THE BASICS OF ANGEL INVESTING

By Alex Day and Eric Dobson

A Note from Alex Day

The Basics of Angel Investing is a book to provide the very basics on angel investing. We provide additional resources on our website. We have assembled this book to help people in their lives and in business. The greatest help I have found in life is my faith in God. We do not use the Sheltowee Angel Network or this book to proselytize or force our theology on anyone. But for those who are interested in learning more about my faith, and how it has impacted my life, you can go to **www.ThisIsWhyIBelieve.org** to learn more. I hope that Sheltowee and this book will be of benefit to you and provide information and ideas that inspire and motivate you.

Sincerely,

Alex Day
CEO and Founder of the Sheltowee Network

SHELTOWEE
Business Network

The Story of Sheltowee

Daniel Boone was a great American Frontiersman who opened new expanses and carved a civilization out of wilderness. In 1778 he was captured by the Shawnee Indians during a hunting trip. He was such an exceptional outdoorsman, and so respected by the tribe that he was adopted as one of their own. The chief that adopted him thought he had broad shoulders and looked like a turtle, and was given the name Sheltowee. We at the Sheltowee Network respect Daniel Boone's skills and what he achieved as an entrepreneur and pioneer. We hope to blaze new trails and open new expanses, just as Daniel Boone did.

It is not the critic who counts; not the man who points out how the strong man stumbles, or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who errs, who comes short again and again, because there is no effort without error and shortcoming; but who does actually strive to do the deeds; who knows great enthusiasms, the great devotions; who spends himself in a worthy cause; who at the best knows in the end the triumph of high achievement, and who at the worst, if he fails, at least fails while daring greatly, so that his place shall never be with those cold and timid souls who neither know victory nor defeat.

Theodore Roosevelt

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Introduction

Angel investing is the practice of investing in early stage companies. This practice has enabled incredible technologies to be developed and has had a major impact on society. Angel investing provides the opportunity for very strong financial returns and offers the opportunity to participate in the building and growth of amazing companies. **A study in 2016 showed that angel investors were achieving annualized returns of 22% and were holding their investments for 4.5 years.**   This is an incredible return, but requires a strong strategy and an appetite for high risk, hight return opportunities.

In this book we cover some of the very basics of this highly misunderstood asset class. It is unlikely you will hear much about this area from your financial advisor, so we hope to get you started and point you in the direction of resources that can help educate and inform you about the potential of angel investing. I believe that the reason for angel investing can be summarized in the following bullets:

1. Make money
2. Participate in something meaningful
3. Leverage your money and your experience

We hope you find this book to be informative and a good first step on your path to angel investing.

The Author's Approach

When you are reading a book to gain knowledge about a subject, it is good to have an understanding of how the author approaches the topic. When it comes to angel investing, the authors of this book view it as INVESTING. This is not a hobby, or a philanthropic endeavor, it is a strategy and approach to invest money to make money. Now we also want to point out that our approach is not one that SOLELY focuses on making money. As an investor we must make money, or we will not have much longevity. But while we are investing, we can be kind, generous (looking for win-win opportunities) and provide more than just money to the entrepreneur. We believe part of angel investing can be an investment of time as well as money. So with our businesses we have the core values of:

1. Help others
2. Always act in a kind, ethical and transparent fashion
3. Honor those who assume the risk (entrepreneurs and investors)
4. Expect a financial return on your efforts

Now that you have a better understanding of our philosophical framework for angel investing, I hope you find the information provided here helpful.

What is Angel Investing

Angel investing consists of individuals (and sometimes groups) who invest in early stage companies. We will discuss what "early stage" means a little bit later. But essentially these are individuals who are willing to face an extreme amount of risk (because most early stage businesses fail), in the hopes of a big upside for being an early investor.

Most of the time, angel investors are accredited investors. The term "accredited investor" is defined by the Securities and Exchange Commission (SEC) and essentially means you have enough money that you can afford to lose it if you make a stupid investment. As of the writing of this book (April, 2021) an accredited investor is defined for an individual as follows:

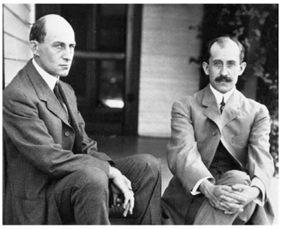
1. a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase, or has assets under management of $1 million or above, excluding the value of the individual's primary residence;
2. a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year

For a complete and current definition of an accredited investor, you can visit the SEC's website.

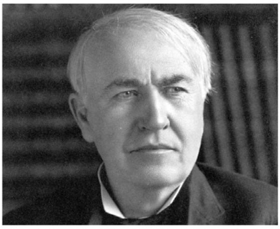
The goal of angel investors is to invest in that early stage company that could really take off. Typically these investments are equity investments, however there are several different types of investments that angel investors can make. We will discuss this in the section on types of investment.

It is easy to find the stories of the angel investors who made big money investing early in Facebook, PayPal or Uber, but the reality is that angel investing is very risky and most of the investments angel investors make fail. Although most investments fail, the ones that succeed more than make up for the ones that fail. In a 2016 study it showed that angel investors achieved 22% IRRs and held their investments for an average of 4.5 years (Robert E Wiltbank, 2016). So angel investing has the potential to provide strong returns, but it is not for those looking for short term investments. These investments generally need to be held for a long period of time.

Beyond the Money



Wright Brothers



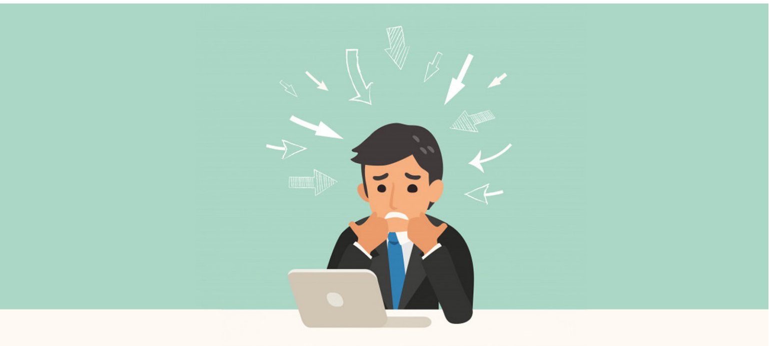
Thomas Edison

Elon Musk

Entrepreneurs have had a profound impact on society. Two bicycle shop owners launched us on our way to powered filght. An inventor in Menlo Park lit up the darkness of night. And modern entrepreneurs are now taking us to Mars and beyond. Investing in innovative entrepreneurs provides the opportunity to make money, but it also provides the opportunity to impact humanity.

Investors have to receive a positive return on their investment, or they won't be "investors" for long. A great thing about angel investing, is that there is not only the financial benefit, but there is also the social benefit. Think about being one of the first investors in a technology that has a dramatic impact on society. Angel investors help launch innovations that without them, would likely never get off of the ground. Below are some of the companies that have been launched with the help of angel investors. There are still many innovations and technologies to help cure diseases and to help ease the suffering of humanity, that need to be funded by angel investors. By investing in these innovations you have the opportunity to make money and have a strong positive impact as well.

Understanding “Early Stage”



To really understand the concept of angel investing, we need to understand the life cycle of businesses. Early stage to one person, may not be “early stage” to another. Let’s walk through the lifecycle of a startup. Typically when we talk about a “startup”, this is a relatively new company that has ambitions to scale their business and has been started by an entrepreneur. There has been a lot of discussion as to whether a “small business owner” is an entrepreneur. I am of the philosophy that if you start a business and assume a financial risk, you are an entrepreneur. Now not all entrepreneurs have businesses that are appropriate for an angel investment.

Let’s look at George. George has an idea for a company. He is pretty sure his idea is a winner and that he can build a billion dollar business around it. George forms a legal entity (a limited liability company or a C-Corporation) and now needs to finance his concept. At this point George owns 100% of his company. George is a true believer and loads up his credit cards and borrows against his house. He makes good progress on his business, but he is still a long way from making his first sale. He has even recruited some people that believe in his vision and are now helping him in the business.

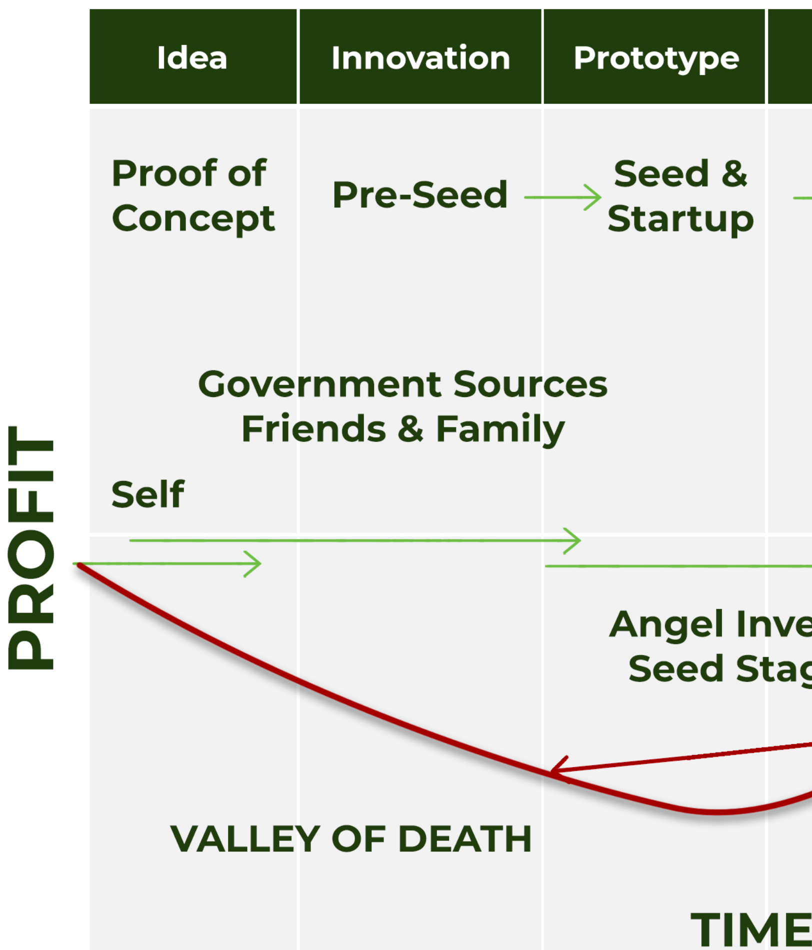
George needs more money for his business. George now uses the “3F” strategy. He approaches friends, family and fools and offers to sell them stock in his company (if he formed an LLC then he is technical selling them units, but they are still equity). Many people would consider this his pre-seed round. This can be a dangerous time for George’s business. It is likely that George does not have a realistic idea of what his company is worth. Valuation of early stage businesses is tricky and many founders (particularly if the founder has an inventive mind) have grossly unrealistic ideas about what their business is worth.

So if George sells his friends and family 0.1% of his business for $100,000 (this equates to a $100,000,000 valuation of his very early stage business), then he has probably created a future problem for himself. When he gets ready to go to a sophisticated angel investor, that angel investor is going to tell him his business is worth more like $1 million to $2 million. So his friends and family are now going to take a horrible dilution and probably never make any money.

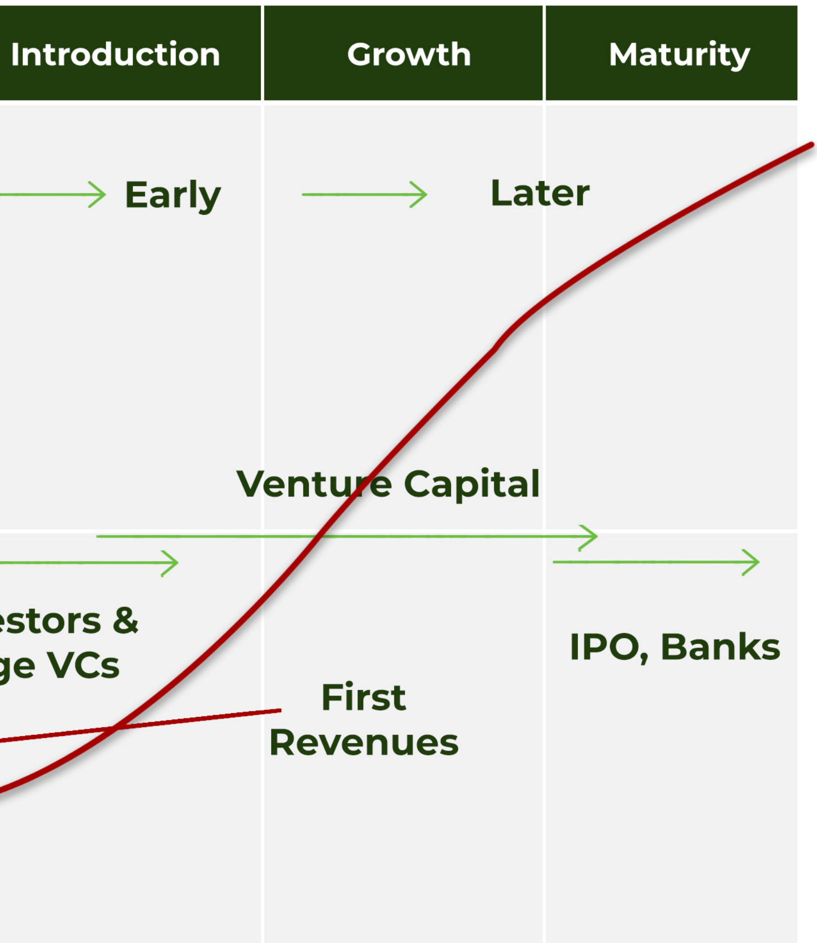
Now that he has moved the business forward with his money and his friends and family's money, he is ready for a seed round. He has tapped out his friends and family and needs $1 million to take his business to the next level. He now is going to approach angel investors. Some of the individuals may self identify as angel investors, and some of them may just consider themselves investors. George is going to try to talk to anyone who he thinks can stroke a check into his business.
So the life stage of a business usually starts with pre-seed investment (often this is from the 3Fs), it then moves on to a seed stage round, and then as they are ready to grow the business they move on to an A-Round. The funding cycle moves on through Series B, Series C and so on. Generally all of these equity financings are private and each round of funding will get a subsequent Series-X notation until the company sells, or it goes public.

Now here is an important aspect that some people are not familiar with. The difference between "private" equity and "public" equity. When people talk about stocks most people are talking about the publicly traded market. These are all companies that have gone through an expensive registration process to list their equity (stock) on a pubic exchange. Angel investors try to find those companies that have tremendous potential and could go public (or be sold to another company or private equity group). This is where the early investor gets their "exit".

PRODUCT AND C



APITAL LIFECYCLE



So let's review. George starts his company and funds the genesis out of his pocket. He then gets friends, family and fools to invest in his pre-seed round. After this he goes to angel investors for his seed round. Some angel investors will invest in pre-seed and seed rounds, and some will invest in Series A or further in the life cycle of a business. But most of the time when a company like George's is ready for a Series A investment they will be talking to professional investors such as formal venture capitalists for those further tranches.

Nuances of Early Stage Investing

There are very few people who understand early stage investing. Because of the regulatory complexities, there are VERY few financial advisors who would ever recommend their clients invest in a privately held company. Is this because they are bad investments? They are highly risky investments, but angel investing can be pretty profitable. There are few reasons financial advisors steer their clients away from angel investing. Now I may sound cynical here, but a primary reason is that they don't make any money if you invest in a "private" deal. Your financial advisor often times makes money from what he sells you. If he places you in a mutual fund or a publicly traded company, he is likely making money off of that transaction in some form or fashion. If he works for a big financial advisory company, then they have done due diligence (will talk about this later) on the products and their legal and compliance departments will have signed off on it. And your financial advisor needs to have lots of "product" to sell. Remember, he may be placing you at $250,000 into this investment vehicle, but he wants to place another 50 of his clients in that same vehicle. And his company (assuming he is not a solo flyer), wants to sell thousands of positions at $250,000.

The problem with a private deal is that it is way too small. Even if you are raising $10 million, this is a really small deal and most financial advisors are not going to touch it. That financial advisors legal and compliance departments are going to need to spend tens and maybe hundreds of thousands of dollars conducting due diligence and making sure that this private placement meets all the regulatory requirements and the statements made in it are true and accurate.

This brings us to a document you are going to hear more about. That is the "private placement memorandum" or PPM. The PPM is what most people call the disclosure documents that are required to place or sell, private equity (remember, this is the stock in Georges company that has not been registered as public yet). We will talk more about the PPM later.

So since you are very unlikely to hear about private deals from your financial advisor, very few people are familiar with investing in early stage companies. This becomes a hassle for most advisors and it also comes with additional risk to them. So even though it is quite feasible to get greater than 20% returns through angel investing, your advisor is never going to put you into an early stage deal. So now the pool of potential investors has shrunk dramatically, because financial advisors are not educating their clients regarding early stage investments in startups. And the learning curve can be quite steep. That is why you are here.

Understanding the Regulatory Issues with Angel Investing

Remember how we told you it was highly unlikely your financial adviser is every going to recommend you invest in an early stage company? Well there are several reasons for this and one of them is the regulatory red tape associated with offering the sale of equity to investors. There are lots of rules about what you can do. Most of these rules are found under the Securities Act of 1933. Yes, that is right, 1933. Now there have been lots of changes in this act since 1933, but many of the basic concepts were established way back then.

Now we need to provide some context as to why the offering of securities (stock and other instruments) became so highly regulated. As with so many regulations this points back to unscrupulous acts by shysters. The sale of equity as a way for people to make a lot of money became very appealing to fraudsters. So it became prevalent for some “stock brokers” to talk grandma into investing her life’s savings into a company that had little or not value. Then when that company failed, grandma lost all of her money.

The Securities Act set forth to stop these types of hustlers by requiring issuers of securities to register with the SEC. This registration process is expensive and time consuming. Today registering and offering your stock for sale on the public market is known as “going public”. A key component of “going public” is that now the company and its representatives can do general solicitations. That means they can advertise and try to sell their stock to anyone. So, until recently if you are selling private equity under an exemption, you could not do a general solicitation. This has changed with the recent crowd funding legislation that has passed.

The SEC put a regulatory framework around the sale of private equity and created a pathway to selling that equity publicly. In order to offer equity in a company, the entrepreneur needs to comply with the laws surrounding the private placement of equity, and to do this they must qualify for an "exemption" from registering their offering.

If the entrepreneur does not comply with these laws they can go to jail. The basis for these laws is that you must "disclose" all the material issues associated with your business and must be truthful in your disclosures. So if an entrepreneur just got sued by a huge multi-national company for infringing on their patents, this becomes a "disclosure" issue if they want to sell stock. They need to tell their investors that this has occurred and that it is a significant risk factor for their business. Does this mean they can't sell equity? Probably not, but it does mean that they need to disclose this to their investors. And a smart investor is going to think twice about investing in a company dealing with potential litigation.

So now if an entrepreneur wants to sell stock in his company, they are required to disclose all of the issues associated with their company. This requires disclosure documents and these disclosure documents are often times distilled into a private placement memorandum.

Recently there have been some major changes to the Securities Act. These changes include providing a framework for crowd funding (think of this as a mini-public offering). In order to sell your equity privately and not require a registration with the SEC, the entrepreneur needs to work under an "excemption". Essentially under section XxX of the federal register there are several exemptions listed under which companies can offer to sell their stock to investors. If you start investing in early stage companies then it is good to be aware of some the following regulatory terms:

S-1 Registration- This is going public and a full registration with the SEC.

Regulation A+- This is an exemption from full registration and allows a company to raise up to $20 million under tier 1 and up to $50 million under tier 2. There are more requirements for Reg A offerings than for Reg D and are more rare.

Regulation D offering (or a Reg D)- This is an exemption that has several different parts.

Reg D- Rule 506 (b)- This is an exemption for a private placement of securities. The issuer may not conduct general solicitation (advertise) and may have an unlimited number of accredited investors, but only 35 non-accredited investors.

Reg D- Rule 506 (c)- Issuer may conduct general solicitations and is limited to ONLY accredited investors. The Issuer must verify that the investors are accredited.

Reg D- Rule 504- Issuers are limited to raising $10 million and there are no limits to the number or type of investors.

Regulation Crowd Funding- Issuers must offer their securities through a FINRA registered crowd funding portal. They are limited to selling $5 million. They may offer general solicitations and have no limits to the number of investors.

Most of the regulatory issues impact the one offering the securities. And the regulations are there to protect the investor. So as an angel investor, it is good for you to be aware of the different regulatory issues, but they are usually not a threat for you. The one big area of regulation you need to be aware of, is that you are often prohibited from selling your stock for a period of time.

Motivations of the Angel Investor

Almost all angels are accredited investors. This means that they have established a decent amount of wealth and can now look at

Strategies for Angel Investing

Because of the extreme risk associated with angel investing, I highly recommend that angel investors take a "portfolio" approach. That is, if you are going to become an active angel investor, then make sure you are building a portfolio of angel investments. The potential return for an angel investor goes up substantially as they add more investments to their portfolio. A big mistake that many beginning angel investors make, is they approach this as, I am going to make one investment and see how it turns out. Well, they are most likely going to lose money on that one investment. It would be much better for an investor to take $100,000 and invest it in ten different companies, rather than putting that full $100,000 into a single deal.

Studies have indicated that angel investors can achieve significant returns through a portfolio approach. In their follow up study in 2017, Wiltbank and Brooks showed that the average return for angel investments was a 22% IRR, but it took 4.5 years to achieve these returns. There is an interesting saying that lemons ripen faster than plums. So the failed companies fail faster and the successful companies take longer to achieve their exits. The average number of companies held to achieve these returns in their portfolios was
Angel investing should also be approached as a long term strategy. If you are looking to make money fast, angel investing is not the place to do it. Remember that your "exit" opportunity is likely to be the sale of the company or an IPO. Private equity in an early stage company if HIGHLY illiquid. If you need to get your money out of it fast, then you are probably stuck. You may even be prohibited from selling it if you can FIND

someone willing to buy it.

How Much Should I Invest

I again want to reiterate that angel investing is a high risk, high reward proposition. This means that you probably should not put 50% of your net worth into angel investments. I believe that 5% to 10% of your overall portfolio is a good rule of thumb for dedicating to angel investing. If you are getting close to retirement then you may want to consider a lower percentage. Remember that angel investing is a long term strategy.

Benefits of Angel Investing

So the obvious objective of angel investing is to make money. The really nice thing about angel investing is that there are other benefits as well. Entrepreneurs have had a huge impact on our world. And contrary to popular belief, not all of our world changing entrepreneurs are based in silicon valley. Societal changing entrepreneurs are innovators. And innovators are not limited to the coast, or limited to people with ivy league degrees. As I am writing these words I am sitting on an airplane travelling to Charleston, South Carolina. Two of the greatest innovators in the world were two brothers who owned a bicycle shop in Ohio. Innovation is not limited to the coasts. So as an angel investor you have the opportunity to positively impact innovators that may just change the world. The early investments that angel investors make are the ones that help propel entrepreneurs past the launch tower on their way into the stratosphere. If you really get into angel investing, then you will probably not only invest money, but you will invest your time as well. Although they often do not understand the importance that human capital will have to their business, entrepreneurs desperately need good people. I often tell entrepreneurs that good people are harder to find than money, and will ultimately provide more value to your business.

As you invest your time, you can help the entrepreneur strategize and navigate the treacherous waters of business ownership. Your knowledge and experience can be worth far more than the check you stroke into the business. So as you are looking at potential investments, think about how those potential companies could have a positive impact on society as well as a positive impact on your bank account.

Common Mistakes

We will talk about some of the recommended strategies for angel investing in an upcoming section. Here I want to talk about some common mistakes that I have seen in angel investing. I think one of the biggest mistakes is approaching angel investing as if it were a philanthropic endeavor. "We only want to invest in companies that are in our community". This creates major issues. You start investing in bad deals because they are close to you. I would much prefer to invest in a good deal that is on the other side of the country than a bad deal that is in my community. When you take the "I only want to invest in deals in my community" approach, you are setting yourself up for bad returns on your investment.

Another mistake I have seen, is making one investment, and then waiting to see how this one turns out. If you want to be an investor, then you need to take a portfolio approach. If you want to put money in one deal and see how it turns out, you are a gambler, not an investor. You are much better off putting $5,000 in ten deals, than putting $50,000 in one.

Another big mistake that is made is bad or no due diligence. Due diligence is very important and studies have shown that the more rigorous the due diligence, the stronger the returns. So a strong due diligence approach is really important.

What We Know So Far

Angel investing is risky

Angel investing CAN provide significant returns with a portfolio approach

The sale of private securities is highly regulated

You should allocate a reasonable percentage of your overall portfolio to angel investments (5% to 10%)

You need to focus on good deals, not local deals.
You need to have a strong due diligence approach
Angel investing can allow you to have a positive impact beyond a financial return

Finding the Companies in Which to Invest

Okay, we have convinced you that investing in early stage companies is not a crazy idea and you are ready to get started. So how do you find the right companies in which to invest? We strongly believe that angel investing is a team sport. So a great way to find companies is to first find a group to join. When you join a group, they probably already have deal flow. Deal flow is an important term. Remember that successful angel investing is a numbers game. The more companies in which you invest, the higher the chance of increasing your returns. Since it is a numbers game, you have to have a good flow of deals to choose from.

It is possible to fly solo as an angel investor, but in my opinion it becomes much harder. As you engage in your local entrepreneurial ecosystem, you will find opportunities. Or I should say the opportunities will find you. If you let it be known that you are an active angel investor, the entrepreneurs will find you. But the problem is, how do you vet that opportunity all on your own. That is where being a member of a group can help. We list some resources to help you find companies in which to invest.

The Term Sheet

Now that you have found George, he will likely present you with the terms of the investment. This is usually captured in the Term Sheet. The really important parts of the term sheet are:

1. Valuation of the business
2. Investment being sought (how much)
3. Type of investment
   - Priced round
   - Convertible debt
   - SAFE
   - Revenue share
4. Other terms depending on the type of investment

We will discuss in more detail the different types of investment, because there are nuances to be aware of for each one. But the term sheet essentially tells you what you are getting. Now that you have reviewed what you are getting as an investor, and you think that the terms are reasonable, now is the time to invest in due diligence. The following is an example of what you might see in a term sheet.

The All Important Due Diligence

So, you have found George. And you like George's company and George needs investment to take his business to the next level. What do you do now? Well this next part is really important. You need to do your due diligence. The Oxford Dictionary defines "due diligence" as:

a comprehensive appraisal of a business undertaken by a prospective buyer, especially to establish its assets and liabilities and evaluate its commercial potential.

I think this definition fits, because, although you are not buying the whole company, you are a buyer of a piece of the company and as such you need to have a good understanding of where the business really stands. Entrepreneurs are the ultimate optimists. And their assessment of where their business is, may not be an accurate assessment. This is where due diligence comes in. You (and preferably your team) really need to dig into the company and find out where things really stand. In Wiltbank's and Brooks' study, they found a direct correlation to the amount of time spent on due diligence and the subsequent returns. This is where a team comes in handy where you can break up the different sections of the due diligence process.

We at the Sheltowee Angel Network are attempting to standardize the due diligence process across multiple different angel groups. Currently different groups have much different standards and processes for due diligence. This can be a challenge for an entrepreneur, because if they have multiple angel groups as investors, they may have to go through multiple different due diligence processes. Due diligence can be a huge time drain for the entrepreneur.

At the Sheltowee Angel Network we have broken the due diligence process into the following areas:

- Entrepreneur and Management Team
- Product
- Business Model
- Markets and Marketing
- Sales Plan
- Competition
- Competitive Advantage
- Legal and Regulatory
- Intellectual Property
- Valuation, Terms and Use
- Potential for Investors
- Financials
- Exit Strategy
- Other Investors
- Risks

Entrepreneur and Management Team
This part of the due diligence process looks into the backgrounds of the individuals running the company. This can include background checks and a check of references. If the individuals have issues that have not been disclosed this can be a major red flag. Past felony convictions, particularly if those charges involve fraud, can make it really easy to make a decision on whether to proceed. Rarely is that cut and dry, but we have seen cases where it is.

Product
Due diligence on the product can include looking at the supply chain and verifying cost of goods for the product. Can they really make the product for the price they say they can? What volume can they deliver if the product takes off? An item that is associated with the product, but is looked at as a separate issue, is intellectual property. We talk about that later.

Business Model
What is the business model for the company and how realistic is it? Is it a subscription model for a SaaS company? Is it an advertising model? Looking at the business model and how

it companies to other companies and other business models needs to be covered under due diligence.

The Dark Arts of Company Valuation

So a REALLY important part of making an investment is knowing what the value of the company is. Valuations are a tricky business. The entrepreneur thinks his or her company is worth a lot, and does not want to give up much, and the investor thinks it is worth less and that they should get a lower valuation on the business and thus a higher percentage of ownership in the company for their investment. Determining the valuation of an early stage business is MUCH different than determining the value of a later stage company. Often times the company doesn't have revenue, so a value based on a multiple of EBIDTA (earnings before interest, depreciation, taxes and amortization) is not possible. So by the way, multiples of EBIDTA are common means of valuing companies who have a track record of revenue. If you play the stock market you can think of it as it Price to Earnings ratio.

So if we can't do a discounted cash flow, and we can't do a multiple of EBIDTA, then how do we value a company? There are lots of factors that go into the valuation of an early stage company, but the fact of the matter is that it is more art than science. Below we will discuss some of the key factors for valuation.

The Team

For angel investors this is one of the most important aspects of valuation. What is the quality of the team? If you have an entrepreneur who just exited their last gig and has this great idea for the next one, then they are likely going to garner a higher valuation than someone who has never started a business and is just staring out. The ultimate success (or failure) of the company rests with the team. It primarily rests with the CEO, but it takes the entire team to make a company successful. An experienced team can easily garner a valuation that is 2 to five times greater because of the experience of the team.

The Market Size

This can have a great impact on valuation. If you are going after a market that is a $100 billion industry and you have the opportunity to capture a part of that market, then your potential sales are really big. If you are addressing a much smaller niche market, then your valuation is likely going to be lower. Now some other factors go into this. I may have a $200 million addressable market, but have a real shot at capturing 50% of that market because of the new innovation I have developed. This company may get a higher valuation than a company that is addressing a $100 billion market, but has a much smaller chance of capturing that market.

Barriers to Entry

If I have an idea that when I release it to the world, everyone and their brother can copy it, then I have low barriers to entry to the market and this negatively impacts my valuation. Intellectual property provides barriers to market entry for competitors. Type of intellectual property include patents, trademarks, copyrights, and trade secrets. If you have good IP and can demonstrate that when you execute in your market, you can keep competitors from duplicating your product or service, then you strengthen your valuation.

Stage of Investment

Generally the stage of the investment will have a large impact on the value of the company. If you are looking for pre-seed money, then it is likely that your valuation is going to be less than a million. If you are looking for a seed stage investment, then a valuation of $1 million to $5 million is reasonable. Once you get into series A investment and beyond, you are looking at valuations north of $10 million. Remember that these are rules of thumb and that every situation is unique. You could run across a seed stage deal that has an experienced entrepreneur with a rock solid patent, that garners a valuation of $15 million for his seed round valuation. But this is not the norm.

Who Is On the Cap Table

Another item that can impact valuation on a company is who the other investors, or previous investors are. A common term you will here is cap table, which is short for "capitalization table". This essentially shows you how much money other investors have invested and how much of the company they own. Having a lot of people on your cap table can become problematic.

Conclusion on Valuation

In conclusion, the value of a company is what someone is willing to pay. With that being said, the entrepreneur must be careful how they position their company. If they have mad sales and promotion skills and convinces someone they are worth a $100 million dollars, are they going to be able to convince a sophisticated group a year or two from now when they need more money, that they are worth that or more. For the entrepreneur, selling at too high a valuation can become problematic down the road.

Types of Investment

As an angel investor you will see several different types of investments. We will discuss the main types you will see here. Below is the quick list and we will go into more detail in each one of these.

Priced Round
Convertible Note
SAFE
Revenue Share

Priced Round

This is a good old offering where you are buying stock for a specified price. Well it is rarely that simple, but that is the jest of it. So George is offering his seed round to angel investors. He thinks he has moved the ball forward and is offering $500,000 for 20% of his company. So this would equate to a $2 million pre-money valuation (the value of the company before the investment comes in) and a $2.5 million post money valuation. It is very important that when an entrepreneur quotes the valuation of the company that you understand if it is a pre-money or post-money valuation. It is often to the entrepreneurs advantage to quote pre-money valuations (the number is smaller, so it sounds better to the investor).
Now that you know what the valuation is, you need to know what the rights are associated with the equity you are purchasing. Are you getting common shares or preferred shares? Are they series Seed preferred, Series A preferred, or some other issuance? Common shares are generally what the founder

of the company has.

Preferred Shares

Preferred shares have preferences that are favorable to the individual that holds that class of shares. Some rights you may see with a preferred class are:
Liquidation preference- This means that the preferred equity holders will get a preference on the liquidation of the company. This is often a 1x but can sometimes be higher. The liquidation preference can be participating or non-participating. If the liquidation preference is a non-participating preference, then when the company sells the investor can get their liquidation preference or be treated as if they had converted to common, depending on which is more. So if investors put $1 million in and they own 10% of the company, and the company sells for $9 million on an exit, the investors would get their $1 million back on their liquidation preference. If the company sold for $15 million, then they would take their $1.5 million as if they had converted to common shares.

If the liquidation preference is a participating liquidation preference, then in the previous example, when the company sold for $9 million, the preferred investor would get their $1 million back and then they would get 10% of the remaining $8 million, so they would get a total of $1.8 million, and the remaining investors would get the rest.

Preferential dividend (cumulative or non-cumulative)- A dividend that is paid to the preferred stock holder prior to the other stock holders receiving their dividends. If the dividend is cumulative then it will accrue each year and be paid on liquidation of the company. A non-cumulative dividend will only be paid out if dividends are declared by the board and paid out to the preferred class first. This can be a safety feature for investors to prevent founders from treating the business as a lifestyle business and just pulling the funds out of the company as a dividend. Cumulative preferred dividends are not very common in angel deals, and some consider them punitive to the founders.

Anti-dilution rights- Anti-dilutions rights provide protection for the investor for what we call “down rounds”. It is likely that an entrepreneur is going to have multiple rounds of investment prior to an exit. As long as each round of investment is at a higher valuation than the previous, then things are going pretty well. But when the entrepreneur runs into a snag, and his last round he raised at a $10 million post money valuation, but now he is going to need to raise money at a $5 million valuation, he is experiencing a down round. This means that the investors who invested at the $10 million valuation are going to get diluted. Anti-dilution rights protect those investors by issuing them more shares and disproportionally diluting the founder.

There are different types of anti-dilution rights including broad based weighted average, narrow based weighted average and a full ratchet. Anti-dilution rights can have a negative impact on future financings and are usually a weighted average (rather than a full ratchet) so we will not go into great detail on this feature of preferred stock.

Protective Provisions

Protective provisions give the preferred share holder additional protections from the common shareholders. These can include special voting rights on particular items. Often times there are specific items that would require a majority vote of preferred shareholders in order for the actions to be taken. Some of these actions may include:
Changing the terms of a preferred class
Issuance of new shares or a new preferred class
Amendments to the charter or by-laws
A merger or sale of the company
A change in the size of the board of directors
Authorizing a dividend

As you can see, there are a lot of aspects to closing a deal on a priced round. Lots of things to take into consideration. There are a number of groups who have attempted to provide documents that help to alleviate some of the burden of closing angel deals by standardizing some of the documentation. A set of documents that the Sheltowee Angel Network uses frequently are the Series Seed documents. We will be listing this resource and additional resources in an appendix.

Convertible Note

In the past when an entrepreneur wanted to raise money there was always the argument of what the valuation of the company should be. The convertible note was developed to help avoid these arguments between investors and founders. The concept is essentially that as an investor I am going to loan you the money, and then when you raise your next round, I am going to convert to equity, but at a discount to what the price of your next round it. So now we are not arguing about valuation and we can let the next round of investors set a price for the company, and hopefully the entrepreneur has been able to make a lot of progress and significantly increase the value of the company.

That concept has evolved and now there has been an additional feature added to this. So now for a convertible note we have an interest rate, a discount rate (discount off the next round's price), and now we have added a cap. So the entrepreneur is now capped at what the next round price can be. This cap was not as prevalent 20 years ago, but now is found on almost every convertible note that is done. So the argument has moved from "what is your company worth today" to "what should the cap on valuation be for the next round".

So how a convertible note works, is that if an entrepreneur is looking for $1 million for their business, the investor will loan them $1 million with an interest rate. Upon the next financing, the investor agrees to convert to equity (usually the same class as the next investors get) and they will convert at a discount. So let's say the convertible note has an interest rate of 8% and a discount rate of 30%. If after one year the entrepreneur raises money at a $10 million valuation, the investor in the convertible note will convert their initial investment and their accrued interest into equity at a $7 million valuation (the discount). Now if the note has a $5 million cap on it, the initial investors would convert at the $5 million valuation.
Components of a Convertible Note Graphic
Investment Amount
Interest Rate
Discount Rate
Cap

SAFE

A SAFE is an agreement that was developed by Y-Combinator and stands for Simple Agreement for Future Equity. This has some aspects of a convertible note, but is not debt. This is a very founder friendly instrument and is not used much in our region (our groups are based in Knoxville, TN, Nashville, TN, and Louisville, KY). Essentially this is a contract that says an individual can purchase equity at a discount to the next round. It is similar to a convertible note, in that it is not actually equity, but it has fewer protections for the investor than debt.

Revenue Share

Most of the time when we talk about angel investing we are talking about an equity investment, or a direct path to an equity investment. The revenue share can be a very different path that is becoming more popular and we are seeing it more. The revenue share falls somewhere between debt and equity. It is essentially the entrepreneur selling you a piece of their revenue. This can be very lucrative for an angel investor but can also limit the amount of upside you may have no a deal.

If an entrepreneur is generating revenue, or very close to generating revenue, they may want to preserve their equity and offer a piece of their sales. This is usually when the company is not quite in a position to secure debt from traditional debt issuers. The revenue share sweetens the pot for investors and gives the entrepreneur the opportunity to raise capital without giving up equity, or not giving up as much equity (some revenue share deals have equity components to them).

Strategies for Investing

Active or Passive Angel Investing

At the Sheltowee Angel Network we are promoting two types of strategies for angle investment. The first is the traditional approach that I call the active angel investor. The active angel investor likes to interact with the entrepreneur and attend meetings where the entrepreneurs pitch they companies. It is likely that the active angel investor is going to contribute more than just money. They will likely play an active role in the due diligence on the company and are likely going to provide advice and guidance as well as money. This can be very helpful and beneficial to the entrepreneur.

The second type of angel investor that we are trying to cultivate is the passive angel investor. This is someone who is an accredited investor who likes the idea of making money while helping innovative companies, but does not want to take the time to attend meetings and actively participate with the companies in which they are investing. We are attempting to address this type of investor by providing them with the option to invest in funds that do the work of screening and evaluating the companies for them.

A Portfolio Approach

We believe that regardless as to whether you are going to be an active or a passive angel investor, you need to take a portfolio approach. Studies have shown that the more companies an investor has in their portfolio of angel investments, the greater the return on investment is. In the ______ study it showed that angel investors could make a 22% IRR with a 4.5 year hold time for their investment.

Glossary of Terms

Articles of incorporation
Articles of organization
Business Plan
Cap Table
Common stock
Convertible Note
Corporate by laws
Disclosure documents
Due diligence
EBITDA
Family office
Full ratchet
Leading a round
Offering documents
Operating Agreement
Pitch Deck
Preferred equity
Priced Round
Private placement memorandum
SAFE (Simple Agreement for Future Equity)
Side car deal
Term sheet
Valuation
Weighted ratchet