HOW TO INVEST IN A STARTUP

eGuide

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PART I: Know the Startup Before You Invest

The Definition of a Startup

I work with funds, entrepreneurs, and startups of all kinds across the state of Texas. I was recently talking with an international fund manager looking to invest in Texas deals. He said his investment group wanted to invest in startups. I asked him,

"*What is your definition of a startup?*"

He looked a little surprised at the question as he like most people assume that everyone shares the same definition.

I've learned over the years that where you are in the world molds your definition of what counts as a startup.

In Austin, if you have a great idea, and two people working on it, then you're a startup.

In Dallas, if you have $1M of revenue, then you're a startup. If you have less than $1M, then you don't exist.

In Shanghai, if you have $10M of revenue, then you are a startup.

I once heard a fund manager refer to a $20M company as a startup.

What makes entrepreneur communities vibrant is their inclusion of all players in the ecosystem, not just those with substantial traction. Startups without significant revenue can bring innovation, ideas, support, and other essential drivers for the community. I welcome the broader definition of a startup as it creates a larger community within which to share ideas and foster innovation.

So, ask yourself: what is your definition of a startup? Make sure your own definition is clear before you consider investing and always keep these 5 key principles in mind:

1. It always takes longer than you think.
2. It costs more than you thought.
3. There's always a better idea.

4. The journey is the reward.

5. The team is what you will remember.

Building a Board for your Startup – Noses In, Fingers Out

There's an old saying:

> *"If you want to live long, choose your parents well."*

This came from Dave Berkus of the Tech Coast Angels during an Angel Capital Association Summit held in San Diego. Dave sits on ten for-profit boards. He went on to describe how entrepreneurs can prolong the life of their startup by choosing their board members well. As an angel investor, you may be invited to sit on the board of a company. Dave provided sage advice on the subject for both entrepreneurs and investors alike.

The first question to the entrepreneur sitting up a board is why are you building the board?

1. Advice or governance?
2. Do you have outside investors?
3. Do you need legal expertise or expertise otherwise?
4. Source of appeals for management?
5. Do you know what you don't know?

The entrepreneur faces risk on several fronts with the board because the board can:

1. Hire/fire the CEO
2. Influence/control the strategy

3. Withhold approvals for funding, acquisitions, and more
4. Become misaligned with the management

Dave advises the entrepreneur to:

1. Not stack the board with family and friends
2. Balance the board with financial, operational, and industry experience
3. Determine the frequency of the meetings. For a startup, a weekly meeting is not uncommon

The board has legal responsibility. The first is the duty of loyalty to the corporation and the second is the duty of care to the shareholders. Dave recommends setting up two committees—the audit, and compensation committee.

Dave summarized the board's posture as **"noses in, fingers out."** The board should know what's going on, but they should let the management team operate the company.

Compensation for the board is typically in the form of stock options usually amounting to 1% over 2 to 4 years. Cash is rarely used, and stock grants create tax events. The stock options are generally non-qualifying and are priced at the last transaction price. Dave also noted that common stock is worth about 1/5 of preferred shares so that factor must be taken into account as well.

As a board member, Dave looks for the bottleneck:

> *"Who or where is holding us back?"*

He then focuses the group on that problem. Dave noted the "every $3M" crisis. The first $3M crisis comes when the company reaches about 20 employees. The first crisis is the financial crisis; thus, the company seeks funding. Those who grow the business then reach the organizational crisis – how to organize the people into a capable team. Finally, the company enters the product crisis usually related to quality issues.

For those who will sit on a board, D&O insurance is a must. A $2M policy will cost $6K to $7K. The value of the policy is in the legal representation it brings and not just the dollar value of coverage. Dave noted that he had been sued four times.

You can find out more about Dave Berkus and his philosophy in **Extending the Runway**. All proceeds go to the Boy Scouts of America.

Board Planning – Finding the Company’s Competency

In addition to building a board, Dave Berkus of the Tech Coast Angels also offers important advice about the work of the Board of Directors in a startup. Aside from governance, most startups need help in setting strategy. Dave Berkus outlined an exercise he uses with startups to help them find their core competency.

It goes something like this— make a chart with the following column headings:

Candidate Company	What they want	What you want	Ranking 10-1

Now go through and for each candidate company that may one day want to purchase the startup, list out what they would want from your startup. Likewise, write down what the startup would want from the candidate company. After you list out five or ten of these, go back through and rank them based on the value a proposed buyout would bring.

This exercise brings into focus what the startups’ core competency is and helps the entrepreneur set a strategy to develop that competency. As a secondary benefit the exercise highlights which may want to buy out the startup and why. Along the way, the startup can start building a relationship with the candidate company.

In the early days of a startup, a strategy is equally important as governance. The planning strategy outlined above can help set the agenda for the board in working with the startup.

Capitalizing on the One-on-One Conference

The appointment-based event is gaining popularity with those who want to raise funding as it turns a conference into a series of deal-flow meetings. Both investors and entrepreneurs are making more use of the One-on-One conference to find prospective matches.

For those not familiar with a one-on-one conference, the venue offers the participants the ability to see who will attend the event and schedule meetings at the event. The conference also provides panels, keynote speakers, and workshops. In a one-on-one discussion, one participant invites another for a meeting. If the invite is accepted, the scheduler provides a date/time/location for a meeting. The meetings are typically 15 to 30 minutes in length. The objective is to meet as many qualified contacts as possible. Detailed follow up comes after the event.

In running several of these events, I've seen how some find better results than others.

Here are some tips on how to make the most of your next one-on-one conference:

> **Preparation**—a one-on-one conference takes a great deal more preparation than the typical panel/speaker filled conference in which the participants find contacts through general networking. The meeting will provide a scheduler system with profiles of attendees.   You must log into the scheduler system for several weeks in advance of the conference to set up appointments.
>
> **Fill out your profile**—most schedulers offer a place for the participant to fill out their profile. It's important to make it compelling to others so they will accept your meeting invites.
>
> **Make it interesting**—give the others a reason to accept your meeting invite or to initiate an invite. Show the values in your business and make clear what you have to offer.

Indicate whom you are seeking to connect with—it's fair game to include what you are looking for as others can determine if they fit.

Research the other candidates—in addition to scheduling, it's essential to research the other participants. Since some conferences have hundreds of participants, this could take some time so start early.

Log in daily to see who else has just joined—new participants join the conference every day in the run-up to the event, so you have to check back to see who joined recently.

Know the network—it helps to know the community and network as it will help narrow down your list of contacts to pursue.

What's the Risk in a Consumer Product Deal?

The entrepreneur looks at the opportunity.

The investor looks at the risk.

So, what's the risk in a deal?

While some risks are universal to all deals such as the ability to execute and having the right team, there are sector-specific risks the investor should know.

In the consumer product goods space, one can make and sell just about anything but for those seeking to raise equity investment what's the risk to the investor?

The short-term risk is that you won't have enough margin to make a profit. Without a healthy profit, you can't grow the company from sales alone. The category growth rate of the product makes a big difference in the company's ability to grow organically.

The long-term risk is that you won't be able to raise more funding. Most consumer product good companies need to raise funding every 24 months to continue a healthy growth rate as you have to fund the inventory increases that come with opening new distribution channels. To boost private equity funding, you need sales north of $10M. To sell the business for a decent return, you need sales north of $20M.

The risk in the deal is failing to reach those levels on organic sales growth or earlier stage funding and not be able to raise more funding to grow the business to the $20M+ exit point.

PART II: Learning Where and How to Invest

Are You Ready for Marriage?

Investing in early-stage companies is not unlike getting married— it follows the same steps. In many cases the time some investors spend in a deal is longer than some people spend staying married. The average length of a marriage today is eight years. I know many investors who are in deals for ten years or more.

Here's a comparison between getting married and investing in a startup:

Marriage	Investing in a Startup
Longing	Seeing others make a profit
Introduction	The entrepreneur pitch
Dating	Getting to know the team
Engagement	Due Diligence
Marriage Ceremony	Signing the terms sheet
Honeymoon	Excitement of joining a new company
Post-honeymoon	Day to day work on the business

I draw this comparison because I see many investors rushing through the **"dating"** process only to find they picked the wrong one.

As an investor, you'll spend quite a bit of time with the startup over the coming years, so you want to check compatibility with the management team. The key areas to look for alignment are: hiring people, managing budget, and building culture. Products and strategy will change to fit the market and the current business conditions.

If you're investing in a startup, you're about to get married. Make sure you've done the necessary due diligence on the people.

How to Identify Quality Companies

In funding startups, investors need to find a source of deal flow that provides venture-fundable deals.

Venture-funded companies typically share these characteristics:

- ☐ Recurring or repeat revenue business model
- ☐ Doubling revenue year over year
- ☐ Tech-enabled
- ☐ A strong team with industry experience
- ☐ Broad target market allowing the firm to scale

In searching for a startup to invest, you should look for all these characteristics.

Startup Investor Types

There are many kinds of startup investors today. **Venture Capital, MicroVC Funds, Corporate Venture funds, Family Offices, Angels, High Net Worth Individuals (HNI),** and **Crowdfunders** to name some of the current types of investors.

Venture Capital

Most startups think of venture capital when they start their fundraise. The reality is that venture capital is only for a small number of startups. VCs draw their funds from outside sources called LPs or Limited Partners. The VC charges a management fee and a carry (share of the profits) from the funds raised.

There are VCs who still raise funds in what is called committed capital- the funds are committed by the LPs. Newer VC funds are often called "Pledge funds" in which the LPs pay the management fee for access to the deal flow, but they review each deal before funding and have a say in the funding process.

For some VCs, you may notice the turnaround time on questions, and deal flow takes longer. For pledge funds, the VCs must gain the approval of the LPs to move forward- hence the turnaround time is longer.

VCs fund only the top 10% of all qualified startups. They look for high growth, large target markets with scalable business models.

MicroVCs

These are venture capitals funds with less than $100M in funding. Typically, MicroVCs start with $25M to $50M funds and then deploy the funds to 10-12 companies. They often have particular investment criteria since the management fee on the fund doesn't add up to much, and one needs to keep the costs low on such a fund.

Corporate VCs

Often called strategic investors in that they invest for strategic reasons rather than financial. They seek new technologies, talent, and other tools to help grow their business. They often invest as follow on investors and typically do not lead the fundraise for startups. In the past, some firms had a strategic fund, but today just about every company has a fund for startup investment.

Family Offices

These are investors based around a family partnership that allocates some of their funds to startup investing. Some family offices go it alone and are called single-family offices while others band together into groups and are called multi-family offices that share the deal flow and due diligence. For every venture capital fund in the US, there are five family offices. They are less prominent since they invest privately and provide very little publicity around their work.

Angels

Angles are individuals that meet the SEC accredited investor requirement. That means they have $1M in net worth not counting the house they live in. Angels invest their own money. Some band together into groups to share the deal flow and the due diligence.

Sometimes the group is formed around the “dinner club” model, and a formal application process is used to recruit the deals. Others form syndicates in which a deal that is led is shopped to others in the group. The dinner club model can be a substantial time sync since most of the meetings are in person and only occur at specific times of the year. The Syndicate model is lighter and focuses on deals that have a lead.

Angels look for the same thing as VCs but often invest outside those parameters since it’s their own funds. They often invest in things that matter to them personally such as impact funds.

High Net Worth Individuals

HNIs are similar to angels but typically have more investing experience. They most often invest their own funds, and in areas, they understand well. Some HNIs band together in informal syndicates to share the deal flow and due diligence.

Crowdfunders

These are either accredited or unaccredited investors seeking to make a return by investing with a large number of other investors in startup deals. Because their investment size ranges from $100 to $5000 in most cases, the startup needs a large number of them to complete a round. Crowdfunders more than any other investor make their investment decision on factors other than financial return. They often invest to support family and friends, or businesses they care about in some manner.

The Real Due Diligence Work

I'm always surprised by how many investors say the team is the most crucial element of a startup but how little the due diligence focuses on the team itself. I can look back on successes and failures in my startup investing career, and almost all failures can be traced back to the **"team wasn't up to the task."** I recognize that I often underestimated the challenge at hand, but in all cases, failure was due to the team lacking skills or focused commitment.

In running due diligence, it's not about the product – it's about the team.

There are standard checklists, and the investor should verify the basics such as legal entities, tax filings, patent filings, etc. But the real due diligence comes when you go to the startup's office and meet the team.

I had a new angel investor once ask me how he should diligence a startup.

I encouraged him to set up a meeting in the startup's office and to meet the team and interview each one. The first person you want to meet if you haven't already is the CEO. You are assessing leadership, communication, strategy, and other vital skills. If this isn't stellar, there's no need to continue further with the potential investment.

In reviewing the rest of the team, you want to check the skill levels of every individual. If there are advisors or mentors, you want to meet with them as well to see how much time commitment they have for the project.

In the end, time, skills and focus will need to be applied, and you are looking to see if the team can do just that. This is why it is key to visit the startup's office; you can learn a great deal about a company when you go to their workplace.

I had a friend who worked for IBM and considered investing in a startup by some of his former IBM coworkers. He set up a meeting at their office. When he followed the address to their office, it led him to a skyscraper in the downtown area and then to the twelfth floor of the building. There he found the team had rented out the entire 12th floor of the building. Needless to say, the startup ran out of cash in just 6 months.

Walking through their office, you'll get a much more profound sense of who they are and what they are doing.

Products come and go, markets shift and change, but the team is a constant. Always be sure to keep these 3 levels of Due Diligence in mind:

Level 1

Answers the question: do we invest or not?

Level 2

Answers the question: what will the startup have to accomplish to be successful?

Level 3

Answers the question: what can the investor do to help the startup achieve success?

Can You Support the Team— At Least a Little?

As an investor, I see many deals coming through the angel networks and increasingly across the funding portals. I dropped the "crowd" out of the name as it's fast becoming the standard for entrepreneurs to showcase their deals on crowdfunding portals -- so much so, that pretty soon, it'll be the default.

After deciding the team has something and they are in the right market, the next question I ask myself is, "Can I support the team -- at least a little bit." I've learned that passive investing is really not that interesting. It would be easier to invest in an index fund if that's all I was going to do. If I'm investing in a startup, then I want some role in the business. I ask myself:

1. Can I help with the product?
2. Can I help build the team?
3. Can I help make sales?
4. Can I help with the business process?
5. Can I help with marketing?
6. Can I help with lead generation?
7. Can I help with recruiting?
8. Can I help with the operations?
9. Can I help with the logistics/office?

If I go through the entire list and I can't find any way to help, then I take a pass on it.

Angel investing should be active investing— at least a little bit.

Learn About Sectors and Invest in Them

Many startup investors begin with a portfolio theory approach in which one makes a few investments across a broad range of sectors. I often hear, “My strategy is to invest in good deals.” This is easier said than done. A broad-based investing approach requires the investor to come up to speed on each and every sector. That’s a lot of homework for an investment in one or two deals.

Some investors choose to focus on a few key domains and become an expert in those areas. By diving deep one can understand the trends, challenges, and factors that drive company success. There’s a risk that if you have too many companies in a sector, you are at risk for major disruptions.

If the sector is broad enough, you can move to new areas within the space as it matures.

How to find deals in a Sector

To find deals in a sector you can search the Crunchbase for industry-specific reports. Pitchbook produces funded reports by sector by subscribing to their daily newsletter. Conferences are a great place to find personal introductions and meet with new startups. Also, venture capital is now evolving into service models in which they not only fund the companies, but also help with operations such as sales, CFO, etc. It’s not hard to find a list of VC firms focused on a sector.

Understanding the Challenges in the Sector

By focusing on a sector, one can learn the specific challenges and look for companies who are solving those challenges in new and unique ways. By talking with startups about how their product/service works the investor comes to learn the critical issues in that industry.

Identifying the Risks to Overcome

Every sector comes with its risks such as regulatory. Also, disruption from new technologies is an ever-present risk in the industry. By spending time with startups and investors in the space, it becomes clear where the threats come from and what one can do to mitigate the risk.

Tracking the Trends in a Sector

With the increase in newsletters, podcasts, meetups, and more, one can monitor the trends in a sector. There are aggregator tools such as Feedly that let you build lists of sites and find updates as new information arises. By reviewing conference agendas for sector-specific shows, one can learn the topics that are top of mind for those in the sector.

Monitor for Progress Before Investing

On first blush, all investment opportunities look attractive. As the investigation progresses, warts, blemishes, and challenges become clear.

It's **vital** to monitor deals for a few months before investing as it takes at least three months to surface all the relevant details about the deal.

It's also important to assess the capability of the team. Steady progress with revenue, product development, and team deployment need to be measured.

In the **TEN Capital** program, we monitor the deals and give updates about their progress. We rely on the startups to provide updates in the form of a campaign.

The way the startup runs the campaign is a good proxy for how they will run the business.

Some come in and build out their documents expeditiously. They follow up with the investors, and they are able to close an investment using strong communication skills.

Others come in and have difficulty building out their pitch deck. They get distracted with other things in life and can't follow up on time. Some have a hard time closing investors because their business is vague, and the goal is fuzzy. This type of campaign indicates a weak team and makes for a questionable investment.

It's interesting to watch their investor relations campaign because it's a good indicator of how they will run their sales campaign.

How to use Analytical Tools for Startup Investing

Some investors believe the rise of data analytics will take over the decision-making process for funding startups and that most venture capitalists will be out of a job in the next five years.

Data analytics works well in some sectors such as consumer product goods because the business models are clearly defined, and analytics can make meaningful predictions. In tech-enabled models, it's not quite as clear.

Data is used to inform the investor– it does not decide for the investor. It's useful to have additional analytics around a potential investment, but it's unlikely that data analytics will completely take over.

TEN has its own data analytics which it has developed over the last ten years for identifying fundable companies. On the TEN Capital Group website, you can see the details of TEN Capital's Predictors of Funding.

With ten years of funding history, we track the results of the investments and understand why most of them succeed, however, some exceptions did well even though they didn't meet this criterion.

The criteria we found for successful startup investing are:

1. There are two or more industry-experienced C-level leaders.
2. The company has a substantial competitive advantage.
3. The company is solving a hard problem.
4. In every investment, the team comes first.

A competitive advantage is more than just a fistful of patents. It's an advantage that either increases the company's revenue by 30% over that of the competition or decreases its cost by 30%.

A hard problem is a problem that customers will pay for it, and it is non-trivial.

The key here is you need both. Many universities are solving hard problems, but there's no competitive advantage in the sense the market will pay a premium.

There are also **"execution plays"** where a company is out-executing the competition, but without solving a hard problem, it won't last long.

Learn from Other Investors

As an investor, I helped launch three angel networks in Texas. In the process, I set up training programs, attended conferences, and talked with many other investors. Hearing and speaking to other investors was an excellent learning tool. One of the best resources I found was a podcast by Frank Peters. Frank was an angel investor out of the Tech Coast Angels in southern California.

The Frank Peters Show

Frank interviewed every angel, VC, and startup in the southern California community. He later ran interviews across the US and all over the world. He ultimately recorded over 450 episodes which he posted on the web. As I drove my car, I listened to many of the podcasts and heard from angel investors on how they invested, their investment thesis, and lessons they learned from the process.

I recommend listening to podcasts that focus on startup funding. Podcasts are an excellent tool to learn from experts in the field.

Consider taking the time to listen to these: **Jason Calacanis**: Angel Podcast, **Patrick O'Shaughnessy:** Invest like the Best, and there is also my podcast, Investor Connect.

Invest at an Available or Opportune Time

As an investor, you want to monitor the progress of the business to see how fast they are iterating on the company and how well they do with customers.

After being convinced this is a business you want to join as an investor, you look for an opportune **time** to invest.

Some companies are moving from one-time raises to ongoing raises in which the company takes the funding at any time. Some still run discrete fundraise campaigns and when the goal is met, the fundraise is closed. For recurring revenue businesses, you have the choice of raising a little at a time, and you don’t necessarily need a massive cash infusion to keep the lights on in the office.

As an investor, you can approach the company and make your interest clear. It’s often the case that the company can accept you in the last round of terms because the note is still open.

The message here is **“just ask.”**

PART III: The Key Points of Investment

5 Characteristics of a Lead Investor

I often hear of entrepreneurs stuck in their fundraise efforts with several prospective investors but no one willing to be the first invest. That's because the first investor could be the last investor in a deal, and no one wants to be that investor. The lead investor breaks down that barrier by providing the initial capital and due diligence that paves the way for others to join the deal.

Here are some key characteristics of a lead investor:

Provides a substantial sum of capital

At least $100K to start. The $25K check writer should not be leading the deal.

Provides advice

They should have experience in the industry and know the problem the company is solving.

Is the leading advocate

By going first, he's putting his reputation on the line. It's important to keep the lead informed as he's championing your deal -- more so than other investors.

Brings a strong reputation

This should attract others to the deal.

Performs the initial due diligence

All investors should be performing their own due diligence, but most will use the lead investors to work as the basis for their decision. This upfront work can easily reach 30 to 40 hours of work. If the entrepreneur doesn't offer compensation, it can be quite difficult to sign up a lead investor.

Why We Need to Rethink Investor Recognition

I deal with startups from across the country but mostly from the tech centers, Austin, San Francisco, New York, and increasingly Chicago, and Atlanta. I can tell almost immediately if the startup is coming from the Bay Area because they are head and shoulders above all others in how they treat the investor.

They thank the investor for the time they are spending. They show respect for the investor's background (and most often have looked it up and found some talking points to start off the conversation). They show gratitude for the "insight and helpful advice" the investor is giving them. As an investor, I know this is somewhat fawning, and it can be overdone, but the fact that they are taking time to research before the meeting and showing a modicum of respect for the investors time and advice sets a better tone for the discussion.

Outside of the Bay Area, most entrepreneurs come to pitch their deal and get a response--nothing more. They treat the investor and the entrepreneur as equals, and while most say thank you for taking time at the beginning of the meeting, that's about it. There's no tone set for the discussions— this will be another conversation with just another investor— no big deal.

It’s a wise move for startups to research the investors they are going to meet and take an extra step to thank the investor(s) for their advice and show them that their time means something you. After all, you're not just raising funding; you're building a relationship.

How Much Investment Can You Attract?

The investors claim there is plenty of money to be had. The startups argue the opposite.

Let's turn to some data to see where Texas stands. For starters, Texas represents **10%** of the country in population and business across the board. **The National Venture Capital Associate** tracks venture investment by state. The **NVCA** data which you can see on this page clearly shows the amount of VC funding going into Texas companies is currently around 1.5% with a two-year average hovering around 2.5%— well below the 10% benchmark. It appears we are below potential. So, what do we do about this?

I argue that the burden of funding rests squarely on both the shoulders of the startups and the Texas investors. The startups need to look nationally for their funding as the world has gone vertical. Investors are increasingly looking for deals that match a specific criterion (e.g., wearable deal with $1M in revenue and a fund raise of less than $5M). The chance of a startup finding all of their funding in Texas or any one region of the US is quickly shrinking. No longer can you find all your funding in your own backyard. As the startup looks nationally, the range of competition increases. Startups have to bring their A game to the national table— B players need not apply.

For Texas investors, the question is no longer, how much funding are you going to deploy in Texas companies it's also how much your funding can attract from the national stage. The investor's funding should be leveraged to bring in more dollars. All funds are limited, but its ability to attract more funding is unlimited. Investors need to build syndicates with their fundings. Investors absolutely have to bring their A game to the national table.

B players need not apply.

The Rise of Analytics in Fundraising

Analytics is fast turning into a must-have. It comes under various names: **Big Data, Predictive Analytics**, and more. Big Data refers to the acquisition and management of large data sets. Predictive analytics refers to the brand of data mining concerned with the prediction of future probabilities and trends. The goal is to find one or two variables that can predict an outcome. Some are familiar with the law of large numbers which says if you perform the same experiment on a large data set, the expected result will converge as more experiments are done.

In the investment world, analytics are used to determine where and how much to invest. The goal is to yield the highest possible return. The variables cover the type of investment, the duration, and the amount to invest in each type. The same concept now applies to many other areas.

There are now databases of backers for rewards campaigns. Here's one example by Krowdster.

For those raising funding, **Funding Analytics** takes in a large number of potential investors and then determines what factors are the key variables. Since investors change their perspectives, so what they look for in an investment will change as well.

At its most basic level, funding analytics shows you which investors are most likely to invest in your startup or growth company.

How Funding Analytics Helps Raise Money

Fundraising is moving from a local exercise to a global one. One can still get a loan from a local bank or an equity investment from a local angel group, but the availability of capital throughout the world awaits those who know where to find it.

Investment Analytics shows investors how to make better investment decisions. Funding Analytics shows entrepreneurs how to find better investors. By researching the track record and criteria of venture capital funds, private equity funds, and angel group portfolios, the entrepreneur can more accurately target the right investor group for their deal.

Funding Analytics:

1. Includes the current market rate for valuations— always a critical decision in negotiation with investors.

2. Shows the best way to approach the investor and keep them informed of your progress.

3. Shows which investors have funds ready to deploy versus those who are still raising their next fund.

4. Shows what due diligence documents are required and how to build them.

Total capital investment throughout the world is over $100 Trillion. The funding is there— to find it you'll need Funding Analytics.

The Searchfund— Another Investment Innovation

Entrepreneurs typically come up with their own ideas and invest time in building a primary business at which point they seek funding to grow it. There's a method called the **Searchfund** in which an entrepreneur raises funding to find a business which can then be funded for acquisition and growth. The concept comes from Stanford. You can see more at this link about the basics.

The search fund concept originated in 1984 and has become increasingly well known among business schools and private investors. A search fund is an investment vehicle to allow an aspiring entrepreneur the opportunity to search for, acquire, manage, and grow a company. They raise an initial seed amount of funding to support the search effort which typically takes two to three years. Once they have identified the acquisition target, they raise a round of funding to acquire and grow the company. The follow-on funding can be in the form of debt, seller equity rollover, earnouts, traditional senior and subordinated loans, and equity financing from new investors.

One can find opportunities from retired CEOs or trade association presidents, brokers, or other personal contacts. Skills needed for a Searchfund program are the same as for an entrepreneur— a more comprehensive view of the world, attention to detail, perseverance, ability to build relationships, and strategic thinking.

Benefits of running a Searchfund include expanding one's view to a wide range of industries in a short amount of time. One can find a target company to acquire and then lead that company to success with the potential for a high financial gain. About one in five Searchfund ends without finding a target acquisition.

The returns match those of venture funds and angel deals. The Search Funds 2011 study shows the asset class at 34.4 percent IRR and an 11.1x multiple of investment. Results from the Stanford experiment with search funds provided the following results:

> *"As of December 2011, 26 principals or partnerships were either looking for a company to buy or raising funds for acquisition; 50 had*

acquired companies that were still in operation; 3 had deviated from the search fund model, and 71 were classified as "terminal." Of the 71 terminal search funds, 23 acquired and exited a business, 17 acquired then shut down a company, and 31 concluded without an acquisition."

SideCar: Creating Diversification and Participation

It's interesting to note the rise of the fund (sometimes called a SideCar) among angel groups to provide diversification and participation into angel investing by passive investors. In many cases, the fund is applied to deals the angel investors pursue. This means the return on the fund will mirror the return the angels are seeing.

During an Angel Capital Association Summit in San Diego, many groups discussed their sidecar fund and how it worked. The first came from Ian Sobieski of the **Band of Angels** in the Bay Area. It's a $50M fund raised primarily from outside investors. The fund invests $300K in deals with the Band of Angels invests in which allows outsiders to enjoy the same returns as the Band of Angels members enjoy (which was reported at 53% IRR). The fund has a staff of three people who are paid from a 2.5% management fee and a 20% carry fee.

The second example comes from Luis Villalobos of the Tech Coast Angels which has a $3M fund that invests $350K in each deal that the Tech Coast Angel members invest in. The fund has no carry or management fee and so relies on the members to manage the fund. Both funds are ten-year long funds.

Fundraising is Moving Online

When I started angel investing, there were venture capitalists and angel investors. VCs were the **"professional"** money that was usually provided by someone else and Angels were the **"novice"** money and were provided by the investor directly.

VCs had access to more significant amounts of capital and were the go-to group for later-stage funding. While there are many more angel investors by headcount, their investments are smaller.

Startups approached angel investors in the early stage because most VCs wanted to see more traction and there were usually angels in one's network.

Today, the world of startup investing is entirely different primarily because of the rise of the internet and the shift of practically every business function online. Five years ago, I had a startup complain to me that they could run every function of their business (sales, marketing, finance, etc.) online except fundraising. For angel funding, they had to make the rounds of the local angel networks. They had to meet investors in the coffee shop to progress the raise.

As the world increasingly moves online so too does the fundraise. Today numerous sites let the startup access investors. I receive calls daily from startups across the US (and increasingly Europe) wanting to access my investor network.

An established startup that has raised some funding already now expands the fundraise to include other networks across the country. It's an exercise of funding investor networks online and engaging them as part of the overall fundraise process.

I tell startups they need to have a fundraise strategy that goes national from day one. It helps greatly to have some funding from your local community. If your message to the investor networks is that no one in your local community would invest, then this will be a problematic raise. It's best to show up with some funds raised.

The New Normal for Venture Capital

The Texas Entrepreneur Network focuses on helping entrepreneurs raise funding. We also work on launching accelerator programs and providing mentorship, but surveys of the entrepreneur community continually place fundraising at the top of the list, so that's where we spend most of our time. In our fundraising process, we hold open funding forums which allow anyone to come and observe the pitches to see what it takes to raise funding from investors including angels, venture capital, and family funds.

Recently, I've begun to observe where venture capitalists (VCs) are going. Their model is challenged these days as most deals are no longer raising $5M but are now raising $500K. The day of the large fund with 2% management fees and 20% carry are coming to an end for early-stage groups. VCs who had a fund are finding it increasingly difficult to raise the next one.

The IPO market doesn't provide phenomenal returns like it did a decade ago and most can't get paid or paid much until the exit occurs.

Family funds and pension funds, long-time supporters of the VC world are moving away. Pension funds and family funds don't want to pay out for management and consulting fees unless the exit was successful for all involved.

Even in the golden age of the venture capitalist (the 1990s), only 25% of VC firms made a profit, and only 10% made a good profit, and only a handful made a consistent profit.

In particular, family funds are now coming into the forums seeking to make investments directly in the deals.

The only way for the VC to get from here to there is to provide consulting services till the exit comes to fruition. The **new normal** for VCs is to form a team which provides strategic growth consulting or financial services, with a small fund on the side. The fund consists of their own money and maybe a few investors.

I've sent entrepreneurs to VCs for funding only to have the entrepreneur come back and say the VC was not an investor but rather a consultant. I have to explain to them that many venture capitalists have to take on additional consulting roles to keep the lights on. The VCs are still there, and they do invest but don't be surprised to learn that they have to pay bills just like everyone else.

The Angel Investor is the New Venture Capitalist

I started angel investing in the late 1990s. It was the heyday of the Venture Capitalist. Back in those days, entrepreneurs starting up a web company would stand up and ask for $5M in seed capital—quite a sum by today's standards. Back then the entrepreneur had to build their own server farm and buy all their computer equipment. They had to pay American wages for everything, and so it cost quite a bit.

In the ten years following, the cost of starting a web-based company dropped dramatically due to the falling cost of business services. Today those same companies now ask for $500K to get up and running because they pay only for the bandwidth they need from an existing server farm. They lease equipment rather than pay for it up front and they offshore many functions to lower cost areas.

As the cost of business continues to devolve downwards, so do the funds sought to start a business. Today, a web-based company asks for $250K to get up and running. This level of fundraising takes most deals out of the Venture Capital realm and lands them in the area of Angel Investors. Angels invest $200K to $2M in a deal with most rounds going for $500K to $1M. That's too low for most VCs but just right for the individual investor seeking to get in on startup funding.

Angel groups have increased dramatically over the past five years. Some Venture Capitalists have repositioned themselves into the angel world and called themselves **"Super Angels"** indicating they are on the high-end of the angel world.

Another factor is the near disappearance of the IPO market which reduced returns. To maintain returns required to keep their investors engaged, Venture Capitalists are moving to later stage deals and engaging in private equity transactions. For these two reasons – deal flow falling below the threshold and investors requiring returns that push them into later stage deals, the VC community is about one-fourth what it was ten years ago.

Some VCs focus on the early stage companies and bring additional services to help startups such as management consulting, strategic partnerships, and back office administration. In their place now is the angel investor. Deal flow for angels is up along with the number of angel groups and their membership.

The angel investor is the new venture capitalist.

The Cost of Angel Investing—Where are the Fees?

I once read a discussion forum in which the author of the post had bought a financial instrument and later discovered that the investment advisor who sold it to him actually made a commission on the sale. The author was incensed that someone made a commission off selling him something and to top it off the investment advisor didn't disclose his commission. As I read the post, I began to wonder where has this guy been the last 50 years. Of course, people make money selling things, and financial instruments are no different.

When I sit in pitches from investment advisors promoting their fund, or whatever their financial instrument may be the first question that nearly always comes up from the audience is how much the fees and commissions are. Of course, this number ranges from a fraction of a percent for mutual funds to double-digit percentages in private equity.

After reading the post, I began to wonder about the cost of angel investing.

Where are the fees?

In a member-managed group such as the Central Texas Angel Network, there is a membership fee to belong to the group, but the members review the deals, perform the due diligence and ultimately decide what to invest in.

The main cost comes in three areas, and while those costs aren't paid directly by the angel investor, the business pays them, and ultimately the angel investor takes a reduced return based on those costs. An experienced angel should ask about the costs.

The **first cost** is the management salaries. Management salaries are kept low in the early days of a company to give the business every chance of succeeding. I was recently in a deal in which the members asked about the CEO's salary. He replied it was $300K/year. You could feel the air leaking out of the room after he said that. While he was an active manager, there was no way the business was going to survive paying salaries like that.

The **second cost** is that of consultants whether they are on the board or as advisors. It’s fair to ask who is getting paid and how much for the work they are providing. There are good consultants out there, but I’m often amazed by how vague their duties are. Often, I hear things such as “they are going to help us.” There’s no job description, no metrics, no deadlines and it’s all very nebulous.

The **third cost** and what I consider the most important is the angel investor’s time. If the deal requires a day a month or worse a day each week, then the deal must be spectacular to make it worthwhile. The angel investor should figure out up front what value he can add and if the business runs into trouble who is going to help them. The angel investor’s time becomes a critical factor in calculating the cost of angel investing.

The Benefits of an Open Angel Group Model

During a Texas Entrepreneur Network Funding Forum in Austin, I saw the benefits of an open angel group model in action. From the event, five of the presenters received interest, and three are in discussions to receive funding. The event brought over fifty people into the room— some were investors who expressed interest in the deals, but most were entrepreneurs watching the pitches and listening to the panelists' questions. This provides mentorship to those who are considering raising funding. In talking with several entrepreneurs afterward, some expressed interest in joining the next round while others spoke about the work they need to do in advance of pitching.

To be successful in the Funding Forum, you need to have a:

1. Solid product with some differentiation
2. Clear and focused target market
3. Competent management team
4. Some proof that the product will sell

Also, investors interested in pursuing startup investing find the Funding Forum educational as one learns the most from listening to the questions the other investors ask.

Do Angel Investors Ever Have Down Rounds?

I met an investor contact recently who happened to be a venture capitalist. At the start of the discussion he posed the question:

Do angel investors ever have down rounds?

A **“down round”** is an investment of capital at a value below the previous fundraise. In thinking back over the last five years, I had to admit I hadn’t seen a down round in that time. In fact, I haven’t heard of anyone even suggesting such a thing.

There are several reasons for this. Previous investors don’t want to see any dilution. Entrepreneurs don’t want to admit they didn’t hit their milestones. Valuations at this stage are based on negotiations more than facts.

He went on to say that as a VC he sees quite a few deals coming to him that have $3M to $5M in revenue, but their valuation is at $60M. $60M? After numerous angel rounds, all at increasing valuations, they pushed the valuation out of the stratosphere.

So, what can the VC do with this deal?

Nothing.

There’s no way they can fund it at that valuation. The entrepreneur operated under the false assumption that eventually the company would catch up to that valuation. But sadly, no.

My question to entrepreneurs is:

Do you know what the value of your company is, and do you know what it would take to raise the value of your company?

What Angel Groups Can Learn from Crowdfunding

I came from the world of angel group investing and now run a crowdfunding portal. As the first director of the Central Texas Angel Network, I helped build the groups programs and processes. Today, I run a crowdfunding portal that focuses on Texas deals and now view the angel group process as one under siege. The number of deals and the increasing virtualization of the membership requires angel groups to move online or at least some portions of the investment process.

Angel groups have used Angelsoft/Gust and Proseeder, but those tools are built as repositories of information and not promoters of deals or membership. They work well for due diligence as they can store and share critical documents throughout due diligence, but in general, they are rarely used for the rest of the investment process because they require the user to log in and search for deals proactively.

Crowdfunding teaches us to place the deal in a mailer and send it out to the investors so when they open it up, the deal is staring them in the face with only a few choices such as **"Invest"** or **"Pass."** The email that shows up in their inbox is something they must react to in some manner. In today's work world, if you don't make it easy for users to interact with your system, they will bail out on you and your program.

The traditional angel world sees the angel meeting as the core of the program. People coming together is how investors and entrepreneurs exchange information. In crowdfunding, the web portal is the core of the program and is where people come together to find deals, share information, and interact with each other. In most crowdfunding deals, the investor ultimately wants to meet with the team, and that's the benefit of the angel group process. Its strength is the face-to-face engagement between the investor and the entrepreneur. Its weakness is the rest of the process: screening, monitoring, researching, and closing the deal as well as the ongoing post-investment follow up. Combining the angel group's face-to-face format and camaraderie with the efficiency of online funding tools for screening, monitoring, and closing the deal makes for a strong partnership.

Angel groups can improve their process by drawing technologies and formats from crowdfunding as they move into an online world.

Screening

This needs to shift online and in particular to well-formatted mailers through which members can view and vote on deals. Instead of slogging through fifty deals in one sitting, the submitted deals could be sent out 1 or 2 a day to the members to see which ones capture interest. By the end of the month, the top vote generators move to the next stage of the process.

Presentation

This part can be done in person and provides the high touch interaction which is always vital to closing the deal. Angels want to meet the team and share experience and the entrepreneur wants to know whom they are pitching to.

Monitoring

This is another key step where crowdfunding can help the current angel group process. Regular updates from the entrepreneur can be distributed and then archived with previous updates so people can see the historical progress of the deal. This works well for deals that are interesting but not ready for prime time.

Due Diligence

The online tools for researching the deals increases every day. Online databases, comparisons to competitors and other tools are available to help investors decide which deals to pursue.

Closing

Most angel deals are still papered the traditional way with hard copy papers. Crowdfunding brings online tools for completing the transaction without having to sign physical documents but rather using electronic signatures instead.

Deal Syndication

This is where crowdfunding really shines. It gives the angel group the ability to take a funded deal and pass it to another group or "crowd" of investors. A strong syndication network raises the value of the angel group as it can bring more dollars to the table and thus attract better deals.

In summary, crowdfunding brings online tools that make the angel funding process more efficient and effective. It can save the angel investors time as well as manage the increasing deal flow.

5 Signs you Invested in the Right Startup

Several signs indicate the investor invested in the right startup and these are my top five.

The startup is:

1. Focused on core products and processes— you see a strong focus on the core product/service, and everyone is pushing in the same direction.

2. Revenue and results— you see the team focused on revenue and solid results and not secondary metrics such as likes on Facebook or user downloads.

3. Customer focused— you see the team more worried about what their customers think than what their competitors think.

4. Numbers— the leadership knows their numbers well including sales, cash spend, and runway.

5. Updates and information— you receive updates and news that includes bad news as well as good news.

About TEN Capital

TEN Capital Group provides funding as a service to companies anywhere raising venture capital. Its network of over 5000 accredited investors represents venture capital, angels, family offices, and high networth individuals.

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