.

Preferred shares – Investors' shares are preferred to founders' common shares. Investors' shares can include anti-dilution, liquidation preferences, veto rights, say over pay, board seats…

Loans – This is a debt instrument and not an equity purchase. It can be collateralized against assets such as equipment, intellectual property and source code.

Convertible debenture – This is a loan that converts into equity upon some trigger event, like the next round of financing. If things go badly, the investors get the assets and if things go well, the debenture converts to equity at a discount to the next round.

SAFE – Simple Agreement for Future Equity – This is a standardized hyper- simplified form of discount to next round that saves the cost and effort of issuing shares.

Visit **www.nacocanada.com** for more information on deal terms from the Common Docs Initiative.

Valuation
How Much are you Paying for how much of the Company?

Unlike the public stock market, private company valuations are open to negotiation and often lead to disagreements between Angel and Entrepreneur. One way to avoid the argument is to use a convertible debenture.

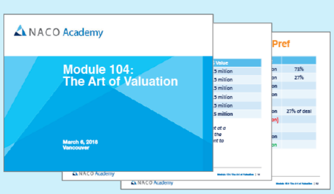
Pre-Money vs Post-Money Explained

If you invest $100,000 into a company with a Pre-Money Valuation of $100,000, then you will buy ½ of the company and own 50% of the Post-Money shares (now worth $200,000). If you invest $1M into a company worth $2M (Pre-Money), you will own 1/3 of the Post-Money shares worth $3M. This assumes the company is issuing new shares for investment purposes and you are not simply buying shares off of current investors without the funding going into the company itself.

When valuing pre-revenue companies, Angels use several different valuation methods that value human capital, intellectual property, key reference accounts and partnerships.

Factors that Can Contribute to Company Value:

1. Sound idea
2. Prototype
3. Quality Management
4. Strategic Relationship
5. Product Rollout or Sales



NACO Angel Academy Module 104: The Art of Valuation

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Grow Good Companies

Introduction to Angel Investing

Step 4: Grow Good Companies

- ✓ Ask Questions
- ✓ Unwrap Assumptions
- ✓ Use Your Connections

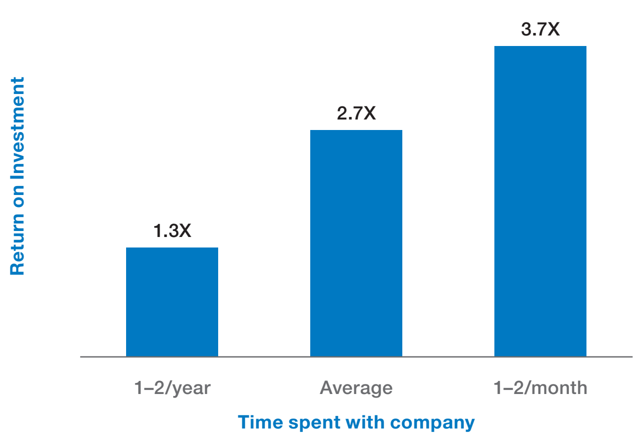
After the investment is made, Angels add value to their investees by sitting on boards, providing corporate governance and executive expertise, and leveraging their capital to obtain government grants.

Setting up for Success: 4 modes for interacting with a company

1. Governance: meeting, coaching, board, reporting
2. Metrics: metrics that matter, orient to shareholder value, changes by stage
3. Money: how much at each stage, will there be a follow-on?
4. Network: introductions, build trust, make introductions, connections help

Research shows that Angels who spend time helping grow their companies get a better Return on Investment (ROI).

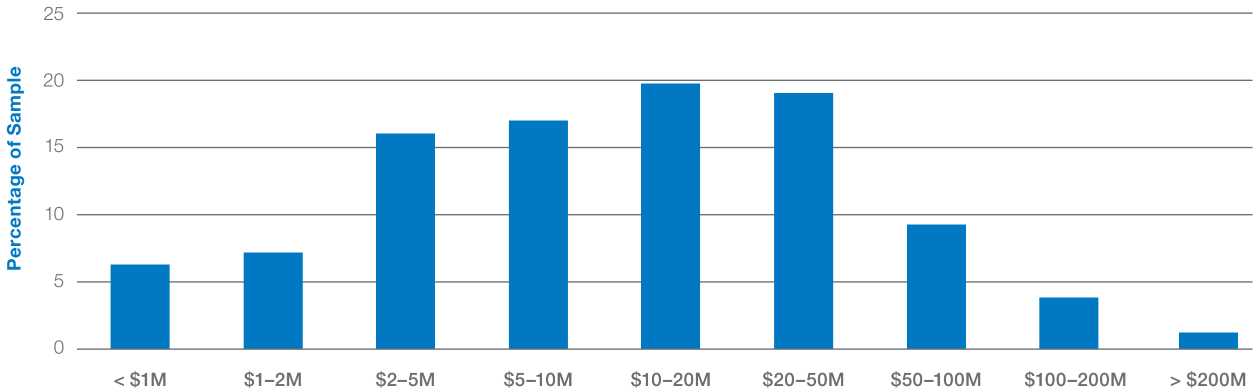
Return on Investment



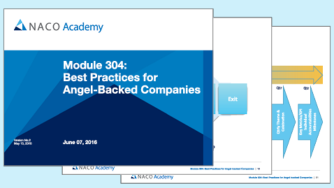
Source: **Wiltbank & Boeker**

In general, Angels seek to add value and gain at least a 3X increase in valuation before raising another round of financing or seeking an exit.

Distribution of Exit Values



Source: **Wiltbank**, *Returns to Angels in Groups, 2015*



Module 304:
Best Practices for Angel Backed Companies

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Get Your Investment Back

Step 5: Get Your Investment Back

As a direct investment in a private company, Angels cannot simply sell their shares whenever they want, like they can in public companies. Eventually, Angels will need to get their cash back out of the company in what is called an “exit” or “liquidity event”. There are 4 major types:

1) Take the Company Public

While initial public offerings (IPOs) were an important exit mechanism prior to 2000, they now account for less than 10% of large, publically reported startup exit events.

2) Sell the Company to a Bigger Company

The vast majority of successful exits occur through the investee company being acquired by another.

3) The Company Buys Back the Shares/Loans

Sometimes the founding team may have the right to buy the investors out of their shares. Or due to a preferred shares agreement, the investor can force the repurchase of their shares.

4) Zombies, the Walking Dead and the Dead

If a company continues without you and never pay back their investment, they become zombies.

About NACO

Canadian Angel Investment Asset Class

Canada has one of the world's most advanced, stable and successful Angel investment ecosystems. The investment climate has favourable tax incentives, low interest rates and stimulative government policies for early stage companies. (See the latest NACO Annual Report)

National Angel Capital Organization (NACO)

NACO supports over 4,000 Angel Investors and Angel Groups with resources, best practices, events, networks, and education.

- NACO Guidebook – *A Practical Guide to Angel Investing – How to Achieve Good Returns*
- NACO Academy Education Modules – topic-specific workshops, delivered locally and at conferences.
- NACO Website and Online Sample Documents and Resources
- NACO Common Docs – template Term Sheets
- *NACO Report on Angel Investing Activity in Canada*
- NACO World Angel Summit – Annual Conference

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