

**DR. TOM MCKASKILL**

# **An Introduction to Angel Investing**

*A GUIDE TO INVESTING  
IN EARLY STAGE  
ENTREPRENEURIAL  
VENTURES*

Angels invest to have fun, for the challenge, to get involved in doing deals and to give back but they only invest where they see a high potential return on their money.



Angels invest where they see passion, commitment and outstanding people.



The Angels bring funds, wisdom, mentoring and strategic input to the venture.



The investment evaluation takes a holistic view of the business. Every facet of the business model is important. It is not sufficient to just have a great product or service.



Angels look for venture potential and rarely invest where they can't add value beyond their money.



Angels are active investors working alongside the entrepreneur and the management team to make the venture successful.



While luck always plays a part in any success story, a comprehensive and systematic evaluation by the Angel of the investment proposal will greatly improve the probability of success.

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“Amongst the spectacular successes, the Angel investing community is littered with corpses of those that have fallen victim to some very basic and preventable mistakes. This book provides the essential basic groundwork for anyone contemplating investing in the exciting world of Angel investing.”

– *John Mactaggart, Chairman Australian Association of Angel Investors*

“Tom newest book is another in his impressive list of publications for angel investors and entrepreneurs. He summarizes what it means to be an angel, how to get started and how to succeed. I recommend it to anyone who wants to learn more about angel investing.”

– *Basil Peters, Angel Investor, Fund Manager for Fundamental Technologies// author of ‘Early Exits – Exit Strategies for Entrepreneurs and Angel Investors (But Maybe Not Venture Capitalists)’*

“Anyone considering Angel investment should read this book. Tom makes it clear what he sees as the role for Angel investors in the early-stage ecosystem and offers a pragmatic process which Angels can use to source deals, evaluate, negotiate and manage their investments through to a healthy exit.”

– *Jordan Green, Founder/Chairman Melbourne Angels, Co-Founder/Deputy Chairman Australian Association of Angel Investors Limited*

“An Introduction to Angel Investing by Tom McKaskill is a must read for any successful entrepreneur wishing to stay actively involved with early stage ventures. Tom provides a solid foundation from which to understand the process of Angel Investing. He clearly shows how an investor can make a positive difference to the success of an emerging business through an active mentoring and coaching role while at the same time achieving a good return from their investment portfolio. “

– *Andrew Loch, Chair Gold Coast Angels, Angel Investor & CEO of the Gold Coast Innovation Centre*

“Tom’s latest book on Angel investing provides a thorough overview of the topic with some valuable personal stories. I tested the Angel investing Indices on a business that is currently looking for Angel capital. The Founding Board found it to be an invaluable tool for bringing together the different perspectives sitting around the boardroom.”

– *Dean Prebble, Entrepreneur and former Director, New Zealand Centre for Entrepreneurship, Unitec New Zealand*

“Having been involved in reasonably large growth business, government boards and a university business school, I am always on the lookout for practical, easy to read and well presented publications that focus on the direct issues that I need to comprehend. Tom McKasill’s book on Angel investing is a must read for both potential Angels, VC’s and those that are interested in securing an Angel, because it details a step by step approach to understanding the mindsets of the key stakeholders in the field and the basic requirements that need to be considered in the process of Angel investing.

I found the book delivered a refreshingly practical approach to the key issues and kept me focusing on reading further on, without being distracted by an inordinate volume of footnotes. The book sits as a reference book for me in my work and I suggest it should for most accountants, lawyers and those in the financial industry involved in VC and Angel investing. The material is comprehensive and well presented in sufficient detail to enable the VC seekers and Angels to have a full understanding of the matters to be considered in the pre, during and post relationship.”

– *Alan Wein LL.B, Entrepreneur, Mediator & Business Commentator*

“This book is a must read for anyone contemplating venturing out into the exciting world of Angel investing. The world of Angels has many success stories and is also littered with spectacular failures. The book points you to the keys to success and the homework that is required to be done before you actually commit the money.”

– *Baboo Jeena, Executive Chairman, Jeena Partners, Financial Services*

“This book is a must read for any Angel looking to venture into the lucrative ‘Venture Capital Industry’.”

– *Ivan Kaye, CEO BSI*

“This could be considered as ‘the’ book on Angel investing. For both the Angel investor and entrepreneur looking for an Angel, this book gives an up-to-date commentary on the state of Angel and other new venture funding.”

– *Tony Falkenstein, Entrepreneur*

“Angel investing can be exciting, challenging, lucrative – and daunting. Dr. McKaskill’s book provides the ideal introduction to the ins and outs of private venture investment for entrepreneurs and investors. Packed full of practical hints, it’s the one book that provides a solid grounding on how to make your investment work.

Plenty is known about how venture capital investors work, but not enough information is around to help start-up business Angels who want to invest their own funds in entrepreneurial projects. At last we have one book that gives the reader almost all the answers they need. If you’re planning to enter the Angel investment arena, don’t start until you’ve read this book.”

– *Dr Michael Schaper, Former Professor of Entrepreneurship*

“Easy to read, practical, hands-on, full of useful information and data, and a good resource for both Angel investors and those who may be seeking funds from them. Particularly valuable is the included Awareness and Alignment Index – an easy to use tool for assessing new ventures, suitable to both investors and investee companies and entrepreneurs. Highly recommended.”

– *Adolph M. Hanich, Chairman, Telematics Fund and the first Chairman of the Global Entrepreneurship Research Association*

## Dr. Tom McKaskill



**G**lobal serial entrepreneur, consultant, educator and author, Dr. McKaskill has established a reputation for providing insights into how entrepreneurs start, develop and harvest their ventures. Acknowledged as the world's leading authority on exit strategies for high growth enterprises, Dr. McKaskill provides both real world experience with a professional educator's talent for explaining complex management problems that confront entrepreneurs. His talent for teaching executives and his pragmatic approach to management education has gained him a reputation as a popular speaker at conferences, workshops and seminars. His approaches to building sustainable, profitable ventures and to selling businesses at a significant premium, has gained him considerable respect within the entrepreneurial community.

Upon completing his doctorate at London Business School, Dr. McKaskill worked as a management consultant, later co-founding Pioneer Computer Systems in Northampton, UK. After being its President for 13 years, it was sold to Ross Systems Inc. During his tenure at Pioneer, the company grew from 3 to 160 people with offices in England, New Zealand and USA, raised venture capital, undertook two acquisitions and acquired over 2,000 customers. Following the sale of Pioneer to Ross Systems, Dr. McKaskill stayed with Ross for three years and then left to form another company, Distinction Software Inc. In 1997 Atlanta based Distinction raised \$US 2 million in venture capital and after five years, with a staff of 30, a subsidiary in New Zealand and distributors in five countries, was sold to Peoplesoft Inc. In 1994 Dr. McKaskill started a consulting business in Kansas which was successfully sold in the following year.

After a year as visiting Professor of International Business at Georgia State University, Dr. McKaskill was appointed Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship (AGSE) in June 2001. Professor McKaskill was the Academic Director of the Master of Entrepreneurship and Innovation program at AGSE for the following 5 years. In 2006 Dr. McKaskill was

appointed the Richard Pratt Chair in Entrepreneurship at AGSE. Dr. McKaskill retired from Swinburne University in February 2008.

Dr. McKaskill is the author of eight books for entrepreneurs covering such topics as new venture growth, raising venture capital, selling a business, acquisitions strategy and angel investing. He conducts workshops and seminars on these topics for entrepreneurs around the world. He has conducted workshops and seminars for educational institutions, associations, private firms and public corporations, including KPMG, St George Bank, AMP, AICD and PWC. Dr. McKaskill is a successful columnist and writer for popular business magazines and entrepreneur portals.

To assist Angel and Venture Capital investors create strategic exits for their investee firms, Dr. McKaskill conducts seminars, workshops and individual strategy sessions for the investor and their investee management teams.

Dr. McKaskill completed three e-books for worldwide, royalty free distribution. He has also produced over 150 YouTube videos to assist entrepreneurs develop and exit their ventures.

Tom McKaskill is a member of the Apollo 13 Angel Group on the Gold Coast and of the Australian Association of Angel Investors.

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June 2009

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## **The Ultimate Deal 1**

*Selling your business*

This book is aimed at those businesses which need to maximise their profit and growth opportunities in a sale to a financial buyer to leverage the best sales price. It sets out a breakthrough process which includes reducing risk, improving sustainable profits and building growth potential in the business to maximise the sales price. This world first process can increase the value of the business between two and ten times the conventional sales value of a firm.



## **The Ultimate Deal 2**

*Get an unbelievable price*

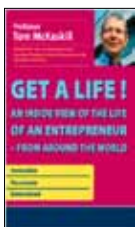
This book uncovers the secret of how to leverage strategic value in the business to create a large revenue opportunity for a strategic buyer. Dr. McKaskill's is the world's leading authority on selling a business to a strategic buyer and sets out a comprehensive and systematic process for selling a business to a large corporation. Sales values of 40 times EBIT and/or many times revenue are highly probable using his Strategic Sale Strategy for a business with underlying strategic assets or capabilities.



## **Angel Investing**

*Wealth creation through investments in entrepreneurial ventures*

Designed to help high net worth individuals become successful Angel Investors. Angel investing involves active mentoring and coaching of an early stage management team towards sustainable profitability or additional funding, probably from a venture capital firm. This book sets out a comprehensive and rigorous process that will help the Angel generate deal flow, evaluate investment proposals and manage the investment and subsequent harvest. The book also provides a useful guide to managing operational risks in the venture.



## **Get A Life!**

*An inside view of the life of an entrepreneur - from around the world*

This book is a collection of stories from entrepreneurs around the world where they describe their work and their lives. They explain what it is like to be an entrepreneur, how they got started, the successes and failures of their ventures and the highs and lows of their personal and business lives. The stories are rich in content and provide deep insights into how entrepreneurs think. If you are an entrepreneur this will resonate with your inner being. If you are not, this will provide you with a great understanding of entrepreneurs.





## **Finding the Money**    *How to raise venture capital*

The purpose of this book is to educate the entrepreneur on how Venture Capital firms work, what they seek in an investment and how they manage that investment through to an exit transaction. It helps the entrepreneur judge whether they have a venture suitable for VC investment and whether they wish to be part of such an activity. It lays out a comprehensive process that the entrepreneur can follow which will assist them in raising VC funding.



## **Winning Ventures**    *14 principals of high growth businesses*

Explains the major contributors to high growth success. Includes a comprehensive Growth Check list for each principle as well as a robust Growth Potential Index to help the reader judge the growth potential of their venture. Based on established theories of growth, venture capital selection criteria and the author's personal experience, this is a must for entrepreneurs.



## **Masterclass for Entrepreneurs**

*Creative solutions for resilience, growth and profitability*

This book is a collection of published articles by Dr. Tom McKaskill. This volume expands on 30 of those articles to provide a wide-ranging guide for entrepreneurs on how they can manage their businesses more effectively.



## **Fast Forward**

*Acquisition strategies for entrepreneurs*

In this book, Dr. McKaskill sets out a systematic and pragmatic process for identifying, evaluating, valuing and integrating financial and strategic acquisitions. He draws extensively on his own experiences as a CPA, entrepreneur and academic, as well as his experience with acquiring and selling his own businesses. He brings a systematic and comprehensive approach to growing business through acquisitions.



## **Raising Angel & Venture Capital Finance**

*An entrepreneur's guide to securing venture finance*

This book is aimed at those entrepreneurs who have high growth potential ventures and seek to raise finance to assist them to develop their business. To secure the finance, the entrepreneur will have to demonstrate that their business is capable of achieving a premium on exit, usually through a strategic sale. The book provides a checklist for the entrepreneur to assist in developing a strategy to raise finance.



## **An Introduction to Angel Investing**

*A guide to investing in early stage entrepreneurial ventures*

Designed to help high net worth individuals become successful Angel Investors. Angel investing involves active mentoring and coaching of an early stage management team towards sustainable profitability or additional funding, probably from a venture capital firm. This book sets out a comprehensive and rigorous process which will help the Angel generate deal flow, evaluate investment proposals and manage the investment and subsequent harvest. The book also provides a useful guide to managing operational risks in the venture.



## **Invest to Exit**

*A pragmatic strategy for Angel and Venture Capital investors*

Investors in early stage ventures need to focus on strategic exits if they are to achieve a high return on their investments. This book explains the characteristics of strategic value, how the investor should negotiate the investment and then how they should manage the process to a strategic trade sale. The book includes a very detailed discussion on the problems of high growth ventures, the unrealistic expectations associated with IPOs and the advantages of investing in strategic value ventures.

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## Preface

I am totally convinced that I would never have survived in my very first venture had it not been for the support of a group of Angel investors who provided both funds and active support to the business.

At the time, 1979, I had just completed a Doctorate at the London Business School and my (then) wife and I decided to start a software development business in England rather than return to Australia. We did not even think that it would be another 13 years before we would leave England. The business was started in our dining room in North London with a colleague, Graham Menzies, from the corporation that I was working for, a large computer software consulting firm. We decided we would ride the wave of the newly developed personal computer. Our objective was to provide manufacturing systems for smaller firms.

My wife started working full-time in the new venture, while Graham and I continued working in our existing jobs until the business had the funds for us to join the new venture. We all invested funds to start the business, however, we soon recognised that we did not have enough to finance the equipment and salaries to develop our first software product.

During the previous year we had made friends with some of the Directors of James Burrough PLC, the distillers of Beefeater Gin. We approached them for a corporate investment. While they were interested they stated quite candidly that 'they would have a better chance betting on the horses'. However, several of them made a personal investment of between several hundred and a few thousand pounds. In all, they invested around five thousand pounds sterling and ended up owning about 25% of the business. Several of them were extremely wealthy and I am sure they spent more on a good night out than what they put into our business, but we felt very privileged and never forgot our obligation to them. As a group, they decided that their CFO, Jim Sanger, one of the larger contributors, would serve on our Board and act as their representative. Thus began a 13-year relationship.

It quickly became obvious that none of us understood the first thing about managing a start-up, working with external Directors or even how to manage

ourselves. Even though all three of us had accounting qualifications and my wife Anne and I both had business degrees, these were of little use in the day-to-day operations of the firm. This is where our Angel Director made his greatest contribution.

From the very first meeting, Jim Sanger set an expectation for the information that should be provided to him at monthly updates and at Board meetings. He acted as our Chairman of Directors and personally prepared the Board minutes for the first few years of the business. These notes were sent to the other shareholders to keep them up to date. His major contribution in those early meetings was to specify exactly how the financial and other performance information was to be prepared and annotated. At the Board meetings he would insist on a list of priorities and an action plan for each of us. The ‘worst case cash report’ that he requested became the most important document over the life of the business and probably saved us from insolvency several times. I have described this later in the book.

Jim had considerable senior executive business experience. He was a qualified accountant, a Harvard MBA and had undertaken a number of M&A transactions. He had a lot of business wisdom – been there and done it. His questions were penetrating and he did not suffer fools. He expected us to put our heads down and work hard and to run a highly ethical and fair business. In many ways he established our value system, although I would hope that he would say that he simply articulated the values that we already had.

Naturally as the business became bigger, it became more complex and the way we had to manage its diverse activities became more sophisticated and formal. Within five years, we had 34 employees in England and a few distributors around the world. In 1985 we acquired one of our software suppliers in San Diego and our numbers jumped to 90 employees. James Burroughs PLC put up US\$1.5 million as a private equity (VC) investment acquiring 20% of the new entity in order to enable us to make the acquisition. What was a friendly, somewhat informal arrangement now became a serious investment to be managed by Jim as the CFO of James Burroughs.

A few years into the new arrangement, James Burroughs PLC was acquired by Whitbread PLC. A Whitbread Director was appointed to our Board to represent their interest, Jim stayed on in a private capacity to represent the original Angels. Shortly after the business suffered serious problems and the value of their investment collapsed. We were in litigation with our USA auditors and the prior owners of the business we acquired in San Diego. This distracted us from our day-to-day operations, split the loyalty of the US employees and we lost some key staff. During this period, we negotiated to buy back the Whitbread shares for US\$40,000 and used this opportunity to allow newer senior management to buy into the business and to acquire a distributor in London.

By 1990 the business was again profitable and growing and had 160 employees. In 1991 we sold the business to a recently listed USA corporation for US\$9.6 million. The Angels achieved more than 200 times their original investment.

Six years later and another venture, this time in supply chain optimisation, we had again raised venture capital, US\$2 million for 20% of the business. The VC firm placed a Director on our Board but this time he added little and, in fact, was a decided nuisance because he really did not understand our business. We had become much more sophisticated in our approach to managing the business and had started out, day one, with comprehensive performance monitoring and reporting systems. I found the contrast between the two external Directors very revealing about how good Jim had been and how much he had contributed to our business growth and development. This subsequent venture was eventually sold in 1999 to PeopleSoft for six times revenue, yielding a return to the founders of 30 times their investment over the five-year period from start-up. The VC achieved a positive return on the investment.

On returning to Australia in 2001, I took up the position of Professor of Entrepreneurship and Academic Director of the Master of Entrepreneurship and Innovation program at the Australian Graduate School of Entrepreneurship. In this role I had time to reflect on my experiences as an entrepreneur and had the time and inclination to document the lessons I learned during those 20 years in growth ventures. A few years later, I developed and documented two breakthrough processes for selling a business, one based on an EBIT multiple designed for a sale to a financial buyer and the other, for selling to a strategic buyer (The Ultimate

Deal 1 and The Ultimate Deal 2, Wilkinson Publishing, 2006). The research into these two topics has resulted in interviewing many entrepreneurs, Angels and venture capitalists.

My work preparing entrepreneurs to be ‘investor ready’ has shown me just how poorly the process is understood by them and as a result I completed a book on raising venture capital (Finding the Money, Wilkinson Publishing, 2006). It was while I was completing that book that I recognised just how applicable much of the process was to Angel investing. I spent time with Angel forums and business advisory firms which work closely with Angel investors to understand more about their involvement with entrepreneurs. My book ‘Angel Investing’ (Wilkinson Publishing, 2006) was the result.

Angels play a vital role in start-up and early stage businesses, not just in the funding of them, but in the mentoring and strategic input they provide. Many of them are primarily driven by the excitement of getting involved with early stage ventures, helping to do deals and sharing their knowledge. However, they will only invest where they see a significant potential return on their investment. I hope this book will help them have fun and yet accumulate personal wealth.

I retired from AGSE early in 2008 and now have more time to devote to my work with Angel investors. I am now a member of the Apollo 13 Angel Group on the Gold Coast and of the Australian Association of Angel Investors.

I hope you find this book of great value and look forward to receiving your feedback on its implementation. If you have an interest in Angel investing, you should also read my e-book “Invest to Exit”.

Dr. Tom McKaskill



## Acknowledgements

A very large number of people have contributed to my knowledge of this topic. Hundreds of entrepreneurs who have been through my classes and workshops, Angels who have attended my training sessions and discussed their investee firms with me and VC executives with whom I have worked with on exit strategies for their investee firms. Each conversation, question and problem has helped me refine my approach to investing and exits. A special thanks is extended to Basil Peters for his detailed comments and feedback on the draft.

My life partner, Katalin Johnson, has been with me every step of the way, participated in the seminars, workshops and most of the conversations. She has assisted me greatly by asking the hard questions, reviewing the material and making her own contribution to the content.

# **PART A**

## **Angel Investing**

# 1 Business Angels Make a Difference

**T**his book is for Angels and potential Angels to help them be more successful at investing in early stage entrepreneurial ventures. Angels are the unsung heroes of emerging company successes. These are the individuals who stand on the sidelines coaching the entrepreneurial team, offering advice, support and finance to help the new firm survive the turbulent months and years that it takes to reach critical mass, profitability and sustainability. This is a time of considerable uncertainty as the management team learns to work together, products are developed and new markets are penetrated. Not every venture will be successful and perhaps this is the greatest contribution of our Angels, enabling early stage ventures to have a go where risks are relatively high and few investors are prepared to back them.

Entrepreneurs may also find advice and comfort in these pages. While the book is written primarily for the Angel investor, the content will shed light on how Angels work and what they look for in an investment. Armed with this information, the entrepreneur should be more able to assess whether Angel investment would suit his or her venture and

should be able to construct a more compelling investment proposal based on the investment criteria set out in this book.

Angel investing is about passion. Angels get involved mainly because they enjoy helping early stage businesses, mentoring young entrepreneurs and participating in the development of an emerging business. When you enter the world of the Angel investor you will be stepping into a micro-world of investors, advisors, venture capitalists, banks, accountants, lawyers, universities and entrepreneurs all networked together in a somewhat hidden economy. It is a world rich with stories of great successes and unfortunate failures but it is also a world of creative ideas, wonderful business adventures and very interesting people.

Historically, Angel investors have been high net-worth individuals who have privately invested in new start-up firms or in the early formative stage of emerging ventures with little publicity of their involvement. They typically kept quiet about their wealth and discretely searched for deals to invest in. Angels were very wealthy individuals who invested widely across many ventures.

Today the situation is somewhat different. Over the past 50 years the number of Angels has greatly increased. Some of this increase has come from greater spending power in the established professions; much has come from cashed up entrepreneurs from the explosive growth in high-tech industries and some from golden handshakes of senior executives retiring or being made redundant. This wave of potential, but mostly naïve, Angels resulted in a large number of poor investments, especially during the dot com boom. However, over the past few years the situation has changed markedly. Today, most Angels are linked either formally or informally to networks of Angels. This has come about because of the need to band together to share deal investigations, the time required to undertake due diligence and the costs of administration and professional accounting and legal services associated with investments.

Angels still remain somewhat private about their activities, often using an Angel Network, Angel Group or Angel Fund to shield their identities. Often they will work through advisors or local professional service providers and only become involved when a potential deal has been thoroughly checked by a known colleague. This lack of public exposure has its advantages for the Angels

but unfortunately it also means that little is known about them. What we do know comes mainly from a few university research centres in the USA and Scotland. As well, there are some interesting studies from many countries, with most coming from the USA, UK, Canada, Australia, Singapore, Ireland, Sweden and New Zealand. Taken together, they provide a picture of Angel investing and the issues which Angels need to deal with in their role as investors in early stage ventures.

Both Angels and venture capital funds invest in private firms through what is termed 'private equity', often referred to as 'patient money'. It is called patient money because investments in private companies are usually quite illiquid and the private equity investor has to wait for a liquidity event, typically a trade sale or an initial public offering (IPO), to harvest their money. While both parties participate in similar investments, although often at different stages in the venture growth, the venture capital sector is better organised, far more rigorous in approach and much more standardised in the conditions under which it invests. It is this lack of rigor and deal screening sophistication which has been the most serious deficiency of the Angel sector.

Many Angels have invested with friends, colleagues or casual acquaintances. Often they have failed to structure the deal professionally or used the services of a knowledgeable accountant and lawyer familiar with private equity investments. Sometimes, through lack of knowledge, they have been too generous and this has resulted in the entrepreneur having unrealistic expectations in the next round of funding. Alternatively, they have been too harsh, leaving the entrepreneur with too little equity at the next round of funding. Entrepreneurs who don't have enough incentive simply won't put in the effort required to make the venture successful.

Angels who have involved themselves in Angel Networks have been able to tap into a greater knowledge bank, advice on deal valuation and deal structure, shared resources to undertake due diligence and shared costs for services. Many Angel Networks provide members with standardised evaluation checklists, term sheet templates and standardised investment agreements. Many deals are now syndicated, allowing Angels to participate in larger deals and to spread their risks across more ventures. Where several Angels invest together, active management of the venture can be shared and the venture team can gain

access to a wide range of knowledge and experience from the Angel Network members.

Details and contact information for many Angel Networks are available through directories, Angel listings and their own websites. More and more Angel groups are now working like VC funds and have well-defined processes for deal sourcing, deal evaluation and investment.

However, this is only part of the story. Entrepreneurs seeking Angel investment will still need to do a lot of legwork. Not all Angels belong to an Angel Network and many are not active even if they do belong. Most Angels still source the majority of their deals from outside the Network through personal contacts and local professional service providers. Angels typically only take on investments where they have some prior knowledge of the industry, therefore not every Angel is going to be a potential investor.

However, there are many Angels. Estimates in the USA suggest that about 400,000 individuals are active Angels. Others estimate that about 1% of the adult populations of most western countries are potential Angels. Most active Angels invest from US\$25,000 to US\$100,000 per year in two or three deals and it has been estimated that the value of Angel investments in the USA is five times that of the venture capital sector. Estimates in the UK and Australia are a lower multiple; however, this still equates to a very large pool of early stage venture funding.

Angels generally invest across a wide range of investment categories of which private equity represents, on average, only a few per cent of their total portfolio. They typically invest within an hour's journey of their residence and usually only for a period of 3-7 years before exiting the investment, or the venture failing. Rates of return on Angel investments vary depending on the year of the calculation and the period over which the returns are estimated. Some speculate that the returns are similar to the VC sector, others that the returns are higher due to the greater risks of earlier stages. In achieving their returns, their lack of sophistication in investing is balanced by the commercial knowledge which they provide to their investee firms.

What is clear from the anecdotal evidence is that active Angel investing requires money, time and business acumen. While anyone with significant money to invest can become involved, those without extensive industry or general business knowledge are less active but can still contribute to the venture in other ways, for example through network contacts. These individuals are probably less exposed, acting as passive investors, or investing through an Angel Network or Angel Fund, where they can work with more experienced active Angels. Even then, knowledge of the investment process will help passive Angels avoid the most obvious risks.

Venture capital firms typically invest in only 1% of the deals they evaluate which means that they need to evaluate hundreds of possible deals before they find the few in which they will invest. Angels on the other hand, typically invest in one to three per year and about 30% of the deals they investigate. This higher rate of commitment may be because the ventures themselves are smaller and less complex to review and also because the Angel does not have to justify the decision to invest to any external party. Even so, this is a significant workload for the Angel working alone.

You can now see the advantages of Networks and shared costs. By pooling resources, Angels can screen a much larger number of deals, isolate those which have the greatest potential and then possibly co-invest to spread risks. You can also see the advantage of tapping into specific sector expertise for evaluations with the associated efficiency in time and costs which should result. Certainly, benefiting from the experience of older and wiser investors should help avoid common traps and result in better investment agreements for both the Angel and the entrepreneur.

Angels typically complain about a lack of deal flow. What this usually means is that they have a lack of exposure to the type of deals in which they personally wish to invest. While there is a general acknowledgement of a shortage of good deals overall, when you impose a requirement for a specific industry sector, investment stage and amount on a possible deal, the potential acceptable ones are going to be few. Thus, key to an active Angel activity is generating enough suitable deal flow. Since few Angels are lucky enough to have deals chasing them, setting up a network to source possible deals is a critical part of the investment process.

Even experienced venture capital investors will admit they have often invested in ventures which excited them and consequently failed to do adequate, objective due diligence. On balance, these proved to be the least successful of their investments. A rigorous screening process is an essential tool for any Angel. This in itself won't guarantee that a venture will be successful, but at least it should weed out those with major flaws.

Just because an Angel has a background of a successful corporate career does not of itself mean they will be successful assisting an entrepreneurial team to build and harvest a venture. Many corporate executives spend their careers in a specialisation and have deep knowledge of only one part of the business activity. A similar reservation can be placed on an experienced entrepreneur. Success in one venture can blind the entrepreneur to any other way of building a business and what worked at one time and place, may be inappropriate for a business in a different sector or at a different time. The more successful Angels acknowledge their limitations and biases and seek advice and work with others to ensure due process is followed.

Passive Angels should educate themselves on venture screening, due diligence processes and investment agreements and then work with professional advisors to ensure they undertake investments with appropriate terms and conditions which suit their background and involvement. If they don't have the time or experience to manage the investments themselves, they are better to work in Networks or with Angel Funds where they can gain access to individuals who can provide operational and strategic assistance to the investee firm. Those who have the time and energy to be more active should take their time to find the right investments which suit both their risk tolerance and industry background, but also be sensitive to the level and type of contribution they wish to make. They may prefer working alone and sourcing their own deals, but should still take time to investigate local Angel Networks to see what they might offer.

In the end, it all comes down to personal objectives. Most Angels enjoy helping emerging firms and gain personal satisfaction from an active involvement in an emerging venture, but they also like to see an adequate return for their investment.



This book is divided into two parts. Part A provides a background to Angel investing and explains the way in which Angels (should) work, generate deal flow, evaluate opportunities and manage their investments. Part B is a set of specific Indices for measuring the level of attainment or quality of several components of the Angel's investment. The first, Awareness and Alignment, identifies the level of understanding and commitment the prospect investee firm has with regard to Angel investment. The second, Venture Potential, measures the quality of the investment proposal and can be used by the Angel to screen potential investments. The last, Operations Management, is a method by which the Angel can identify the level of change and development needed inside the investee firm to prepare it for the next round of investment, an IPO or trade sale or for sustainable, profitable growth.

## [ 2 ] An Angel Profile

**B**usiness Angel investors, often simply referred to as 'Angels' are high net-worth, non-institutional, private equity investors who have the desire and sufficiently high net worth to enable them to invest part of their assets in high-risk, high-return entrepreneurial ventures in return for a share of voting, income and ultimately, capital gain.

Angel investment is normally the first round of external independent investment. Angels normally invest in early stage ventures where the founding team has exhausted their personal savings and sources of funding from family and friends. These ventures are not sufficiently developed to stand on their own, or sufficiently attractive to gain venture capital funding. These ventures exist in a halfway state, often between possible failure and take-off. Typically the management team lacks experience in a growth venture and the business needs not only the additional funding, but also mentoring to take it to the next stage of development.

Investing in early stage private companies has many drawbacks, which is why this form of investment is typically undertaken by individuals who can afford to lose the money

and/or are willing to wait some years before they see a return on their money.

To put this into context, private early stage ventures have the following attributes:

- The shares are not freely traded and no established market exists for them. An investor is forced to wait for a liquidity event such as a trade sale or a public listing.
- Novel business concepts and inventions are often associated with emerging and untried markets. The risks in the venture are likely to be higher and some aspects of the business subject to high levels of uncertainty.
- Products may be new and/or under development and still subject to technical and market risks.
- The knowledge of the product and its design may be highly dependent on a small number of key staff, who may not necessarily have proven business experience.
- The small size of new ventures and their lack of presence in the market mean they may be highly susceptible to changes in market conditions. Timing may be critical to survival. Small delays in product release or in achieving revenue milestones may be sufficient to cause failure of the enterprise.
- There is limited access to further finance if the business encounters delays or undertakes operations which require additional funds.
- Early stage ventures typically have little collateral to pledge for loans.
- Early stage ventures often have a high cash burn rate as they have yet to reach a critical mass where they are self-funding.
- Funding for acquisitions or expansion can be limited.
- Valuations are problematic – if not speculative. Shares are not readily traded and so no public market value exists for the firm. Often there is little historical performance and future revenues and profits are uncertain.

- Minority shareholders have little power unless it is through an investment agreement. Even if they disagree with management actions, they have little power and can't sell their shares easily.

Angel investments are both risky and problematic. Since most new venture entrepreneurs lack the business experience to anticipate many of the problems they will encounter as the enterprise grows, the investment risk is generally seen as considerably higher than a public corporation.

Private equity is often termed 'patient capital'. This description derives from the fact that the shareholder is basically locked into the investment without having any direct means of selling out. The investor must wait until the business is sold or listed on a public stock exchange to have the opportunity of exiting. During this locked-in period, the investor is highly dependent on the business acumen of the management team and the Board of Directors. Since new ventures lack the resilience of larger corporations, not a lot has to go wrong for the venture to fail and for private investors to lose all, or most, of their investments.

Private equity investment is often referred to as 'investing in securities through a negotiated process'. Unlike purchasing shares in a public company, the investor in a private enterprise negotiates the terms and conditions under which the investment will be made. A defining characteristic of Angel investing is that it is a 'transformational, value-added, active investment strategy', in which the investor expects to have a hands-on approach to their investments, not possible in public company investments.

Entrepreneurs often seek out Angel investors to help them develop their business. Apart from the funding they bring, an Angel would be expected to contribute in one or more of the following ways:

- industry experience
- experience in start-up or business building
- networks
- experience in raising venture capital
- access to VC firms
- access to strategic partners.

There are different types of Angels. An Angel with direct experience in the firm's industry and with entrepreneurial experience can help with business development, recruitment, sales, strategy, contacts and so on. Their expertise and experience can be an invaluable help in developing the business. Often cashed-up entrepreneurs with start-up experience will invest back into new ventures. They can bring the experience of a successful venture through its growth stages. However, they may not have experience in the industry in which the firm operates. Wealthy and/or retired corporate executives often make investments in new ventures within their industry. They can assist with customer introductions, recruitment and risk assessment. However, many Angels are simply wealthy individuals with a desire to invest in the private sector and their only real contribution is finance.

The new venture entrepreneur may find Angel investment very useful as a bridge to VC finance. The Angel can provide much needed finance as well as assist in developing the business further to prove the business model.

One Canadian study showed that 57% of firms with Angel financing in Ottawa subsequently obtained VC funding.

*Source: <http://www.smartlink.net.au/events/2004/events2004.htm> (Allan Riding - Angel Investments)*

However, Scott A. Shane in his book 'Fools Gold?: the truth behind angel investing in the America' disputes this as a general relationship and indicates that the probability of follow on VC is significantly lower.

So what does the typical Angel look like? There have been a number of studies of Angels across several countries; however, because Angels typically stay out of the public eye and are often reticent to speak of their investing experience, data has been difficult to collect and therefore the samples have been relatively small. Even so, the findings are relatively consistent across several studies.

An overview of the Australian Angel investment environment is provided below:

### **Example**

'The private nature of Angel funding means that much information about activity in Australia is anecdotal.

It appears that most investors are worth upwards of A\$10 million, often have an entrepreneurial background and take stakes of between A\$250,000 and A\$4 million. Equity investment generally concerns small or medium sized enterprises (SMEs).

Some Angels also provide loan finance, independently or as part of packages from lending institutions.

Some government and industry studies suggest that the size of the local Angel market is 35% to 50% of VC investing, significantly lower than that of Canada, the US and UK where Angel investing is greater than the total of formal venture capital funding.

Investment criteria appear to be similar to those of VC funds (e.g. rate of return, cash flow, capital growth and time to exit). Most Angels, in contrast to VC fund managers, appear to be averse to publicity – one reason may be wariness about approaches by entrepreneurs – and limited requirements for public disclosure of investments means that information about the sector is problematic. They appear to be biased towards early stage and start-up enterprises rather than funding expansion capital or management buyouts.'

*Source: <http://www.caslon.com.au/ecapitalguide3.htm> Accessed 25/10/03*

The Center for Venture Research at the University of New Hampshire has created a profile of the 'typical (USA) Angel investor'. The predominant characteristics are:

- Angels tend to invest close to their home base, usually no further than a half-day's drive.
- Individual Angels rarely invest more than a few hundred thousand dollars in total.

- Angel investors tend to be older, wealthier and better educated than the average citizen, yet a large number are not millionaires.
- Angels anticipate an average annual return of 26% on their investments.
- Angels expect that up to one third of their investments will fail, resulting in significant capital losses.
- Angel investors reject seven out of every 10 deals that cross their desks.
- Deals are rejected for a variety of reasons, including poor growth potential, overpriced equity and inexperienced management team.

Source: [http://wsbe.unh.edu/cvr/cap\\_locator.cfm](http://wsbe.unh.edu/cvr/cap_locator.cfm) Accessed 21/01/06

In their book *Angel Capital*, Benjamin and Margulis describe the typical USA Angel as follows:

- 46-65 years of age, male
- postgraduate degree, often technical
- previous management experience, started up, operates or has sold a successful business
- invests between US\$25,000 and US\$1 million per transaction
- prefers participation with other financially sophisticated individuals
- strong preference for transactions which match with technical expertise
- 23% prefer to invest close to home
- maintains an active professional relationship with portfolio investments
- invests in one or two transactions per year
- diversification and tax shelter income are not the most important objectives
- term for holding investment is eight years
- looks for rates of return from 22% to 50%: minimum portfolio return 20%
- learns of investment opportunities primarily from friends and trusted associates; however, majority would like to look at more investment opportunities than present informal referral system permits
- income is US\$100,000 per year minimum
- self-made millionaire.

By contrast, a study by Professor Kevin Hindle and Robert Wenban of Australian Angels found that: there were two dominant groups – those with university education and those without, they were slightly younger than their American equivalents, invested less per transaction and were mostly ‘general managers’ or ‘people managers’ by background, although most had been involved in several start-up ventures. They typically invested 10-14% of their net worth in new ventures, although one quarter invested over 25% of their net worth. They were investing in about one third of proposals considered.

*Source: Kevin Hindle and Robert Wenban, 1999, Australia's informal venture capitalist: an exploratory profile, Venture Capital, p199, Vol. 1. No. 2*

The amount of net worth invested in private equity by Angels varies considerably and appears to be somewhat based on the total worth of the individual as well as their prior background. Estimates vary from 5-50% of net worth with the average differing across countries. For example, one German study reported the average to be 20%.

In a Scottish study, 38% of Angels had an SME background while 60% had no SME experience. Similar studies have been undertaken in Australia, Germany and Singapore. While the distribution of responses is not identical for each country, the results are not markedly different.

Motivation for investing varies slightly among the countries for which survey data is available. Benjamin and Margulis, in their book *Angel Capital*, provide the following reasons:

- improve self-image, self-esteem and recognition, ‘you never know how much you know until a small company turns to you’
- alleviate concerns – help others
- obligation to give back, the ‘joy of giving’
- get ‘first crack’ at next high-rise stock prior to IPO
- habit, addicted to high-risk ‘rush’
- fun and exciting
- ROI 30% minimum
- desire to take charge of the stock selection process more directly.



It may be that their sample has more hi-tech Silicon Valley entrepreneurs and is not representative of Angels in other countries. In contrast, Australian Angels appear to have a greater focus on the investment returns.

Data from Scotland shows similar reasons for becoming a Business Angel.

<b>Reason</b>	<b>Main reason number</b>	<b>Main reason %</b>	<b>Other reasons number</b>	<b>Other reasons %</b>
To give something back	11	7.9	49	35
For capital growth	64	45.7	46	32.9
For income	12	8.6	28	20
To create a full-time job for myself	8	5.7	13	9.3
For tax advantages	2	1.4	36	25.7
To give myself a part-time interest	18	12.9	55	39.3
Enjoyment and satisfaction	13	9.3	77	55.0
Other	4	2.9	4	2.9
Unidentified	8	5.75	–	–
Total	140	100	–	–

*Source: Stuart Paul, Geoff Whittam and Jim B Johnston, 2003, The operation of informal venture capital market in Scotland, Venture Capital, October, Vol. 5. No. 4*

Amounts invested by Angels tend to vary from country to country. Individual investments tend to be somewhat larger than where Angels act in a group to co-invest. The majority of Angel investments are co-investment situations.

Co-investments by Business Angels:

Co-investor	Investments in technology-based firms		Investments in non-technology based firms	
	No.	%	No.	%
None	5	10.6	24	29.6
Other Business Angels in the same syndicate	9	19.1	20	24.7
Other Business Angels who invested independently	11	23.4	16	19.8
Venture capital funds	6	12.8	7	8.6
Banks	1	2.1	8	9.9
Public sector	0	–	3	3.7
Multiple (Two or more of the above)	15	31.9	3	3.7
Total	47	100	81	100

*Source: Colin Mason and Richard T Harrison, 2004, Does investing in technology-based firms involve higher risk? An exploratory study of the performance of technology and non-technology investments by business angels, Venture Capital, October 2004, Vol. 6. No. 4*

Rates of investment compared to deals screened seem to be comparable across several western countries. A German study reported an investment rate of one or two out of every nine investigated. Investments take generally between 20 to 90 days from initial contact and involve, generally three to six negotiation sessions.

Research in the USA suggests that Angels invest in about 10 times the number of companies as the VC firms but the total amount of investment by dollar value is somewhat similar. The most recent estimate (2002) is 400,000 active Angels in the USA investing US\$30-40 billion in 50,000 early stage ventures.

‘Through 2001, the 220 members of Tech Coast Angels (Los Angeles, Orange and San Diego Counties) made approximately 800 investments in 52 companies totalling US\$40 million in 81 rounds of investments. The average investment is just over US\$40,000 and 95% of the individual investments have been in the range of US\$20,000 to US\$100,000. Fifty per cent of the investment rounds totalled US\$500,000 or less.’

*Source: William H Payne and Matthew J Macarty, 2002, The anatomy of an angel investing network: Tech Coast Angels, Venture Capital, Vol. 4, No. 4*

Returns on investment and exit paths tend to vary from country to country, possibly depending on the state of the economy at the time of the research, the availability of a robust secondary public listing market and the type and availability of potential deals.

A USA study published in 2002 showed that a quarter of the Angel investments were achieving better than a 50% rate of return and generally exiting the investment through a trade sale.

*Source: Jeffrey Sohl, 2003, The private equity market in the USA: lessons from volatility, Venture Capital, Vol. 5 Issue 1, p 29.*

Investment returns IRR	Investments in technology-based firms		Investments in non-technology based firms	
	No.	%	No.	%
Loss	17	36.2	34	42.0
Break-even (0-9)	11	23.4	17	21.0
20-49	6	12.8	13	16.0
50-99	7	14.9	10	12.3
100 and over	6	12.8	7	8.6
Total	47	100	81	100

*Source: Colin Mason and Richard T Harrison, 2004, Does investing in technology-based firms involve higher risk? An exploratory study of the performance of technology and non-technology investments by business angels, Venture Capital, October 2004, Vol. 6. No. 4*

### Angel investor exits by the Tech Coast Angels, 1997-2001

Activity	Number
Investments	52
Operating independently	32
Exits	20
• Out of business (-1X)	• 10
• Partial return of capital ( 0 to - 9X)	• 5
• Sale to private companies (exit pending)	• 3
• IPO (2X - 3X)	• 1
• Sale to public company (+120X)	• 1

*Source: William H Payne and Matthew J Macarty, 2002, The anatomy of an angel investing network: Tech Coast Angels, Venture Capital, Vol. 4. No. 4*

‘This paper provides the first attempt to analyse the returns to informal venture capital investment using data on 128 exited investments from a survey of 127 Business Angel investors in the UK. The paper finds that the distribution of returns is highly skewed, with 34% of exits at a total loss, 13% at a partial loss or break-even, but with 23% showing an IRR of 50% or above. Trade sales are the main way in which Business Angels harvest their investments. The median time to exit for successful investments was four years. Large investments, large deal sizes involving multiple co-investors, and management buyouts (MBOs) were most likely to be high-performing investments.’

*Source: Colin M Mason and Richard T Harrison, 2002, Is it worth it? The rates of return from informal venture capital investments, Journal of Business Venturing, Vol. 17. No. 3.*

### Exit routes for technology and non-technology investments

Exit route	Investments in technology-based based firms		Investments in non-technology	
	No.	%	No.	%
Flotation	6	14.3	3	3.9
Trade Sale	12	28.6	19	24.7
Sale of shares to existing shareholders	3	7.1	16	20.8
Sale of shares to third party	6	14.3	6	7.8
Written off/shares have no value	15	35.7	32	41.6
Asset break-up	0	–	1	1.3
Total	42	100	77	100

*Source: Colin Mason and Richard T Harrison, 2004, Does investing in technology-based firms involve higher risk? An exploratory study of the performance of technology and non-technology investments by business angels, Venture Capital, October 2004, Vol. 6. No. 4*

‘On average, 60-65% of these investments break even or represent a partial or total loss. So a substantial portion, 6 out of 10, even after meticulous due diligence, result in no financial return or in returns below that of a bank deposit account. Approximately 20% of these investments, based on our research, provide a two to five times multiple on the investment. About 8-9% provide between 5 and 10 times the investment, and about 7 times out of 100, about 6.9%, we see a return of 10 times or more the investment made.’

*Source: <http://www.icrnet.com/faq/home.html#q17> Accessed 22/01/06*

When they do invest, Angels will stipulate similar conditions to their investments as VCs. Typically they will require:

- a position on the Board of Directors
- remuneration for their time spent on the business
- veto power over the issue of new shares
- adjustment of the number of shares issued to the investor if milestones are missed and/or a lower valuation is set in a subsequent round of investment
- veto power over further long-term debt
- approval rights over executive remuneration
- approval rights over issue of options
- the right to put the business up for sale if certain milestones are not achieved
- the right to replace the CEO if certain milestones are not achieved.

Angels are normally active ‘hands-on’ investors. They expect and often enjoy being directly involved in the management of the venture. In fact, this is often one of their prime reasons for investing. They typically spend time with each of their investments on a regular basis.

A study of Angel investors in Germany showed that Angels typically spent 6.2 days per month on their investments, averaging 1.34 days per month on each investment, with the most time being spent on their most recent investees. More active investments might involve a day per week.

*Source: Malte Brettel, 2003, Business Angels in Germany: a research note, Venture Capital, July 2003, Vol. 5. No. 3*

Angel investors play a very important role in developing early stage ventures. It is their combination of funding and mentoring that makes their contribution so advantageous to a fledgling business. Certainly, without Angel help, many early stage businesses would flounder. Even though many fail, at least half grow into more substantial businesses providing essential job and wealth creation.

There are many sites offering information on Angel finance in the USA and several directories of Angels and Angel Networks. One site offers access to more than 20,000 Angels (see [www.vfinance.com](http://www.vfinance.com)). The Angel Capital Association has an extensive list of Angel Networks.

For some background to Angel investing in the United States of America see *Note on Angel Investing* – Prepared by Michael Horvath and Fred Wainwright, Center for Private Equity and Entrepreneurship, Tuck School of Business at Dartmouth University 01/05.

*Source: <http://www.empea.net/peindustry/research.aspx> Accessed 11/12/05*

The UK National Business Angels Network (NBAN) estimates that there are currently 18,000 Business Angels in the UK investing roughly £500 million into 3,500 businesses every year. Information on Angels and Angel Networks within the UK can be found through the British Business Angels Association (BBAA) which is the National Trade Association for the UK's Business Angel Network.

*Source: <http://www.bbaa.org.uk/portal/content/view/12/50/> Accessed 11/12/05*

In Australia, Angel Networks are listed on the website of the Australian Venture Capital Association (see [www.avcal.com.au](http://www.avcal.com.au)). Australia has an association of Angel groups called the Australian Association of Angel Investors ([www.aaai.com.au](http://www.aaai.com.au)) where you can find details of Angel Groups.

A recent report on Australian Angels entitled "Study of Business Angel Market in Australia" by Professor Michael Vitale, Belinda Everingham and Richard Butler (November 2006) is available at:

[http://www.ausicom.com/filelib/PDF/ResearchLibrary/Business\\_Angel\\_Report.pdf](http://www.ausicom.com/filelib/PDF/ResearchLibrary/Business_Angel_Report.pdf)

## 3 Sources of Private Equity

An emerging company which has constructed an experienced management team, a robust competitive position and strong gross margins usually has little need for Angel investment. The same might be said of early stage ventures with strong profit and growth potential which can attract formal venture capital. The Angel plays the middle role: funding the business which has yet to stand on its own feet and not yet mature enough or with enough potential to attract venture capital. Angels typically invest in seed, start-up or early stage businesses.

The Australian Bureau of Statistics' 2001 Special Article – Venture Capital Survey uses a stage classification. The following definitions are used within that report to describe various stages at which a venture capital vehicle may make investments.

- **Seed:** product is in development. Usually in business less than 18 months.
- **Early:** product in pilot production. Usually in business less than 30 months.



- **Expansion:** product in market. Significant revenue growth.
- **Turnaround:** current products stagnant. Financing provided to a company at a time of operational or financial difficulty.
- **Late:** new product or product improvement. Continue revenue growth.
- **Buy out:** [leveraged buy out (LBO), management buy out (MBO) or management buy in (MBI)]: a fund investment strategy involving the acquisition of a product or business, from either a public or private company, utilising a significant amount of debt.

*Source: ABS, 2001, Special article - Venture capital survey*

Investments in private companies are often classified by the stage at which the funding is needed. Common stage definitions are:

Seed Stage	Financing provided to research, assess and develop an initial concept before a business has reached a start-up phase.
Start-Up Stage	Financing for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but have not sold their products commercially and are yet to generate a profit.
Expansion Stage	Financing for growth and expansion of the company which is breaking even or trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital.
Replacement Capital	Purchase of shares from another investor or to reduce gearing via the refinancing of debt.
Buy out	The acquisition of a significant portion, majority control or 100% of businesses which normally entails a change of ownership. Funds are often used for expansion, consolidations, turn-arounds, and spinouts of divisions or subsidiaries.

*Source: <http://www.evca.com> Accessed 29/12/04*

There are only a limited number of VC firms focused on financing seed or start-up stages, although this is often the stage where Business Angels play a major role.

Angels often play the financing role between ‘family, friends and fools’, often referred to as ‘close money’ and formal venture capital. Coping with what has come before and what comes after their involvement in the venture is a challenge

for the Angel. On the one hand, Angels need to develop the business given the constraints inherited from earlier investors and then need to prepare the business for the next round of investment, usually from formal venture capital. Even though the majority of their investee firms will not require venture capital, this will not always be apparent in the early stages of the Angel's involvement with the investee firm.

## Family, Friends and Fools

Most new firms start with whatever funds the new enterprise team can scrape up between them. This may be advances on credit cards, savings and bank loans (generally secured on property). This is the entrepreneur's money and if they lose it, they have only themselves to worry about. Most ventures start this way and may never require further shareholder investment. The profits are normally re-invested to fund additional working capital as the business expands; however, funds for expansion are often limited as the founding team usually exhaust their personal savings. To keep the enterprise going and to fund the next stage of development, founders normally turn to their family and friends.

However, everything has a price and even money from those who are close comes with its own problems. While they may not have the same ROI requirements as an Angel or be subject to the regulations and timescales of the VC, investment from family and friends (close money) has its own issues. Fools are said to be investors who throw their money in on the off chance that it might make a return, but generally don't risk very much and have low expectations of getting the money back.

New ventures are not without their risks. Australian research indicates that up to 70% of new start-ups will fail within five years. Further, few will ever grow beyond six people and very few will achieve significant size. Thus the chance of losing the money from relatives and friends is reasonably high.

One of the considerations which new venture entrepreneurs face is the impact on their relationships with family and friends of the venture failing. What happens when the venture fails and close relatives have invested life savings into the business, having been sold on the dream of owning part of the

next Microsoft? Few non-business people really appreciate the risks of a start-up. Everything appears attractive up-front when it all looks so easy and they are sold on the idea of their young relative growing a monster company. But when it fails and they accept that their relative simply didn't have the experience to make it work, will they really be happy just to write off the investment, or will this be a lifelong problem between them?

The same could be said of close friends. Being work colleagues, school friends or social friends hardly qualifies people to undertake the stress and rigor of going into business together. What happens when their talent and experience proves not to be the level which is required or they don't really want to put in the time or they want to have the final say on all the decisions? Then there is the dysfunctional team which may cause the failure of the venture or which may need to be broken up by forcing some of the team to quit. If they have money invested in the venture and still own equity, how are the remaining shareholders going to buy them out or deal with their ongoing equity interest?

Many start-ups involve couples, business colleagues, school friends and relatives. Not all of them will appreciate the time and effort which must be put into the venture to get it to a reasonably profitable, sustainable state. There are many stories of partners working long hours, taking low salaries and undertaking activities they are not trained for just to survive. Not everyone going into the venture is capable or willing to put in the effort and time it takes to get something up and running.

Close money may or may not come with other constraints. If a founding investor is working in the business, they may well feel an equal partner and want to be actively involved in the decision-making on a day-to-day basis. While this can work in very small firms, it becomes very problematic as the firm grows. As more staff join and the firm becomes more complex, some formal organisational structure is required. At this point, the question of who is boss and who makes the decisions becomes a real issue of debate and often conflict. With independent people, this can be more easily resolved; however, when the other person is a spouse, cousin or best friend, the issue is not so readily resolved.

At the same time, family investors who don't work in the business may feel a need to interfere if they see something they disagree with, even without understanding the situation or the business requirements. So the wife of the cousin who sees differentials in remuneration or different workloads may feel compelled to voice criticism to the aunts and uncles. Now the managers are spending time defending their actions to people outside the firm who may have no idea of the pressures they are under.

Then there is always the issue of a family member, friend or fool who decides that they would like their investment capital back before the other shareholders are ready to exit the business.

An issue common to many new ventures owned by married couples are the problems that arise when they start a family or go through a divorce. Where other owner/managers are involved in the business and one needs to take time out for family reasons, this can create tension and assertions of unfairness and inequality. Where a divorce occurs, it may be impossible to continue a close working relationship. The issue then of ownership and involvement can become a very messy problem, often resulting in the failure or sale of the firm.

A major consideration for the entrepreneur is what happens to the original team as the firm grows. Will they be capable of playing their part in the management team of a firm which grows to 30, 100 or 500 people? If they don't have the experience, personality or capability to handle the tasks, how will the problem be resolved?

Angels are most often confronted with these complex personnel situations. As an external and perhaps a more objective investor, the Angel needs to tread carefully around these relationships. Clearly, if they don't see that a constructive business environment exists, or one that can be readily resolved through discussion and a realignment of roles, responsibilities, remuneration and objective decision-making processes, they are better off rejecting the investment. If the Angel thinks that the team is not capable of delivering the growth and profit required, they will simply walk away from the investment opportunity. If there is a problem between founders and early investors and the Angel feels that this will limit the process of building the business, then they are better off not investing.

At the same time, the Angel needs to acknowledge that the venture probably would never have survived had it not been for the investment, time and commitment of those people who were willing to come in at the start. This is an interesting problem for the Angel to deal with.

Before proceeding to invest, the Angel must be satisfied on the following issues:

*Will the family, friends and fools interfere in the negotiation for the investment, the management of the company or the decision on the exit strategy?*

*Do the family and friends who helped start and grow the company form part of a management team? Does the investor have confidence in them and is he willing to trust them to grow the business to achieve its potential?*

Current management and shareholders should be aware that these issues will need to be addressed as part of the investment agreement. The Angel may require that some of these problems be resolved as part of the decision to invest. This might involve a restructuring of the business, new job descriptions and a more formal organisation structure. The Angel might also be willing to buy out some of the early shareholders in order to simplify the shareholdings.

## Venture Capital

Estimates vary as to the percentage of Angel investee firms which receive VC finance. This could be at the same time as an Angel investment or as a follow-on investment. From the limited data available, it would appear that one in five investee firms also raise VC funds. The others would seem to survive without it, fail during their period with the Angel or are exited through a trade sale or IPO alongside their Angel investor.

Most Angels are either unwilling or unable to provide significant follow-on funding as part of the development of an investee business, thus access to VC finance can be critical. While VC investment is somewhat similar to Angel

investment, there are material differences which the Angel needs to factor into the funding strategy of the investee firm.

Venture capital is the most formalised form of private equity investment. Unlike most Angel investments where the Angel takes a personal role in deal due diligence and management, Venture Capital provides a channel whereby high net-worth investors can participate in higher risk ventures without having to personally undertake the burden of venture evaluation and management. The VC fund itself provides the expertise in sourcing, evaluating, investing, managing and harvesting the venture investments.

Whereas most Angels invest in their own right, VC investment is through a fund. The common structure of a Private Equity Fund or Venture Capital Fund is the Limited Partnership. This structure is commonplace in both the USA and UK markets and has recently been introduced in Australia. The benefit of this structure is that the fund itself is not a legal entity for tax purposes for the investor. There is a pass through treatment of any gains for tax purposes. Thus any gains and losses pass directly to the investor and are taxed in their hands. The investor also has the benefit of limited liability at the level of the fund itself. No liability from the investee firms can pass back to the investor. A comprehensive description of the Limited Partnership Agreement can be found on the British Venture Capital Association website (see [www.bvca.co.uk/](http://www.bvca.co.uk/)).

Funds are normally closed-end in structure, meaning that the investor has very limited or no ability to withdraw their investment during the fund's life. Funds are typically established for a 10-year life, but may be extended in some circumstances. The investor (also known as a Limited Partner) commits to make available funds as needed for the underlying venture investments. Investments are then normally made by the Investment Manager (otherwise called a General Partner) generally over the first one to five years of the fund life. As investments are harvested, proceeds are returned to the Limited Partners and not re-invested into new opportunities. Since the timing of exits cannot be known in advance, Limited Partners must be prepared to wait for some time before they start to see any return on their funds.

In his book, 'Early Exits: Exit Strategies for Entrepreneurs and Angel Investors (But Maybe Not Venture Capitalists)' Basil Peters notes the following:

Most VC funds are designed for a lifetime of 10 years. But in practice, the actual lifetime of technology (IT) VC funds averages closer to 13-14 year.

Limited Partners typically give a wide degree of discretion to the General Partner to invest on their behalf as they cannot know before the fund starts to operate the types of investments which may present themselves. The fund agreement typically specifies the minimum and maximum investments the fund can make in any one venture. The Limited Partners are committed to the investments made by the General Partner and there is generally no ability for the Limited Partner to withdraw from any investment made by the General Partner. Typically, General Partners or Fund Managers issue a Prospectus or Information Memorandum to investors to raise their investment capital.

The typical Private Equity Fund terms are:

Minimum investor commitment	Often \$5 million or greater.
Manager's commitment	General Partners typically invest their own money in the fund. Often this will be around 1% of the total fund and is sometimes a prerequisite of the Limited Partners.
Partnership term	The fund life is normally 7-10 years with the possibility of limited extensions to facilitate exits. Distributions may be made as investments are sold.
Investment/commitment period	On average, Private Equity Funds invest committed capital over a 3-5 year period.
Management fees	Normally the management fee is set between 1.5% and 2% of committed capital.
Incentive/performance fees	Typically 20% of the total returns and is usually only paid once the Limited Partners achieve a predetermined hurdle rate. This is known as the 'carried interest'.
Preferred return or hurdle rate	The carried interest may not be paid out until total returns exceed some agreed threshold. Currently (2004) this is around 8%.

Source: <http://www.evca.com> Accessed 27/10/03





General Partners have the responsibility of sourcing, evaluating and negotiating investments in private firms. This can be a lengthy and time-consuming task. Due to the immature nature of many of the firms being examined and the uncertainties associated with their products and business models, combined in many cases with the lack of proper systems or audited accounting records, considerable expertise is needed to undertake the task effectively. Since such experience is in limited supply, Venture Capital Funds have difficulty recruiting senior managers, although the work may be outsourced in some areas to external advisors. The ability of the VC Funds to invest is constrained by the number and experience of their managers. At the same time, firms receiving investments (investees) are looking to their General Partners for advice, contacts and help securing customers, grants and staff.

When investee firms get into trouble, such as not achieving targets, making losses or losing key staff, General Partners need to devote considerable time to their current investments and have little time to source and evaluate new investments. General Partners will also be actively involved in setting strategy, planning and executing the exit. Around 70% of the General Partner's time is taken up working with their investee firms; hence the capacity of the Venture Capital Fund is limited. Venture Capital Funds therefore typically make few investments: only a few in any year. They often have limited time to carefully evaluate new investments and often spend only a few minutes on an executive summary establishing whether the proposal is worth further investigation.

Even when a proposition looks attractive, extensive time will be spent with the new venture team evaluating them as well as the merits of the business. Considerable due diligence will be undertaken before any investment is made. Often 20-30 or more proposals will be investigated for every single offer made.

The 2004 Australian Bureau of Statistics (ABS) survey reported similar ratios.

'The selection of investee companies (into which venture capital is invested) was an intensive process. The total of 137 venture capital managers reviewed 10,530 potential new investments during 2003/04 and conducted further analysis on 1,067 of those, with 181 being sponsored for venture capital. These

managers spent a total of 179,000 hours with the investee companies (190,000 in 2002/03), advising and assisting in the development of the enterprises.’

*Source: ABS 5678.0 Venture Capital, Australia Accessed 26/11/2004*

In the 2007/8 ABS survey, fund managers spent on average 3.9 days a month on each investee company.

Due to the complexity of the business proposals, VC firms will often limit themselves to specific industry sectors where they have both the expertise to evaluate the deal as well as the experience and networks to add value to the investment. In the US and UK markets some funds have a single industry focus; however, in Australia most funds have a more general focus.

VC firms will also often limit themselves to certain development stages, such as start-up, expansion or buy out, where they can add real value. VC firms which spread themselves across too many sectors or too many stages will often be viewed less favorably by investors as they will see higher risks in such a spread. At the same time, larger funds prefer only to invest larger amounts as they can only support a limited number of investments. A typical fund invests in approximately 10-12 investee companies with individual investments of between 5-15% of the individual fund’s total investment capital. The increasing cost of proposal analysis and subsequent due diligence is itself an inhibiting factor. If only one in ten proposals investigated are being invested in, the average cost of investigation of an investee firm is quite high. Therefore small investments are simply not economical.

The drift towards larger funds and the lack of early stage expertise within the VC community has led to an increasing shift of investments towards later stage investments. For example in 2003, 55% of venture capital investments in Australia went into various types of buy outs of existing businesses – the vital seed, start-up and early expansion phases accounted for only 16% of investments.

*Source: <http://www.smh.com.au/articles/2004/04/11/1081621834935.html?oneclick=true>  
Accessed 31/12/04*

In the ABS 2007/8 survey the percentage in later stage private equity fell to 36% of total funds invested.

The 2005 ABS *Venture Capital* report shows the following breakdown of investments by stage:

Stage of development	Number	Value \$ million
Seed	145	65
Early	313	665
Expansion	265	1,183
Turnaround	34	118
Late	65	267
LBO/MBO/MBI	90	1,234
Total	912	3,532

For the 2004/5 year, 49% of investments went into ventures which were 2-4 years old and 26% into those which were 5-10 years old. In 2007/8 41% of investments were in ventures between 2 and 4 years old with a further 28% in ventures between 5 and 10 years old.

USA data from the MoneyTree™ Survey for 2004 shows the following breakdown:

Stage of development	Number	Value \$ billion
Startup/Seed	178	0.391
Early Stage	850	3.883
Expansion	1,217	9.653
Later Stage	700	7.578
Undisclosed/Other	–	–
Grand Total	2,945	21.506

*Source: PricewaterhouseCoopers/Thomson Venture Economics/National Venture Capital Association, MoneyTree™ Survey, Total U.S. Investments by Year Q1 1995 – Q3 2005 <http://www.nvca.org>*

2004 data for the UK from the BVCA showed the following:

Stage of development	Number	Value GBP million
Seed/Early Stage	264	188
Expansion	522	789
MBO	237	3,778
MBI	30	320
<b>Grand Total</b>	<b>1,053</b>	<b>5,075</b>

Of the total funds raised by UK VC firms in 2004 (£3.3 billion), 90% was expected to be invested in the MBO/MBI stages, 6% in expansion and 2% in early stage.

*Source: <http://www.bvca.co.uk>*

Many of the more successful and longer established VC firms receive so many business proposals that they restrict their time to recommended proposals from individuals or professional firms which have already reviewed the business plans, so they can better use their time. It also means that to access the better VC firms, an entrepreneur needs to first work with an Angel or professional firm which has access to the General Partners.

The legal structure of the fund, the manner of remuneration for General Partners and the process in which Limited Partners achieve a return of their initial investment plus their desired ROI, means that investments need to be harvested within a relatively short period of time. Most VC firms target a period of between 3-5 years for harvesting. However, if you take out the last year for the exit execution, this leaves only 2-4 years to create the pre-conditions for a successful exit.

If investments go over the five-year mark they are at risk of running up against the fund term. This means the General Partner has to apply to the Limited Partners for an extension or they need to force an exit event. To achieve a 25%

compound return, they need the value of the investment to double almost every three years. An investment that has been in play for six years needs the capitalised value to have reached 3.8 times the initial investment. If the VC fund only held 20% equity in the investment, a \$2 million investment in a \$10 million capitalised firm has to achieve an exit valuation of nearly \$38 million to provide the VC firm with a 25% ROI over the six years. Since few firms consistently achieve this type of growth, the pressure is on the VC firm to choose the right investments and then to actively manage them to get the desired growth rate.

Any slippage from the agreed targets will create considerable pressure on the VC to intervene to sell the business or to replace the management team to get the firm back on track. Few entrepreneurs seeking VC investment really appreciate the impact on the firm of a 25% cumulative growth in value and how difficult it is to reach.

Usually the VC fund is a minority investor which normally would give them little power or authority to force a sale of the investee firm. However, the investment agreement would typically provide the VC fund with the power to intervene to ensure they are able to exit under certain circumstances. Typical provisions would include the following:

**Voting trust:** Entrepreneurs hand over shares if they don't perform. The VC has the ability to take control, notwithstanding it is initially in a minority position.

**Unlocking provision:** A shareholder receives an offer they don't wish to accept but the VC does – the shareholder must buy the VC out.

**Put provision:** The VC may have the right to sell the business to the 'highest bidder' if an exit is not achieved by a given date.

**Registration and public offering provision:** The VC may require an IPO after a given date. If this is not possible, the firm will be sold.

**Piggyback option:** The VC can sell their shares anytime the business sells shares either in a public offering or in a trade sale.

**Come along:** The VC can force the business to sell shares if the VC receives an acceptable offer for its shares.

**Drag along:** The VC can force all shareholders to sell their shares if the VC receives an acceptable offer for its shares.

**Tag along:** If a shareholder receives a favourable offer for its shares, other shareholders have an option to notify the purchaser that they too wish to sell their shares.

*For additional details see: D Gladstone and L Gladstone, 2002, Venture capital handbook – An entrepreneurs guide to raising venture capital, Prentice Hall, pp 180-208 and B Ferris, Nothing ventured, nothing gained: thrills and spills in venture capital, Allen & Unwin*

Many people incorrectly think that VC General Partners are business experts who are knowledgeable about growing a business. In truth, most of them have a banking and finance background, with limited management experience outside the banking and finance sector and little hands-on experience in most of the markets in which they have investments. In many cases, the investment manager acting for the VC firm will be in their late 30s or 40s, have not worked in any sector other than financial services and have never undertaken any entrepreneurial activity. Their ability to help with specific experience in the development of a long-term strategy or with market development is limited. Some of the better funds have expanded their investment team with managers with operational experience, but these are certainly in the minority.

The more experienced General Partners will have learnt through a series of investments, will have developed good networks across a range of industries and will have participated in several exits as well as several write-offs. However, this experience can make them more cautious in their assessment of opportunities.

For the most part, VC General Partners are financial administrators. They are good at financial analysis, working the ratios, accounting for the money and making sure the legal requirements are satisfied. But they can only remain in the VC business if they can raise a new fund, since funds have a limited life. Raising a new fund means delivering healthy returns to their Limited Partner investors. That means getting both the investment and the exits at the right price. Without the exit returns, they don't achieve their bonuses and they don't have the opportunity to raise a new fund.

Mature VC firms which have been actively involved in funding emerging companies for a number of years have discovered just how hard it is to cope

with innovations, emerging markets and untried teams. Those VC firms typically have recruited senior staff who have technical (and often business) qualifications as well as a number of years of senior operational experience if not direct entrepreneurial success. In mature markets such as the USA, top VC firms will not employ an investment manager who does not have senior operational experience. While they have discovered that financial administration can be outsourced, operational experience is a real asset when it comes to understanding how a value proposition will achieve traction in the marketplace and understanding whether or not the management team has the attributes to build a good business.

Occasionally a VC firm will be able to sell to another VC firm which might be interested in taking the business to the next level of development. Thus an early stage VC firm may sell their position to another VC firm interested in an expansion investment. This may also involve a further round of investment in the investee firm. VC firms attempt to maximise the value of their return through the most favorable exit vehicle. IPOs generally achieve the best returns with buybacks usually the lowest positive return. As an indication of the frequency of each type of exit, consider the following data sets.

In Australia, from March 2000 to September 2002 there were a total of 209 exits, of which 117 or 55.6% were at a profit, 10 broke even, and 79 or 37.8% were at a loss.

*Source: <http://www.asto.com.au/news03/techbottoms.htm> Accessed 27/12/04*

In 1999/2000, 24 companies were sold, 12 companies went public, four companies were bought back and 19 investments were liquidated. The value of exits during the year 1999/2000 was A\$536 million. The average trade sale was A\$3.7 million, while the value of all IPOs was A\$346 million.

*Source: Venture Capital in Australia (Research Note 28 2000-01)  
<http://www.aph.gov.au/library/pubs/rn/2000-01/01RN28.htm> Accessed 31/12/04*

Not all exits can be achieved quickly, as this data from 1995-2001 shows.

Exit path	Full exit	Partial exit	%
IPO	22	16	29.3
Private (undisclosed)	10	1	8.4
Acquisition	25 (cash)	5 (shares)	23.0
Secondary Sale	9	1	7.7
Buyback	9	8	13.1
Write-off	24	0	18.5
<b>Total</b>	<b>99</b>	<b>31</b>	<b>100</b>

*Source: G Cumming and G Fleming, 2002, 'A law and finance analysis of venture capital exits in emerging markets' Working paper series in finance 02-03, Australian National University*

The ABS 2005 and 2007/8 Venture Capital Reports show the following exit statistics:

Exit path	Value A\$ million	2005	2007/8
Trade Sale		291	456
IPO		246	376
Buyback		35	11
Write-offs		49	45
Left the Industry		215	162
<b>Total</b>		<b>836</b>	<b>1,050</b>

Ratios for the USA are comparable. Data from Q3 2005 from the NVCA showed that there were 19 IPO exits compared to 76 trade sales (25%).

*Source: <http://www.nvca.org/pdf/2005Q3IPOreleasefinal.pdf> Accessed 5/12/05*



Data from the NVCA in the USA for 2004 show investment losses occurred in 61 of the 181 exits (34%); however, 20 of the 181 (11%) exits resulted in the VC firm achieving more than 10 times their investment.

*Source: [http://www.ventureeconomics.com/vec/news\\_ve/2005VEpress/VEpress05\\_04\\_05.pdf](http://www.ventureeconomics.com/vec/news_ve/2005VEpress/VEpress05_04_05.pdf)  
Accessed 11/12/05*

Exit data from the UK for 2004 shows that, by value, 28% was from trade sales, 20% were sales to another private equity firm, 13% were write-offs and 10% was from IPOs. Similar percentages were experienced for 2007 but with just 3% of divestments via IPO in that year.

Unlike VC funds, Angels are not restricted by the closed fund limitation, thus they can stay with their investments longer if the occasion warrants. They can also be more selective with their investments. The General Partner of a VC fund is under pressure to allocate the money during the early phase of the fund and so a high volume of possible deals needs to be sourced for evaluation. Angels can invest without an expectation of a positive return, perhaps to 'give back' or to fund or assist a young entrepreneur. The VC firm can really only be involved if it can see a healthy return for their Limited Partners.

Angels typically invest in one in three proposals they evaluate where VC funds only invest in one in one hundred. Perhaps, because of the higher cost of investing and the higher return expected, the VC firm has a much more difficult task in finding appropriate investments.

With this as a background, it is easy to see why VC firms might actively seek Angel connections. Angels have a reputation for developing early stage businesses, putting in much needed discipline and more formal management structures, assisting them to become larger entities and educating them on how to work with external investors. Angels who have good relationships with VC firms can provide a logical path for their investee firms for larger injections of funds, with the necessary groundwork for such investments already achieved.

## Private Equity Funds

Another form of private equity is the Private Equity (PE) Fund, a term normally reserved for funds that invest in late stage ventures. Where Venture Capital Funds typically which a minority investment in a firm and actively manage through the original management team, the Private Equity Fund typically takes 100% or a majority stake in an investment. PE firms typically aim to acquire firms where direct intervention can overcome prior problems or constraints and provide a short-term turnaround situation or performance uplift which will yield an attractive return. PE firms look for inefficiencies to exploit. Common approaches are:

- Improve the profitability. Access to more experienced management, networks and technical knowledge may provide the basis for a relatively easy improvement in profitability.
- Buy at a favourable price when the market is low and wait until the market improves when valuation multiples are higher.
- Break the business up and sell off the assets or business units. Some businesses are undervalued where one part of the business is more risky or where the market does not understand the business economics. More focused businesses will often sell at a higher multiple.
- Leveraged buy out. The PE firm uses debt to finance a major part of the buy out. When the value improves, the returns to the equity portion are magnified due to the high debt component.
- Management buy-out.
- Management buy-in.
- Make bolt-on acquisitions to generate economies of scale or gain access to new products or markets.

PE could be used to remove the burden of existing debt which might allow the business to reinvest and grow. Existing management may be retained with incentives or may be allowed a minor equity position as an incentive.

PE investment might be used to provide existing management with the opportunity to buy out the existing owners, re-engineer the business and then

position it for an IPO. The PE firm would use the IPO as their exit strategy leaving the management team in control post IPO.

PE funds have become active in 'sell down' transactions in recent years. This occurs where the PE fund buys shares from a founder representing only part of the ownership, although most often the majority. In this way the founder has the opportunity to cash out part of their investment in the enterprise. The PE firm will then work with the founder to actively progress the business to a higher exit valuation which could be achieved either through an IPO or a trade sale. In undertaking the development strategy, the PE firm might arrange for additional debt financing, replace some of the management team, restructure the Board of Directors, assist with acquisitions and development of new strategic partnerships and so on.

This strategy has the advantage of allowing time for the business to be properly prepared for an exit with the active co-operation of the founder and the management team. The founder may also achieve a secondary harvest at a higher valuation. An Angel might seek out a PE fund as an exit strategy if the business could be substantially developed with significant capital injection, a new management team or as part of a roll-up strategy.

## Corporate Venture Capital

An Angel may co-invest with a corporation or seek follow-on funding from a corporation as part of an exit strategy. Many corporations have Venture Capital Funds specially for the purpose of investing in early stage ventures. The manner in which these corporate funds are managed and the terms under which funds are invested closely mirror traditional Venture Capital Funds. Ventures successful in acquiring a corporate investor can often gain additional benefits beyond those which can be offered by the traditional Venture Capital Fund.

Corporations have a variety of reasons for investing in early stage ventures although the most common are:

- access to specialised knowledge, intellectual property or equipment
- exposure to emerging technologies

- investment in potential acquisitions
- understanding of new or emerging markets
- access to entrepreneurial talent
- preventing competitors from acquiring a technological breakthrough.

For the new venture, a corporate investor could provide the following benefits:

- access to industry expertise, networks, equipment and/or research and development facilities
- access to a key customer or to an established distribution channel
- access to complimentary technologies.

Typically, Corporate Venture Funds invest in their core or closely related technologies.

According to a joint study by Venture Economics and the National Venture Capital Association in United States, in 1994 only 2% of venture capital investments were corporate venture capital, but in 2000, corporate venture capital accounted for 17%, nearly US\$20 billion. In four years, from 1996 through the end of 1999, the number of companies investing in outside ideas increased elevenfold, from 30 to 330. During the same period, corporate venture capital spending rose from US\$100 million to US\$17 billion annually.

*Source: [http://www.1000ventures.com/business\\_guide/corporate\\_vinvesting\\_external.html](http://www.1000ventures.com/business_guide/corporate_vinvesting_external.html)  
Accessed 3/01/04*

In 2003, US\$1.1 billion was invested in the USA in growth orientated companies by corporate venturing groups, representing 6% of all VC investment. The amount invested by corporate venture capitalists has tracked similarly to the trends of the overall VC industry. The 2003 figures were close to the activity seen in the last pre-bubble year, 1997, when corporate venturing groups invested US\$957 million, also representing 6% of total VC invested in that year.

*Source: [http://www.nvca.org/nvca02\\_04\\_04.html](http://www.nvca.org/nvca02_04_04.html) Accessed 3/01/04*

There is limited information available about Corporate Venture Capital Funds in Australasia.

Overseas and local corporations may undertake venture investments through a local fund, via a traditional Venture Capital Fund or through a local subsidiary. The major problem most corporate businesses have with VC investments is access to experienced VC executives. Since the VC investment model is one of active intervention as well as portfolio investing, this type of investing is foreign to most corporations. Many will invest in an established VC fund in order to access the investment evaluation experience and venture investment skills.

An early stage venture which can clearly show how their innovations relate to the business of a large corporation should include that corporation in their list of potential investors. However, corporations not familiar with investing in early stage ventures can be a mixed blessing. Because they are not familiar with the norms of such investments, the firm may find itself wasting considerable time trying to convince the corporation of the value of an external investment, although benefits may come from a more favorable valuation, access to corporate resources and an early exit opportunity.

The Angel should be wary of the motivation of the corporate investor. Their involvement is mostly driven by their own strategic objectives and their support may be highly influenced by wanting the investee firm to develop in a particular direction. They may inhibit, consciously or unconsciously, the direction of the business and limit the exit opportunities.

## 4 Your Angel Activity Profile

**A**ngel investing is not for the faint-hearted or for those who prefer to extract their funds whenever they have an urgent need. It has relatively high risks associated with it and relatively long periods before harvesting occurs. Before you jump into the pond, it is worth spending some time working out whether this type of investment is really for you as well as how much involvement you want in sourcing, evaluating and managing investments. Perhaps, most of all – why are you contemplating doing it?

More and more Angels are becoming involved in formal Angel groups. One of the questions that potential Angels need to ask themselves is whether participating in an Angel Network would add value to their Angel investing activity and whether they would be willing to participate in syndicate investing.

## Personal investment profile

There are many different types of Angels and many different forms of Angel involvement in investee firms. Just what type of Angel you want to be, or are able to be, are fundamental questions.

### **How much are you prepared to lose?**

Private equity investing is probably best done on a portfolio basis. That is, the more investments you make, the greater the likelihood you will make the average return in the Angel investment sector. If only a few investments are made, then given the dispersion of possible outcomes, you have a reasonable chance of losing all or most of your investment. Of course, you could simply be lucky and end up with a considerable capital gain, but can you afford the risk?

While estimates vary, it appears that somewhere between 30-60% of Angel investments lose money, with perhaps half being written off. One of the most important questions an individual contemplating Angel investing is: 'Just how much money am I prepared to lose?' Most Angels only invest a portion of their wealth in this type of investment for that very reason. The returns are by no means guaranteed and the lack of liquidity can mean that you can see your money being tied up in an investment which has gone wrong and yet have no way of extracting the funds. Unlike the public investment market where you can simply sell your shares, no such mechanism exists for shares in private companies, especially when they are in trouble.

### **How much time do you have available?**

Angel investing is typically done at the coal face. It is an active, hands-on, style of investment. Angels spend time sourcing deals, evaluating them, negotiating agreements, assisting in the governance through a Board of Directors and being directly involved in helping with strategic activities. The research survey data shows that most Angels devote about a day per month to each of their investee firms, although new investments often need more time than this.

It is difficult to see how this role can be achieved if the Angel investor has a full-time job or where they don't have significant influence over how and where

they spend their time. Perhaps this is why most Angels are cashed up high net-worth individuals; few others would have the flexibility to devote the time.

### **What contribution can you make?**

Most early stage ventures which need Angel investment have relatively inexperienced management. While they may have technical expertise or even deep functional expertise in one area of business, it is unlikely they have start-up experience or general management experience. Few will have experience working with an external Director and most will not have experience with developing an organisation through its various stages of growth. You might characterise the Angel as a business mentor. Part of their contribution to most investee businesses is to help them manage the growth of their ventures. Do you have the background, experience and temperament to act as advisor, mentor or coach without taking over? The entrepreneur is not normally seeking his replacement, just advice and assistance.

### **Are you able to act in the role of coach?**

Many entrepreneurs seek out Angels with specific expertise or useful networks. An Angel may play a role in assisting the entrepreneur connect with key customers or strategic partners or they may be able to help access the next round of finance or help execute a trade sale exit. Generally speaking, the finance by itself is not sufficient to be attractive to the new venture entrepreneur. In fact, an Angel investor who does not understand the business problems faced by the venture is a definite liability.

Some entrepreneurs will take the money out of desperation. The Angel needs to be sensitive to this and ensure that the management team accepts the active role and knowledge contribution that the Angel is expecting to bring to the venture.

### **Are you able and willing to act as a non-executive director?**

Most Angels require a seat on the Board of Directors, this way they can closely monitor their investment, influence decision-making and provide strategic input. They are also able to use their veto powers directly from their Board position. However, being an external or outside Director is not the same



as being in control of day-to-day operations. A non-executive Director is not an employee or a manager, they do not make operational decisions and do not implement the decisions of the Board. An Angel is part of the decision-making process but is not the decision-maker. Many cashed-up entrepreneurs want to be in control and want to make all the decisions but this is not the role of a non-executive Director.

In recent times there has been increased scrutiny of Board members' actions and an increase in penalties for failure of directors to act honestly and with due care. While there are clear obligations on directors set out in the legislation controlling corporation activities, there is also a raft of obligations on Directors stemming from other legislation which governs how businesses deal with the environment, health and safety of their employees, competitors, reporting requirements to various government departments and customers. What this all means in practice can be open to interpretation. The requirement to take 'due care' or use 'reasonable judgment' or apply 'all due diligence' can seem somewhat daunting to a potential Director. However, most situations in which serious penalties have been applied, do seem to cluster around fraud, gross negligence, conflict of interest, gross dereliction of duties, knowingly trading while insolvent and improper use of the position of Director for personal gain. Angels who act as Directors who exercise reasonable care, take their responsibilities seriously, act in good faith, diligently use and rely upon professional specialists and act in the interests of all the shareholders have been able to more than adequately defend their actions.

Even so, an Angel investor who acts as a Director should not undertake the activity lightly. Acting as a Director is a role which most Angels accept as part of their management of their investments. Is this an activity you wish to undertake?

### **Are you able to let management run the business?**

The role of the Angel is mentor and coach rather than CEO. An Angel who wants to micro-manage the business will end up alienating the very people who have to make the business successful. Too many Angels become involved in the detail rather than set overall policy and guidelines. If you have several investee firms, you simply do not have enough time to micro-manage them and your active involvement may leave them without leadership when required. As an

Angel you need to stay back a little and guide with loose reins and only become involved in the detail when the situation warrants it.

### **How much involvement do you want?**

Angels have a variety of reasons for becoming involved with early stage ventures, not the least is that they expect to make a difference to the development of the firm. Therefore, understanding your own motivations and interests and mapping these to your involvement is a critical part of the relationship between the Angel and the investee firm. This relationship has to work for both parties for the investment to be manageable. Most Angels don't want to have day-to-day responsibility which is part of the reason why their normal investment is less than 50% of the voting shares. However, they are deal makers in the main and like to become more active in major strategic activities such as setting up agreements with key customers or strategic partners.

Some Angels prefer investments where they are able to limit themselves to Board meetings and seek out investee firms which have more mature and capable management. Others like the role of mentor and coach and work best with younger, less experienced management teams. Some Angels with strong technology backgrounds like to be involved with R&D projects and will take an active role in that area of the business.

Involvement is a factor of both the time available and need. A proactive Angel might be expecting to spend considerable time working with their investee firms while a more passive Angel might only want to become involved in a crisis. There needs to be a match between what the firm requires and what the Angel is able and willing to offer. This is perhaps one of the reasons why Angels get personally involved in the screening process: they are looking for something which matches their ability to add value while also offering a level of excitement in being involved in the development of a new enterprise.

### **Will you be sourcing your own deals?**

Finding early stage ventures worth investing in can be a significant task for an Angel. Most Angels complain that they do not see enough deals even though they are actively seeking. Even if you work through an Angel Network, you will still be expected to make a contribution by sourcing some deals for the

Network. Therefore, do you have the contacts to generate a stream of possible investments and do you have time to work your network sourcing connections to find entrepreneurs seeking Angel finance?

**Will you be doing your own evaluations?**

While it is always possible to invest money in any venture, the Angel who does not undertake adequate due diligence on the firm may as well gamble the money away. Most experienced Angels would state that their least successful investments occurred where they failed to undertake rigorous due diligence. But due diligence takes time, expertise and knowledge. Of course, this can be outsourced to professional advisors but that will significantly increase the cost of the investment. Many Angels restrict their investments to industries in which they are familiar as this enables them to make more informed judgments about the venture's potential. Many Angels now work in Angel Networks, Angel Investment Clubs or Angel Funds to spread the workload of investment screening and due diligence.

**Will you be investing alone or with other Angels?**

Some Angels prefer to be the sole external investor while many prefer to co-invest with others. Angels acting alone need to be able to devote the time to their investments and take an active role in each. Acting with other Angels, an Angel can share the 'lead' role with others, perhaps acting as a Director on some investments while taking a passive role in others.

**How well educated are you about Angel investing?**

Investing is not the same as managing an enterprise and being an experienced entrepreneur does not in itself ensure that you can work as an effective mentor to other entrepreneurs. Undertaking due diligence, negotiating a share purchase agreement and working as a Board member is a very different experience than that acquired in a past career as a corporate executive or a member of an entrepreneurial team.

### **Example**

The USA National Association of State Venture Funds (NASVF) provides Angel training seminars – Seed Investing as a Team Sport – around the United States of America. Seminars include such topics as:

- Angel Networks — their impact and potential
- Seed Investing — the complete process
- Due Diligence — effective, proven methods
- Investment Appetite — finding what’s right for you
- Valuing the Enterprise & Pricing the Deal — essential techniques
- The Term Sheet — structuring the deal for success
- Negotiating the Deal — dos and don’ts; win-win strategies
- Closing, Mentoring and Cashing Out — coaching the team to success

*Source: <http://www.nasvf.org/web/nasvfinf.nsf/pages/sits> Accessed 20/01/06  
NB: now called National Association of Seed and Venture Funds (6/09)*

Angel education is available in most western countries and is provided through the venture capital associations, Angel Network associations or through some universities and private institutions.

## **Angel investment syndicates**

In recent times there has been a movement for Angels to band together into Angel Investment Clubs, Angel Groups and Angel Networks. Some Angel groups have organised themselves into Angel Funds, a structure closely resembling a VC fund.

The main advantages of syndicate membership are:

- sharing the risk with other investors
- receiving the views and inputs of other investors
- a greater flow of possible deals through the membership

- the possibility of having a public profile to source deals
- having the syndicate provide administrative support
- some syndicates employ staff to screen proposals
- some syndicates employ executives to manage any investments
- the investment is more likely to have better screening and due diligence
- access to business contacts
- enhancing the Angel's management skills
- access to additional funds.

Some Angel Networks are loosely organised where Angels simply meet occasionally to compare notes and to decide if they wish to co-invest in a deal. They have no formal agreement, no regular agenda and no obligation to attend or to co-invest.

A more formal Angel Network would have a membership fee, regular meetings and an obligation to make investments and to share some of the workload of deal screening and due diligence. More sophisticated Networks employ administrative staff and staff to screen proposals. They meet on a regular basis where they review potential investments, listen to presentations from entrepreneurs and share experiences. They accept an obligation to participate in investments but they can choose which ones. They also accept an obligation to undertake a share of the due diligence work. Some Networks invite early stage VC funds to join in their activities either for co-investing or to smooth the way for subsequent follow on investment. An Angel Network typically establishes dues for its members, manages network finances, promotes deal flow and recruits new members.

In most Angel Networks, a champion must be found before a proposal will go forward to a more in-depth due diligence. It is expected that the champion will assist the entrepreneur to prepare a proposal and presentation and will be the lead investor.

As an example of how an Angel Network operates, the following is a description of the Vancouver Angel Network.

An Angel Fund resembles a VC fund in its operation. Angels commit a specified amount of capital and invest as a group in companies based on a

### **Example**

Deals are brought to the attention of the membership through a structured, if somewhat informal process. An Angel member must sponsor a prospective business in order to bring it in front of the group. To be a sponsor, the investor must work with the network and be interested in making a personal investment in that company. By making an individual member do this initial due diligence, the group avoids having to deal with a formal application and screening process.

Approximately one in four presentations made to the group receive capital. The investments range from as low as US\$25,000 to as high as US\$4 million. The group has a definite technology focus and only looks at applications from local Vancouver businesses.

Three or four companies are brought before the group at each monthly meeting. The meetings begin at 7.30 am and typically last two hours. Each presentation is restricted to 15 minutes; the presenters have 10 minutes to present to the group, with five minutes reserved for questions. The presentations are not intended to spark a detailed discussion, but to gauge general interest among the group.

Generally speaking, presenters do not listen to other presentations. At the end of the meeting, each business' sponsor leads a discussion on the presentation, without the presenter in the room. Gauging interest is normally a simple process, with people just speaking their minds. Often it becomes clear very quickly who, if anyone, is interested in the opportunity.

A nominal annual fee is used to defray the minimal administrative costs and to provide coffee and muffins for the breakfast meeting. No presenters or investors are charged for attending the seminars.

*Source: [http://www.Angelcapitalassociation.org/dir\\_downloads/resources/BestPractices\\_AngelPrimer.pdf](http://www.Angelcapitalassociation.org/dir_downloads/resources/BestPractices_AngelPrimer.pdf) Accessed 21/01/06*

vote of the members. Angel Funds usually employ a professional manager who screens deals, leads due diligence efforts using member expertise and assists with generating deal flow. Managers are normally compensated with a salary, often based on the value of the pooled funds, plus a share of the capital gains achieved on investee exits, generally between 5% and 20%. An example of this type of arrangement is the Ottawa Angel Network.

### **Example**

Ottawa Angel Network – Band of Scoundrels: The Band of Scoundrels, formed in 2001 by several individuals to facilitate investing in the Ottawa community, is a general partnership consisting of eight individuals and two corporations. It is structured as a pooled interest with a formal process for selecting investments. Rather than providing a forum for individual investors to select targets, the Band pools the members' funds and decides as a group on a per investment basis. Decisions are made by voting, with a 70% vote carrying the day.

Finding and evaluating deals: Band members nominate candidates to present to the group; however, two members of the Band must examine the deal before agreeing to hear the presentation. The champion or sponsor is responsible for ensuring the necessary information is presented.

While each member of the organisation shares equally in the financial risk, workload varies among the members depending upon availability.

*Source: [http://www.Angelcapitalassociation.org/dir\\_downloads/resources/BestPractices\\_AngelPrimer.pdf](http://www.Angelcapitalassociation.org/dir_downloads/resources/BestPractices_AngelPrimer.pdf) Accessed 21/01/06*

Angel Networks are listed on most national venture capital websites and many have their own websites. Most countries have directories of Angel Networks and many have Angel Network associations.

**Example**

The British Business Angels Association (BBAA) is the National Trade Association for the UK's Business Angel Networks and its associates and affiliates. It has evolved from National Business Angel Network (NBAN) and is backed by the DTI and is sponsored by Nesta and Kingston Smith.

BBAA is promoting the recognition of Business Angel Networks (BANs) and organised Angel groups. BBAA has a number of roles ranging from highlighting the contribution Business Angels make to the entrepreneurial culture to supporting its members and lobbying government to encouraging the exchange of best practice, experiences and ideas between its members. It specifically does not have a purpose to promote investment opportunities to investors or to advisors.

Source: <http://www.bbaa.org.uk/> Accessed 21/01/06

The European Business Angel Network (EBAN), established by the European Association of Development Agencies (EURADA) with the support of the European Commission in 1999 provides an online Directory of Angel Networks for each of the member countries.

*Source: <http://www.eban.org/members.php> Accessed 22/01/06*

Lists of Australian Angel Networks can be accessed from the website of the Australian Venture Capital Association (see [www.avcal.com.au](http://www.avcal.com.au)). Australian Angel Groups are also listed on the website of the Australian Association of Angel Investors ([www.aaai.com.au](http://www.aaai.com.au)).



## 5 Strategic v.s Financial Investments

There are basically two types of investments. Financial ventures create value on exit via a financial trade sale or an IPO by assigning a value to the future profit generating power of the entity being sold. Alternatively, a strategic venture creates exit value, not on the basis of what profit it could inherently generate, but on the basis of what future profit could be generated by the buyer exploiting the underlying assets or capabilities of the entity being acquired. These are fundamentally different types of businesses and the Angel has to ensure that the business development process and the exit preparation align to the appropriate exit.

In order to assess the potential exit value of any entity, we must first understand how the business creates value for its buyer (financial or strategic sale) or its future public shareholders (IPO). Those businesses which deliver inherent profitability must create value for its future owners through enhanced profitability and future profit growth. By contrast, strategic value businesses create value by enabling a large corporation, the strategic buyer, to exploit a significant revenue opportunity enabled through the combination of the

two companies. The strategic seller builds value by developing strategic assets and capabilities which a large company will exploit.

In the case of a strategic sale, it may not matter whether the selling business is making a profit, has revenue or is growing. This is in direct contrast to a financial exit which is entirely based on revenue and profit growth which the business itself must deliver to its new owners.

Because these outcomes are very different, the manner in which the Angel and VC investors will evaluate the investment and then should plan the exit for their investee business depends greatly on which type of exit is most appropriate.

I have grouped financial trade sale and IPO under the financial exit as they both have the same basic value creating process, they both need to generate a future stream of positive earnings to create a successful exit event. The IPO exit is an extreme situation of a financial venture where the projected revenue levels and the projected market capitalization is very high. While the IPO exit requires a more sophisticated organization to be successful, the fact is that both the financial sale and the IPO require a proven, high growth potential business concept to generate a successful exit value.

Smaller firms and firms with limited growth potential which create value through projected net earnings need to be directed towards a financial trade sale as they will not be able to meet the rather high threshold of revenue and potential growth requirements needed for a successful IPO. Given that only a very small percentage of firms are able to achieve IPO status, the vast majority of firms need to be prepared for a financial sale. For the purposes of this discussion, I am going to refer to all financial exits as a 'financial sale' with the understanding that some exceptional firms will be able to achieve an IPO. Also, for the purposes of this discussion, I am going to assume that all financial exits will be to an individual or corporation, that is a 'financial buyer', and that the buyer is setting the purchase price based on the anticipated future stream of earnings from the acquired firm alone. That is, the buyer is not assigning any synergy or benefit to the acquisition based on what is happening, or could happen, in the rest of the buyer's organization.

The financial sale is very different from a strategic sale where value is created through the combination of the buyer and seller businesses. We have all heard of businesses which were sold for many times revenue and staggering multiples of profit. These situations are all cases where the business being acquired had something which the large corporation needed to counter a major threat or to chase after a major new revenue opportunity. Most of these acquired businesses had unique intellectual property, deep expertise or well established brands or rights (e.g. to exploit forests, minerals, fishing etc). The assets or capabilities being acquired were considered by the buyer to be too expensive to copy, build or develop, or would take the buyer too long to assemble or to create internally. The delay in acquiring the asset or capability may also expose the acquiring corporation to an unacceptable level of risk.

In a strategic acquisition, a small business can often provide the means by which a large corporation can quickly generate many times the purchase price by leveraging its own assets and capabilities alongside those being acquired. Such acquisitions are bought, not on the basis of the profits of the acquired business, but on the value that can be generated within the combined entity. Few acquisitions, however, fit this profile. I will use the terms 'strategic sale' and 'strategic buyer' to describe a situation where a business is sold on the basis of its strategic value to the acquirer.

Businesses which are typically sold to a strategic buyer are those in biotechnology, information technology, research and development, designer fashions, mineral exploration, agricultural science, computer hardware and telecommunications. Also companies in consumer packaged goods with strong brands or with manufactured products which have global market potential can often secure significant premiums on sale. Acquisitions which can deliver very significant synergies in operating costs through integration would also fit into this category.

Probably about 95% of all private businesses which are sold are acquired by a financial buyer. In some, there will be synergies in the acquisition but these will be minimal and not sufficient to override the need for the acquired business to show its inherent profitability. Most companies don't have the type of assets or capabilities to leverage large scale opportunities for an acquirer.

Instead, they build profits through their own inherent competitive advantages for a local customer base.

A financial buyer seeking an acquisition will often have many choices of similar businesses, although sometimes geographically separate. The buyer may be buying a business to own and manage or a corporation undertaking a consolidation strategy by acquiring many businesses of a similar type. What the financial buyer is acquiring is a profit stream and so the basis of the purchase is simply how much profit the firm makes now and is likely to make in the future. Purchase value is calculated almost purely on the inherent profitability of the acquisition with little regard to the combination synergies in the acquisition. The seller to a financial buyer must put effort into increasing profit and profit potential.

Businesses which would normally be sold to a financial buyer are professional services firms, marketing firms, management consultancies, distribution companies, trucking companies, most retail businesses, wholesalers, import/export companies, agricultural enterprises, printers, professional practices, builders, construction companies and so on. Non complex manufacturing also attracts a high proportion of financial buyers. Basically any business which does the same as many other businesses will fall into this group.

Businesses acquired to be operated as a stand alone business will be purchased on the basis of their inherent profitability as there are no synergistic benefits in the deal for the acquirer. Therefore, a business bought by an individual who wants to invest retirement or redundancy funds to buy a business to manage will be a financial sale. Similarly, a business purchased by a private equity fund which intends to increase its profitability through new management, increasing its debt level and refocusing the business will also be a financial sale.

Businesses acquired by corporations can be expected to have both financial and strategic contributions. Many acquisitions are undertaken for roll-up, consolidation or expansion purposes. These businesses typically are purchased to add revenue and profit generation through their own inherent operations although the acquirer may gain some synergistic benefits from operating at a larger scale or some benefits through reducing duplicate functions, but the prime consideration is generating operating profit from the business purchased.

The purchase price would be driven by the current and potential profit of the acquired business itself. While the additional synergies may make it more attractive, the seller would need to prepare the business for a financial buyer.

Acquired businesses which are expected to contribute significant synergistic benefits to the acquiring corporation may contribute little inherent profit. They are acquired because of the benefits which the acquiring corporation expects to achieve through the combination of the businesses. In most cases, these acquired businesses bring some asset or capability to the acquirer which the corporation is able to leverage through their own operations thereby generating significant future revenue and profits for the acquirer. A seller who was able to make such a contribution would seek out a strategic buyer.

Some firms will be able to do both. That is, they will have good profit capabilities and also be able to provide strategic benefits to the acquirer. But one will be more significant than the other. To the extent that strategic value benefits are greater than inherent profitability benefits, the seller would be much better off seeking a strategic buyer. Financial sales are always going to be limited by the profit generating capability of the seller. A strategic sale, however, is only limited by the size of the opportunity generated within the acquiring corporation. Thus, a very large corporation which can significantly leverage the strategic contribution of a small acquisition may be prepared to pay many times its financial sale value to ensure it receives the benefits of the acquisition rather than allow it to be acquired by one of its competitors.

I have extensively examined the process of a financial trade sale and have documented a methodology in my book, *The Ultimate Deal 1*, which can be used by business owners to significantly improve their sale value.

My book, *The Ultimate Deal 2*, examines strategies which owners of businesses with strategic value will use to sell their businesses to a strategic buyer. Angels and VC investors who wish to examine the strategic sale preparation process in greater detail should also read my e-book '*Invest to Exit*'.

## Financial or Strategic Sale – Which One?

I often confront Angels with existing investments with a stark choice – what is the best strategy to prepare your investee business for a sale – build up the profits or develop underlying assets and capabilities for a strategic sale. You might well ask ‘Why can’t you do both?’.

### Financial v.s Strategic Buyer Strategies

Attribute	Financial Buyer	Strategic Buyer
Source of value to the buyer	Profitability, risk minimization, growth potential.	Threat elimination and/or revenue potential in the combination of the two businesses.
Value created by	Increasing profits, reducing risk, future growth and proven growth potential, roll-up or consolidation opportunities.	Underlying assets and capabilities which the buyer will leverage to eliminate a threat or exploit a large revenue opportunity.
Additional value created by	Increasing current profits, increasing growth rate, developing additional substantiated growth potential.	Reducing integration time, increasing rate of scalability and speed of exploitation, adding additional strategic assets and capabilities for the buyer to exploit.
Buyer	Individual, investment trust, private equity firm, corporation undertaking a roll-up or consolidation strategy.	Large corporation which can exploit the strategic assets and/or capabilities in a large customer base.

<b>Attribute</b>	<b>Financial Buyer</b>	<b>Strategic Buyer</b>
Impact of increased profitability	Major impact on value.	May be irrelevant. Profits are only needed to ensure survival prior to a sale.
Size	Any size.	Large acquisitions may have difficulty creating sufficient new incremental revenue.
Existing growth	Significant impact on value.	Size must be sufficient to allow a critical mass platform for opportunity exploitation. Growth itself may not be important.
Growth potential	Significant impact on value.	May have no impact on the buyer's opportunity.
Underlying assets and capabilities	Must deliver competitive advantage within the seller's business as a stand alone entity.	Must deliver a sufficiently large and robust base for exploiting a strategic opportunity in the combination of businesses.
Inherent risks	Must be eliminated wherever possible.	Must be eliminated wherever possible.
Succession planning	New buyer must be able to run the business if the senior management leave.	Key manager and key employees needed to exploit the opportunity must be retained.

<b>Attribute</b>	<b>Financial Buyer</b>	<b>Strategic Buyer</b>
Advisors	Business broker, professional services firm, business advisor	Large professional services firm, investment banker.
Preparation time	18 months to 2 years	2 years or more.
Level of integration	Most often continues as a sole business or might be loosely integrated bolt on acquisition. May contribute administrative synergies in a consolidation.	Varies. Often fully absorbed. Sometimes integrated into only one part of the business. Could be left as a stand alone entity passing products, IP or processes to group.

I am sure that some companies can do both, but when you look at the processes involved and the priorities which will determine where to use surplus cash, you often see a clear choice – if the company doesn't have the resources to do both it needs to decide which strategy is going to achieve the highest exit price.

There is sometimes the possibility that a single venture can throw off more than one exit. This can happen where the firm has developed IP across multiple markets or solves quite different problems. It may be worth separating the different IP into distinct ventures and preparing each for an exit.

Another possibility is that a single venture may have quite different activities each of which could be directed towards their own sale, perhaps with some being financial sales and others being strategic sales. This can happen, for example, where IP is the basis of a sales transaction of a product but is then followed by maintenance or service sales. The IP may appeal to a global corporation but they may have no interest in the local services business. In such a case, it may



be worthwhile splitting the business and selling the different parts to different buyers.

Companies which are sold as a financial sale are those which provide the buyer with a platform which enables the buyer to generate a stream of future earnings through the use of the resources contained within the acquired business. While these might be augmented by the buyer through the insertion of better processes, more capable management and better funding, essentially it is the same underlying business which is generating the profit stream. Thus any acquisition valuation will be based on the net present value of those future earnings. Most businesses fall into this category. Financial buyers typically buy retail, wholesale, light manufacturing, transport, property and services based businesses.

You increase the value of such businesses by reducing the inherent risks for the buyer, improving the visibility and reliability of future earnings forecasts, improving on-going profitability, building growth into the business and finding ways to create growth potential for the buyer.

By contrast, those businesses which appeal to strategic buyers have some underlying assets or capabilities which a large corporation can exploit through the buyer's own organization. Small companies will often develop products or services which can be sold by the acquirer through their very large distribution channels. In the right circumstances, a buyer might be able to scale the revenue by 50 to 100 times that of the seller just by having the right access to global customers. The key to a strategic sale is to find a large corporation which can exploit the underlying asset or capability of the seller to generate very large revenues. In these situations the size, revenue, number of customers or employees or level of profits of the seller may be entirely irrelevant. It is the size of the revenue opportunity of the buyer which is the key to strategic value.

Thus a business which has the right type of assets or capabilities which can generate strategic value may be much better off putting additional effort into developing those assets and capabilities to provide greater or earlier revenue generating power for the intended buyer. A higher exit price will be achieved if the buyer can scale or replicate the asset or capability faster and can integrate the seller's business quicker. The only size consideration for the seller is to be

big enough to provide the launch platform for the buyer to fully and quickly exploit the strategic value.

Angels need to be sensitive to these two types of ventures as it directly impacts the evaluation of the venture and the manner in which the business would be developed for an exit.

## [ 6 ] Build a Deal Pipeline

**M**ost Angels desire to see more potential deals. It seems that deal flow, or at least good deal flow, is their biggest impediment to investing in more ventures. Those who band together in syndicates do see more deals and certainly co-investing will get them into a higher volume of deals, but many still prefer to find their own and be the sole investor, especially at a very early stage.

Angels develop personal networks to stimulate contacts with entrepreneurs who require funding. Sources of contacts are many and varied with most Angels generating most of their leads from friends, family and business associates. Those that are in Angel syndicates have the advantage of a greater pool of people seeking deals and are exposed to many more opportunities than most Angels working alone. Even so, Angels in syndicates still source many of their own deals personally. Sources include local lawyers and accountants, business advisors, universities, research institutions, incubators, venture clubs, PR and media companies, science parks, VC firms and government agencies.

There have been a number of studies into Angel investment. Analysis of deal sources shows that personal contacts are used in conjunction with Angel syndicate deal flow.

A 2003 Survey in Scotland found the following as the best way for Angels to find investment opportunities.

Source	Number	Frequency
Friend/family	5	5.7
Business associates	15	28.7
Angel syndicate	23	26.4
Introduction network/service	19	21.8
Professional referral (e.g. accountant/lawyer)	4	4.6
Direct from entrepreneur	6	6.9
Banks/financial institution	0	0
Other	5	5.7
Total	77	100.0

*Source: Stuart Paul, Geoff Whittam and Jim B Johnston, 2003, The operation of informal venture capital market in Scotland, Venture Capital, October, Vol. 5, No. 4*

Comparable studies in other countries have shown patterns which are similar, although countries with less mature Angel Networks have a higher level of contacts directly with the entrepreneur.

Benjamin and Margulis in their book *Angel Capital*, surveyed 600 Angels in 1998. When asked how they found their deals, 57% said they were mentioned by a friend, family member or co-worker; 12% came directly from the entrepreneur and 31% came from professional referrals. At least 70% wanted pre-screened referrals over direct approaches.

## Personal Deal Sourcing

Active Angels have many potential sources for connecting with entrepreneurs seeking Angel funding. However, they need to be proactive in establishing those sources and, where they can, they prefer that some level of pre-screening occurs. This ensures that they are referred to only those investments which are likely to fit their criteria. This requires the Angel to establish an 'Investment Profile' which can be discussed with possible sources. For example:

<b>Attribute</b>	<b>Preference</b>
Size of investment	Minimum and maximum value
Stage of investment	Pre-seed, seed, early etc
Size of business	No. of employees, revenue
Profitability	Pre-revenue, break-even, profitable, established
Industry	Preferred industries
Management team	Still being formed, developed
Management experience	Little or no business experience, corporate but no SME, SME functional, experienced
Products	Design stage, prototype stage, released to market, established
Board of Directors	None, established
Board of Advisors	None, established
Location	Central location and distance from home. Maximum travel time
Co-investment	No, maybe, preferred
Time available	Hours or days per month. During business hours or not
Income requirement	None, Director's fee, consulting fee, salary
Harvest	Repaid from cash flow, trade sale, IPO, MBO
Timescales to exit	No limit, maximum number of years, preferred
Contribution	Start-up management, customer contacts, strategic relationships, international business, finance, R&D, etc

Some Angels are prepared to provide a profile in writing to local contacts to help with deal sourcing while others prefer to seek out entrepreneurs directly.

## Primary contacts

Places where the Angels can gain direct access to entrepreneurs seeking funding would include the following:

### Investor forums

Venture forums are periodic events arranged so that investors and entrepreneurs can network. They are typically sponsored by non-profit organisations, such as business development corporations or universities, incubators, Angel groups, and for-profit groups involved in funding and investment banking. While some are educational events, the most successful forums allow pre-screened entrepreneurs with prepared and schooled presentations the opportunity to give a short pitch, 10-30 minutes, to a group of potential investors.

#### Example

The enterprise angels Private Luncheons (in Australia) are private and confidential forums designed to provide the opportunity for up to five registered Investee companies to promote their investment opportunity to a number of enterprise angels private clients and other interested parties. Private Luncheons have been running successfully since early 2000, and today operate regularly throughout the year in Brisbane, Sydney and Melbourne.

The typical format for these events is for the investee companies to present their investment opportunity in seven minutes each, and then upon completion of the presentations a light lunch is served and networking time is provided.

Source: <http://www.enterpriseangels.com/events.htm> Accessed 21/01/06

Local, state and national governments and government bodies often fund not-for-profit organisations to set up investment forums where entrepreneurs can pitch ideas to local Angels. As an example, LINC in Scotland is a public/private partnership which acts as a matchmaker by providing a service bringing together Business Angels with entrepreneurs seeking investment funds. Membership is open to any individual with an interest in becoming a Business Angel upon payment of a nominal membership fee. It is a non-profit making body and is the main Business Angel Network in Scotland.

LINC arranges regular investor meetings in various parts of Scotland, at which companies get the opportunity to present their case directly to an audience of investors. Members also find it valuable to network with other Business Angels at these events.

*Source: <http://www.lincscot.co.uk/DoForYou.htm> Accessed 23/01/06*

Lists of such forums can readily be obtained through an internet search.

BSI Corporate Finance (BSI) in Australia developed an event called the BSI Investor Forum, where every three months, they showcase eight companies to 150 plus high net-worth individuals and funds in Sydney, Melbourne and Brisbane. BSI has also developed a process to assist the companies presenting at a forum to become investor ready over a period of time prior to the forum. In the past few years, BSI has showcased 12 Forums and 90 ventures. Of the 90 companies which have presented, over 50 have raised capital with the help of the Forum process.

BSI owns a small Private Equity Fund (ADI) supported by the Australian federal government. (\$6 million). BSI will co-invest in companies presenting to the forum in exchange for equity. So far they have made A\$2.5 million in 14 investments together with A\$25 million of co-invested funds.

The forums have become a 'networking event' for Angel investors and provide an opportunity for Angels to get together with each other and identify potential investments over a breakfast session.

*Source: <http://www.bsi.com.au/corporate/default.asp>*

### Internet-based matching service

Since the rise of the internet, there have been numerous sites set up to register entrepreneurs seeking finance and business angels offering assistance. Web-based matchmaking sites which attempt to match Angels with entrepreneurs seeking finance have, however, proved to be disappointing. Most Angels prefer some form of personal recommendation before spending their time evaluating a candidate or prefer to meet the entrepreneur at a venue. The major complaint by Angels of matching services is that they tend to list only those deals that are unable to source Angel finance through normal channels and thus are mostly the less-appealing deals.

#### Example

Business Angels Pty Ltd provides a central register where both private investors and businesses find each other by matching the needs of businesses with the investment criteria of private investors.

Australian Business Angels facilitates the identification and introduction of investment-ready companies to Business Angels who are able to provide capital. Australian Business Angels primarily works with businesses with turnovers of \$1 million to \$20 million. Private equity capital of \$100 000 to \$5 million can be sourced through Australian Business Angels without a prospectus under the class order exemption (02/273).

*Source: <http://www.mmv.vic.gov.au/Access to Venture Capital> Accessed 22/01/06*

A very powerful facility for Angels and Entrepreneurs is the Angelsoft platform. This provides tools for the administration of Angel Networks as well as a matching service for start-ups seeking finance. See <http://angelsoft.net/>

### Angel directories

In most countries an Angel can register their interest with a local or nationwide directory. Most countries have such directories, often as part of an Angel



association or as a sub-set of the local venture capital association. There are also local government agencies, sponsored organisations, development corporations and so on.

For example, in the USA, the Center for Venture Research has created a nation-wide list of VC resources to help entrepreneurs in their search for early stage capital. This list does not contain contact information on Angel groups but it does provide contact information on organisations interested in funding/assisting early stage companies and entrepreneurs. The list includes organisations such as VC groups, venture forums, matching networks and educational forums for entrepreneurs. The list is updated annually.

*Source: [http://wsbe.unh.edu/cvr/cap\\_locator.cfm](http://wsbe.unh.edu/cvr/cap_locator.cfm) Accessed 21/01/06*

A list of Angel contacts in Australia is provided in the Caslon Analytics *e-capital guide* (see [www.caslon.com.au/ecapitalguide3.htm](http://www.caslon.com.au/ecapitalguide3.htm)).

### **Venture capital firms**

VC firms often see deals which are too small, too early or in the wrong sector or simply timed badly for their existing funds. Angels with active connections to such firms can step in and hopefully provide the funding required. At the same time, deal flow might work the other way. Angels who see deals which require larger funding amounts or are outside their area of expertise or preferred growth stage can be forwarded to the VC firm for review. In this way a complementary relationship can exist which benefits both parties.

### **Local banks**

Banks which have close relationships with entrepreneurs may advise them to seek funding from an Angel investor if the financing needs are best met by an equity injection. Alternatively, a bank might be approached by a local entrepreneur who does banking business elsewhere in the hope of securing a loan. Again the bank may pass on the lead if equity is the best form of growth financing. To stimulate this type of referral, the Angel may spend time to meet with local bank officials, especially loan officers, or be active in the local business associations where bank managers typically network.

### **Local development corporations**

Many regions have a local not-for-profit development corporation which assists emerging firms with loans, education and contacts. Development corporations normally maintain a list of Angels and will provide introductions.

### **Local chamber of commerce**

The local chamber of commerce would normally provide an introductory service to local Angels. Some sponsor Angel Networks by providing administrative support and/or office space for administration, correspondence and meetings.

### **Incubators**

Local incubators assisting early-stage ventures will often require access to investment funding. Angels known to them will often be contacted with venture details to determine if they have an interest.

### **Universities**

Universities active in R&D spin outs will often seek help from Angels to assist in the early stage management of a spin out. Many university entrepreneurship programs actively seek guest speakers and mentors for students.

### **Business plan competitions**

Many educational institutions and local not-for-profit organisations sponsor business plan competitions. They are often seeking mentors for management teams as well as judges for final presentations. Angels who actively assist with such events can make direct contact with entrepreneurs.

### **Business associations**

Local business associations and trade associations sponsor events and provide forums where the Angel can connect with local businesses. Angels can use those events as an opportunity to express an interest in investing in local emerging businesses.

### **Business associates**

Current and former business associates provide a source of network contacts to entrepreneurs. By expressing an interest in Angel investment, the network can pass on the Angel's interest to entrepreneurs known to them.

### **Friends and relatives**

By making known their interest in Angel investing, family and friends will pass along this information to anyone they meet with a need.

### **Lawyers**

Legal firms often work with clients who are seeking an injection of funds. Sometimes they act as an introductory service, at other times they simply pass on the contact to the local Angel. Because they are often familiar with the client's business, they are in a good position to see a match between the needs of the firm and the investment preferences of the Angel.

### **Accountants**

Smaller accounting firms will often refer a client to a local Angel if they can see a match between the client's needs and the Angel's investment preferences. Larger accounting firms will often act on behalf of the client in sourcing finance and sometimes will require an introductory fee.

### **Business advisors**

Business advisors actively seek contacts with Angels in order to help their clients. Quite often they will attract entrepreneurs seeking Angel finance by advertising their ability to find capital. Many Angels have a network of local business advisors who source deals for them. In some cases, the business advisor will receive an introductory fee on successful funding.

### **Investment banks**

Investment banks typically work with larger clients and with larger funding rounds. Often an Angel syndicate is able to put together a sizeable pool of funds in a situation which might not suit a VC firm.

### **Local public relations**

An Angel may wish to develop a local profile by writing for a local business or trade magazine, speaking at local business functions or participating in local business-sponsored charity events.

### **Business brokers**

While business brokers typically act for sellers or buyers, they are often in a position to talk to firms interested in acquisitions which might need additional finance to complete a transaction.

#### **Example**

Don't miss MerchantBanc's next InfusionLab June 6, 2002 at the Radisson Hotel in Chelmsford, MA from 8:00 am – 1:30 pm

Special Guest Speakers:

Craig Benson, Co-Founder of Cabletron Systems Gordon Baty, internationally renowned author and venture capitalist. InfusionLab 2002 invites entrepreneurs and investors to make valuable contacts, exchange information, discuss ideas and create strategic business alliances at this one-of-a-kind event.

*Source: <http://www.wedu.com/merchantbanc/6-6-02/> Accessed 21/01/06*

### **Network events**

Angels can readily connect with local entrepreneurs through networking events.

## **Sourcing deals through Angel Networks**

Angel Networks or Angel Groups are generally much more publicly active than individual Angels. Because they can provide an interface between Angels and entrepreneurs which does not require individual Angels to be readily identified, many Angels like this type of deal sourcing.

Some Angels work with Networks exclusively while others supplement their own activities with Network sourced deals. Many Angels find it convenient to take their own sourced deals to Network meetings so they can benefit from the greater pool of resources available through the network and also to benefit from co-investing possibilities, especially if the funding requirement is greater than the amount they prefer to invest personally.

Networks often have their own websites which provide information about their activities to both potential Angels as well as entrepreneurs seeking finance. See example below.

### **Example**

Cherrystone Angel Group, based in Providence, offers start-up investment funds to Rhode Island-based companies that need seed capital.

Typically, Cherrystone will invest between \$100,000 and \$500,000 and work with the emerging companies to proceed to the next stage. Cherrystone also helps recruit new members of the management team, develop strategic partners, and refine product strategy.

Companies seeking capital should complete the standard Cherrystone Company Survey.

The completed survey will help determine if there is a viable investment opportunity for Cherrystone.

NOTE: Cherrystone Angel Group takes all reasonable efforts to assure that information submitted to it is held confidential, but will not sign a non-disclosure agreement (NDA) before reviewing completed surveys.

*Source: <http://www.bdcri.com/BDCFinancing/AngelFinancing.html> Accessed 21/01/06*

Experienced Angels use multiple sources for deal flow; however, an inexperienced Angel may prefer to work only with an Angel Network in order to gain the benefits from the mentoring of more experienced Angels and access to shared knowledge and resources.

## 7 Evaluating Possible Investments

**B**usiness Angels don't consider themselves charities and while they may be motivated to assist entrepreneurs in start-up and early stage ventures, they still want to see a return on their money. Even those who are highly supportive of young entrepreneurs and want to 'give back' know that their ability to help more ventures will depend on their success, thus each investment should be approached with rigour and an objective of achieving a good return.

Given the early stage environment in which the Angel participates, a summary of their investment objectives would normally be as follows:

- The objective of the investment is to exit with a return of at least 25% compound across the whole investment portfolio.
- The time period from investment to exit needs to be planned for 3-7 years.
- The investee firm is most likely going to need mentoring and help with its growth strategy.

- While Angels are prepared to take risks they prefer to invest where the risks can be minimised or managed.
- While Angels seek investments with a very strong up-side valuation, they are still quite averse to losing their investment through a lack of due diligence.
- Angels will typically invest where they have industry experience, understand the risks in the investment and where they feel they can make a contribution.
- Due to the high level of involvement in their investee businesses, the number of investments they are prepared to make concurrently will be limited.
- Early stage ventures don't have the proven success which later stage businesses have, so the Angel is mostly evaluating venture potential.

Angels play a very useful role in providing funding over the medium term (3-7 years) for firms which don't have the assets to access more traditional forms of debt finance. However, the lack of asset security means that the investment has a higher risk profile. At the same time, the Angel cannot easily exit the investment. There is no established liquid market for shares in unlisted or emerging firms and so this factor also carries with it a risk premium. Since few ventures are guaranteed, even the best Angel funded ventures will carry some level of risk not present in listed or larger corporations with significant tangible assets.

In evaluating a possible investment, the Angel, or lead Angel in a co-investment situation, should approach it on the following basis:

- The business is almost certainly going to be sold within 3-7 years. Outside a boom market, very few firms make it to an IPO.
- The entrepreneur and most of the equity holding management team are unlikely to stay with the business once it is sold to a corporate buyer.
- The Angel, in most cases, will not be involved in the day-to-day operation of the business but will play a mentoring and strategic role.
- The Angel can be expected to provide specific help in an aspect of the business where they have deep personal experience.



- A primary activity of the Angel will be to ensure the business implements formal operational management systems and good governance processes.
- The Angel will most likely hold at least one Board seat.
- The valuation of the business at the time of the initial investment has to take into account the risks associated with the investment and therefore is likely to be much lower than the entrepreneur thinks the business is worth.

Angels see themselves as ‘business builders’ and certainly assist firms to develop, but few investees will ever achieve a public listing. Approximately 50% of Angel investments result in write-offs or, at best, break even. Most successful Angel investments result in a trade sale. At the stage Angels typically invest, only a very few have the size and growth potential to undertake an IPO outside a boom market. The reality is that only about 20% of larger, mature firms with high potential make it to an IPO.

One of the evaluation issues facing the Angel is whether the business will have a financial or strategic exit. Clearly, the financial venture must be able to prove out an entire business model and be able to convincingly demonstrate a capability to produce significant growth in revenue and profit. This is in contrast to a strategic venture which must simply show that it is an ideal acquisition for a large corporation. While there are a number of attributes which both these ventures must demonstrate, the hurdle for the financial business is significantly higher.

For a financial investment to have a serious chance of being successful, resulting in an IPO or financial trade sale, it needs to show that it can demonstrate the *potential* to achieve the following set of attributes:

- Clearly identifiable and reachable customer with a compelling need.
- An emerging and growing market with significant global potential which is fragmented and where demand exceeds supply.
- A business model with sufficient barriers to entry to protect the business over the first few years.

- A growth strategy which can achieve the levels of revenue and profit within 3-7 years to easily sustain the ROI needed by the Angel.
- A proven product or service which has clear customer acceptance.
- A management team which can demonstrate they have the skills and experience to execute the growth strategy over the next several years in conjunction with assistance from the Angel.
- A robust exit strategy with a high probability of execution within 3-7 years.
- A set of shareholders and a management team that is willing to sell the business within 3-7 years and walk away if necessary.
- A well-defined plan for the use of the Angel funds, which is directly linked to clear and measurable targets which in turn support the exit strategy.
- A robust business strategy and cash flow which can cope with things going wrong and can still, in the worst case, return the initial investment to the Angel.
- A team willing to negotiate a realistic valuation.

For a strategic investment to be successful it must be able to show a highly probable exit through a strategic trade sale. In the assessment of a strategic venture, the business needs to demonstrate the *potential* to achieve the following set of attributes:

- Clearly identifiable and reachable customer with a compelling need.
- An emerging and growing market with significant global potential which is fragmented and where demand exceeds supply or an established market which would rapidly absorb the firm's product or service.
- A product or service with sufficient barriers to entry to protect the business over the first few years.
- A level of scalability or replication in the product or service which can generate significant new revenue for the strategic buyer in the first few years after the trade sale.
- A proven product or service which has clear customer acceptance.
- A management team that can demonstrate they have the skills and experience to execute the strategic trade sale over the next several years

in conjunction with assistance from the Angel.

- A well-defined plan for the use of the Angel funds, which is directly linked to clear and measurable targets which in turn support the exit strategy.
- A robust business strategy and cash flow which can cope with things going wrong and can still, in the worst case, return the initial investment to the Angel.
- A set of shareholders and a management team willing to sell the business within 3-7 years and walk away if necessary.
- A team willing to negotiate a realistic valuation.

You might well argue that it is near impossible to find an early stage venture which meets either of these sets of criteria. In reality you are unlikely to find a business seeking Angel finance which even understands these requirements. Your evaluation is to make a judgement as to whether you firmly believe that the venture can be taken to a successful exit. After all, if they could already achieve all this, they would not need an Angel or would go straight to a VC firm for a larger investment to exploit their potential.

Angels generally invest where they can see that the venture can be developed over a few years to the point where it can be sold to a corporate buyer or taken to an IPO. Your task as an Angel is to help the business to develop so that you can meet this list of attributes as closely as possible. The closer the fit, the higher the probability of reaching a level of sales and profits where they become a profitable, sustainable, growth business, are able to secure a strategic sale or are capable of securing VC investment at the next round of financing.

The critical factor in Angel investment is to be able to judge potential in an objective and unemotional manner and to do it with a comprehensive and systematic process. The Venture Potential Index in Part B will help you do that.

*What does it take for a venture to be successful?*

*Which parts of the business do you need to give the most attention to?*

*What are you looking for in the proposal from an entrepreneur?*

The entrepreneurship body of knowledge can help us answer these questions.

## The market analysis

There are many marketing texts you can read which talk about market segmentation, customer buying patterns, pricing models and so on. Most likely the Angel will have read those and so understands the jargon. The key to an investable business is more about the execution of a business plan over a limited period of time to achieve the exit conditions. This might be a stated level of revenue and profit, rather than developing a sophisticated marketing plan for market domination. Alternatively, it might be in preparing a product or service for a strategic buyer's market. If the life of the venture is to be 3-7 years before an exit, then very specific targets need to be achieved.

Whether it is the target market of the venture or the target market of the strategic buyer, it can be expected to have the same fundamental attributes. The target market definition needs to be very simple, robust, obvious and easily proven. The ideal model is characterised by the following:

- Well-defined, identifiable and easily reachable customers who have a high compelling need to buy, a willingness and ability to pay the price and are in sufficient numbers that the revenue targets can be readily achieved.
- A segmented market where it is possible to significantly differentiate the product or service from competitors and where that differentiation is difficult to copy or neutralise.

A financial venture would also want to be able to demonstrate the following:

- A total market which is growing, has global potential and would be attractive in the long-term to a major corporation.
- A fragmented market which enables growth by acquisition.

## The customer

The better business to be in is where the business has a list of all possible customers for the product or service. Alternatively, the customer can be readily reached through an established, or readily built, distribution channel. The entrepreneur should be telling you:

- the profile of the ideal customer
- how contact will be established
- what their buying pattern is
- how they have the purchasing power to readily meet the sales price.

You see businesses all the time which reach out to the general public in the hope that they will buy. A retail store, a restaurant and the internet marketing firm are all hoping they can attract customers. But they have little influence over the buying cycle. On the other hand, customers which can be clearly identified, named and are able to be approached with a value proposition are much easier to sell to. This is not to say that other models are not successful, however, they generally carry a greater risk.

Redefining the business to be proactive in reaching its target customer will make the business more likely to achieve sustainable profits.

## The compelling need to buy

Few people understand just how hard it is to build a value proposition which compels a customer to buy. Most products are chosen on a whim, can be readily deferred or have many alternatives and substitutes.

Think about these questions:

*What problem is the venture solving?*

*Is it satisfying a need or a desire?*

*What degree of compliance (penalty or cost) results from not buying?*

*What happens if the customer does not buy?*

*Are there alternative to the firm's product or service they could buy?*

*Who is required to solve the problem? What happens to them if they don't?*

How can the products be made more necessary? Is there a select group of customers the firm could focus on where it could secure a higher price?

### **Example**

Distinction Software Inc. a business established in 1994 in Atlanta, USA, by Dr. Tom McKaskill developed a sales forecasting and inventory planning system for high volume, low cost consumer packaged goods. Using prospect data the software could show a 15-30% reduction in safety stock over a three month period providing an investment payback of 3-6 months on the software cost. Even though many corporations expressed interest, few made the investment. Why?

After five years it became apparent that only corporations that had deep-seated inventory problems were willing to make the organisational and system changes to implement the software. For the others, their profitability was high enough that the changes required to implement the software were simply 'too hard'. For the software to work effectively the customer needed to change job responsibilities, reporting lines and data ownership. The 'compelling need to buy' only existed in a few corporations. For the others, it was a desirable, but not necessary, thing to do.

## Market characteristics

Most Angels prefer their investee companies to operate in medium-sized global markets as this will ultimately attract the corporate acquirer or will be the basis on which to launch an IPO. But for an Angel, it is not whether the market is small or huge, it is simply whether the target market over the next 3-7 years can provide the firm with the capability to achieve the valuation required for the Angel to exit. In the end, it all comes down to valuation on exit and ease of exit. The target market may be directly addressable by the investee firm or could be the target market of a strategic buyer.

For a financial venture, a larger fragmented market where new products and services can find a reasonable size niche market are preferred by Angels as this is easier to achieve than global domination or a share in a commodity market. The firm has to demonstrate in its investment request that it can secure the level of revenue and profits required to achieve the valuation target. Even in a very large market, a lack of customer demand for the specific offering of the firm won't make the target numbers.

For a strategic venture, it is whether the potential strategic buyer has an existing market which can be readily addressed or a potential market which they can exploit.

So in the end it comes down to establishing, with a reasonable degree of certainty, that the revenue, cash flow and profit targets of either the firm itself or the intended buyer can be achieved. This requires a very good understanding of the marketplace, an understanding of the needs of the customers and some level of proof that customers will buy in the quantities forecast. This might be based on existing sales, prospect surveys or expert advice plus experience within the executive team.

However, in order to show a probable exit path, the requirements of the exit strategy need also to be shown. An IPO requires the company to be able to confidently build to, say, a \$100 million valuation within three years after listing. Smaller companies are not excluded from an IPO, in fact many companies smaller than \$100 million are successfully listed; however, they tend to miss out on attracting institutional investors and in many cases do not attract broker

or analyst coverage, accordingly, they present a greater risk to maintain or increase values. Furthermore, as the management team and the Angel usually have at least part of their shareholding escrowed for a period of time, the exit value may ultimately be at prices below the initial listing price. For an IPO exit the firm needs to confidently show that it can achieve the revenue, cash flow and profit targets needed to support the share price over a 3-5 year period after listing. With an IPO exit, hopefully funding through the IPO and subsequent rounds of public capital raising will fund growth. The business needs to have a very strong product/market position to fuel growth.

For a financial trade sale exit, the requirements for revenue and profits are very different. The firm need only show that it can reach the level of revenue and profits needed to close the trade sale deal. In the case of a strategic trade sale, achieved revenue and profit may be zero or limited, that is, the deal is based on some other aspect of the business which needs to be achieved, such as a product development stage. At other times, the acquiring corporation may want to see a limited number of customers actively using the product as a proof of design, marketing and operational use.

In many cases, corporations enter into a strategic trade sale with an emerging firm to acquire a product which has considerable global potential. In proposing a trade sale exit strategy, the firm needs to convince the Angel of the ultimate size of the market that would attract the proposed buyers, whether they be a financial or strategic buyer. Thus market size and competitive positioning become important, not for the short term, but to secure the ultimate acquirer.

As an Angel, you should be interested in the structure of the industry and an analysis of the market dynamics.

*Which companies are growing and why?*

*Which firms are declining and why?*

*Is this an emerging market where demand exceeds supply and thus even poor businesses will survive?*



*Given the product positioning, which market is the firm attacking and what retaliation, if any, can the firm expect from the current players?*

*Is this a market which will attract new entrants and, if so, how will the firm defend its business from the new competition?*

## Competitive analysis

Angels prefer their investee companies to sell products or services which are differentiated from their competitors. They like to see differentiation based on some level of innovation in product, process or business concept. The innovation itself needs to be difficult to match over the period of time needed to achieve the exit target.

If an IPO is planned, the product needs to be sufficiently different to be able to sustain a long-term competitive advantage. This is the only position which will allow the firm to achieve the revenue, cash flow and profit levels needed to sustain the share price in the public market.

In a financial trade sale, the firm has to be able to demonstrate revenue growth into the medium term. Competitive advantage is going to be a key aspect of the business case to the buyer.

For a strategic trade sale, competitive position is not as important as being the right product for an acquisition. However, if you look beyond the acquisition, you have to deal with the competitive position of the acquiring corporation and the subsequent merged operations. This means the investment proposal needs to show how the acquiring corporation would use the firm's products to secure significant revenue. Although, this may be in combination with the acquirer's other products or by selling the firm's products into their own customer base.

The competitive analysis needs to show very clearly why the firm's products are preferred in some market segments and to demonstrate reasonable proof of that assertion.

## Barriers to entry

Whatever the exit, the future generation of revenue and profit will require the firm to establish that its products or services which drive revenue generation have a level of competitive advantage which itself has a significant degree of sustainability. This implies some reasonable level of barriers to entry.

There are two fundamental questions which the Angel needs to consider:

*Why would customers buy this firm's products or services?*

*What is to stop a competitor from taking the business away from them?*

The first question should be supported in the proposal by the product value proposition, a market analysis, a competitor analysis and a compelling need to buy. 'Why you?' is also an issue of credibility. The firm or the strategic buyer needs to be able to convince the target customer that they can trust it to deliver and support the product. In the case of the investee firm, establishing the product or service in the market, this may be achieved through the experience of the team, from existing customer testimonials or through customer trials.

The second question is simply about protecting the business from erosion from an existing or new competitor. What is to stop a much better funded, larger, more aggressive competitor from duplicating what the firm has done and offering greater incentives for their prospects to buy from the competitor? This gets down to: how is the firm or the strategic buyer going to protect its business?

Protecting the business is achieved by erecting barriers to entry. That is, what can the firm or the strategic buyer put in place to protect its competitive advantage, distribution channel, ongoing customer revenue and source of supply.

Barriers to entry have one, or several, of the following attributes:

- high start-up costs
- expensive to acquire
- takes a long time to acquire
- protected by patent, trademark or copyright
- restricted under licence, rights or agreements
- requires specialised knowledge which itself is in limited supply
- highly innovative and not capable of reverse engineering
- protected by ongoing customer revenue through high switching costs or contracts
- ownership of or contracted distribution channel
- restricted or contracted source of supply.

Strong barriers to entry usually create the basis for a sustainable competitive advantage. This is the foundation of any longer term growth strategy for a public listing. At the same time, a strategic buyer will need to be convinced that these conditions can be established by it subsequent to the acquisition.

## The management team

The literature in the venture capital area is dominated by the quest for the 'A team'. This is the super team. The 'A team' has done it all before and has the skills, capabilities and diversity to cope with anything under any conditions. Regrettably they rarely exist and Angel and VC firms have to put up with business plan presentations from ordinary mortals.

However, that is not to say that their objective is wrong. It is simply that executives who have done it before have probably learnt from their successes and failures. They are well connected in the industry and are knowledgeable of other experienced executives and can easily recruit additional team members. For the Angel, it is all about reducing risk. If they can invest in a well-rounded team with experience, they have a greater chance of achieving their minimum targets.

The 'A team' also brings with them the following:

- a knowledge of the Angel's investment requirements
- willingness to negotiate a realistic valuation
- experience with an exit
- not as emotionally attached to the 'product'
- networks within the industry and with potential alliance partners.

For the Angel, members of an experienced management team are easier to deal with and have a good understanding of the Angel funding process.

Although the venture capital market has been operating in Australia and New Zealand for more than 20 years on a formal basis, there are still very few experienced management teams which have gone through a formal private equity investment and exit cycle more than once, unlike the US and European markets which have floating management teams which move from one investment with an Angel or VC firm through to exit and on to another investment.

Many of the deals brought to the Angel for funding simply lack an experienced set of executives. There can be no question the entrepreneur brings the idea, the passion, the vision and the energy, but other team members usually make it work.

When the Angel looks over the business plan, they are working on the activities which need to be executed to deliver the critical targets. This might be sales, marketing, product development, quality control and so on. For each of these activities, they want to know who on the team will deliver this operationally.

The real test to be applied here is operational. Given where the business is today, can the team execute, with reasonable confidence, the activities needed to get them to the exit conditions within the 3-7 year period? In some cases the Angel will be making a judgement as to their own impact on the ability of the firm to achieve such results. So the fundamental question the Angel has about the management team is: 'Can the team and I together achieve the targets needed to exit?'

For most exits, this will be a trade sale and the management team may not be needed beyond that. Not all proposals need the 20-year veteran or the executives recently cashed out from their IPO. In fact, this may be the wrong team for a clearly defined trade sale exit.

The business proposition also needs to show who is going to deliver on each of the major activities needed to reach the exit conditions. Any weakness in the team will need to be addressed by the Angel. The management team can be supplemented with experience from a Board of Directors, a Board of Advisors and external consultants. Where the management team is not complete, the Angel will want to see an acknowledgement that the existing management recognise this deficiency and accept that new talent will need to be recruited to deliver on the business targets. Some of the founding shareholders may have to step aside. This is a critical time for entrepreneurs as they need to put together a team which has a high probability of meeting the targets.

## Operations

Day-to-day monitoring of the business is an essential characteristic of a well-run firm. The firm has to know where it is, what it needs to do and have the systems, policies and procedures in place to monitor and correct deficiencies. The reason why Angels often become involved in early stage ventures is because it is this experience they can bring to the venture. From their past experience with start-up and high growth revenue ventures, they have learned the importance of being well informed and taking remedial action early.

Operational systems include all the budgeting, financial and operational reporting systems, performance setting and monitoring processes and systems and reward schemes which encourage the right behaviour. High growth businesses are finely tuned because they consume cash in building capacity. They have little room for mistakes and therefore early warning systems and quick response systems are very important.

At the same time, the business must manage its contractual risks. Well written contracts with customers and suppliers, well-designed contracts of employment, well documented intellectual property ownership and assignment are all components of good management of risks.

## Product development

It is unlikely that an Angel will ever know as much about the product as the entrepreneur and his team. Even if they have a technical background, this can be out-of-date quickly and they are rarely in a position to adequately judge the quality of the product development systems or the reality of the timescales. This is therefore a high exposure area for the Angel. To overcome this limitation, the entrepreneur will need to show adherence to budgets and targeted timescales, or show how the available products are capable of producing the results required. The entrepreneur must accept that keeping development costs under control and meeting development timescales is critical to ensuring the Angel's ongoing financial support.

## Later Stage Investments

More mature firms with established management, proven products and demonstrable revenue streams, often seek funds for market expansion, filling out product portfolios, acquisitions or working capital. Such firms offer a very different risk profile to the private equity investor compared to a start-up or early stage venture. However, such investments are not without their risks.

Firms often seek external private equity finance because they don't have the tangible assets needed by traditional banking lenders. Thus the 'assets' which underwrite the funding are often 'soft', such as patents, brands, copyrights or simply a good business model. As such, they are harder to value and often hard to liquidate. Even so, they may be good revenue generating assets and can provide some level of comfort to the Angel investor.

The Angel investor is still concerned with an exit. He will need to balance two opposing concerns, the upside potential of the business and the risks of failure. The upside opportunity will be presented in terms of building market share, establishing overseas offices and penetrating existing markets with additional products. However, the risk will be in the execution. Does the team have the skills and experience to deliver the target numbers? Will the market support their growth?

With more mature enterprises, the Angel has a much greater body of evidence to examine how well the company performs strategically and operationally. The Angel will still need to conduct extensive due diligence to uncover any weaknesses or risks. Established products and relationships can be examined to determine market potential and service excellence.

Many entrepreneurs seek Angel finance at this level to provide a boost to their business so they can reach a size and profitability where they can convert equity to debt or take the company to an IPO. This recapitalisation enables them to gain larger critical mass while at the same time gaining back the equity passed to the Angel investor as part of the financing deal. The entrepreneur is betting they can generate the level of security needed to fund debt within a relatively short period of time (3-7 years) to take out the Angel investor.

Entrepreneurs are often reluctant to part with equity, seeing this as loss of control and/or loss of upside potential. However, a deal which allows the entrepreneur to redeem the Angel's shares at some agreed formula can be a very attractive method of building up the business with an opportunity to buy back the external equity. Expansion finance which is used to build up tangible assets, decrease revenue and profit volatility or increase the portfolio of revenue sources, can provide a platform for negotiating debt to repay an Angel investor.

Entrepreneurs interested in short-term equity investment with redeemable options need to have a clear focus on the security requirements for debt finance. These factors then need to be built firmly into the business plan with the agreement of the Angel investor. Even partial redemption, swapping some equity for debt, during the investment period, may be an attractive option for both parties.

However, the entrepreneur still needs to accept that there is a potential pitfall in bringing in an Angel investor. An investee firm which fails to meet agreed targets or fails to generate sufficient free cash to fund debt obligations is still subject to intervention by the Angel investor. The investment agreement from the Angel should allow the Angel to take action if the investment is in trouble. No business is entirely free of risk, even if this is external to the firm and even to their marketplace. The entrepreneur seeking later stage financing cannot guarantee they can recapitalise or take the business to an IPO. Failure to

provide a liquidity opportunity for the Angel investor will result in intervention by the Angel to ensure that there is an exit opportunity while the business still has real worth. This will often result in the firm being sold in a trade sale.

In more mature businesses, the Angel is likely to play a very different role than that undertaken in early stage ventures. Where early stage ventures typically need advice and direction in moving the business to profit, growth and sustainability, later stage businesses often only need help at the Board level. Their needs are more likely to be advice on strategy and creating the right foundation for an IPO or major trade sale. Good governance, good reporting systems and a structure which reduces internal risks need to be developed. Angels in larger ventures often assist with global expansion, help establish strategic relationships and assist with VC rounds.

## The Investment Proposal

Any request for Angel capital should have a comprehensive business plan. It is not that the Angel could not understand the business from a discussion or presentation, it is just that it is more efficient in the long run for the entrepreneur to have it all documented in advance. The Angel can then reject it with a quick glance at the executive summary, review it prior to a meeting, use it to open discussions with other co-investors and use it to drive the due diligence process if they wish to proceed.

The general view is that, if the entrepreneur cannot put together a good business plan explaining every aspect of their business, they probably don't understand the business well enough to grow it to the point the Angel desires. Part of the entry test for investment is that they have the necessary literacy, numeracy and communication skills to run the business. The business plan is one of the tests they need to pass.

The major benefit to the Angel of the business plan is to provide an opportunity for the management team to demonstrate they can build a model of the business which an outsider can understand. The model needs to be holistic. It has to explain every aspect of the business in sufficient detail to show that they understand how all the parts have to work together over time.



You, the Angel, are being asked to invest considerable funds into a business you are trying to understand. It is unlikely that you will ever understand the business as well as the entrepreneur and the management team. Since your investment is only for a short period, say 3-7 years, you need to see a strong possibility of a trade sale or an IPO during that time. What they need to demonstrate in their investment proposal to you, in non-technical terms, is that they can achieve those objectives.

Most business plans are simply projections of the past. It is simply Excel madness. It is almost as if, by putting the data into Excel and projecting it forward for three years, it will happen. Of course it may. But that would be more hope than strategy. Forecasts need to be based on a set of realistic and defensible assumptions. For many entrepreneurs, the business plan is an expression of what they would like to happen. They work backwards from what they would like to happen to establish the growth rate that will get them there. Alternatively, they use a set of assumptions which seem reasonable and build their business plan on those assumptions. This is often presented as the classic 'percentage of the market' plan: 'The market is huge and we only need 2% of the market to be a \$100 million business.'

However, most often this is not supported by any validation that the customers will buy the firm's products or that they will buy in the volumes asserted. The business plan needed by an Angel has a very specific purpose. It is to convince the Angel that the firm can deliver the objectives they have for the use of their money. Put simply, that means:

- a 25% plus ROI
- known expansion opportunities
- an exit via an IPO or trade sale in 3-7 years
- identified potential trade buyers
- limited support required
- relatively low risk.

Many entrepreneurs think the purpose of Angel finance is to help them grow their business, or they think that Angel investment is simply another form of finance that will help them overcome some constraint within their business.

What they fail to appreciate is that Angel finance is specifically designed with certain objectives in mind which can only be achieved by developing the business so that the Angel can achieve a good return on their investment usually through an exit event in a relatively short period. The purpose of the business plan is to prove that those objectives can be met.

The business plan the Angel should be looking for should have the following three components:

*Where is the venture now and what is the growth opportunity?*

*What is the exit strategy?*

*How are they going to achieve it?*

The business plan should also include details of the management team and their capacity to deal with the business development strategy along with the how the funds sought are going to be utilised in support of the business objectives.

### **Where is the venture now?**

The entrepreneur should have a well-articulated business opportunity which needs Angel finance in order for it to be achieved. So the first part of the proposal for Angel finance should be about the business opportunity and the extent to which it has been validated.

It is almost always going to be the case that the entrepreneur will think only in terms of building a financial business. They will seek to generate significant revenue and profit to justify the Angel Investment. It is highly unlikely that they will have thought of a Strategic Trade Sale exit or be able to show how this could be achieved. Their presentation will almost certainly be around traditional business model concepts.

The proposal should demonstrate the strength of the business case from an opportunity screening point of view. Simply put:

- What is the business concept?
- What is the size of the target market and how will the firm secure its share?
- Who is the customer?
- What is the benefit to the customer and where is the compelling need?
- What price and why?
- How is the product or service distributed to the customer?
- What is the competitive advantage?
- How is sustainability of the business achieved?

If the business is already operational, the existing business should be able to demonstrate the operational aspects of the business model. This should validate the product/market information, the financial aspects of the business and the management team's capabilities. If you see a strategic exit opportunity, you will have to make that assessment based on the data you are initially supplied with.

In summary, you need to be convinced that this is a good business with a good idea or strategy, is well run and has a good chance of achieving the financial or strategic exit you require.

### **What is the exit strategy?**

Most Angels have similar objectives for their investments. While they enjoy the involvement with emerging companies, they want their money back with a 25% plus ROI within 3-7 years. Therefore, the investment proposal should clearly set out how much Angel finance will be needed and how the Angel will achieve that objective.

Most business plans which are used to support investment requests are woeful in setting out their exit strategy. The Angel needs to know which exit strategy is being proposed and why. Potential multiple exit opportunities are even better as they bring flexibility and reduced reliance on equity market cycles. For the vast majority of firms, they simply cannot meet the attributes of an IPO. For others, the strategy cannot be met with their existing business model and it would take a number of acquisitions to create the right IPO vehicle. For a few, they have the right mix of products, markets and potential to undertake

an IPO and also meet revenue and profit targets for several years beyond. Since an IPO generally achieves a much higher ROI than a trade sale, the IPO strategy should be followed. However, a trade sale alternative should be articulated in the proposal for periods where the market is unreceptive for an IPO.

For the trade sale exit, the entrepreneur should be setting out a comprehensive road map for how the sale will be achieved. This should include identification of specific potential buyers, the tactics that will be employed to develop relationships with each and an estimate of the likely sales price.

In his book, 'Early Exits', Basil Peters adds another element to the exit strategy question by suggesting that angels also ask whether the company intends to seek investment from traditional venture capital funds. His analysis shows that adding VC investment statistically adds about a decade to the exit timeline – pushing it beyond the normal maximum investment period for most Angels.

### **How are they going to get there?**

The business plan is simply about execution. The business is at point A (now) and it needs to get to point B (the exit), what are they proposing to do to get there? You need to see exactly how they are going to put the strategy in place over the 3-7 year timescale.

Of course, many start-up and early stage ventures simply don't have the experience to be able to develop an exit plan of any substance. You need to see that a robust plan can be developed. If you can't see your way out, you should be very hesitant of getting in.

Some Angels prefer to keep it simple. Knowing that the management team is somewhat green and need help to develop the business, they need to ask:

*Exactly what are you going to do with my money?*

Say you are a \$1 million revenue business. To get to the exit point, you may need to grow the business to \$4 million. Alternatively you may need to complete product development or establish trial customers to prove the product. How are they going to do it? It is not simply an extrapolation of the numbers. You need to see operational plans for every part of the business.

- A detailed marketing plan
  - Size, growth, customer profile, competition
  - Promotion, advertising, PR plans
  - Proof of effectiveness
- A sales plan
  - Closure rates, remuneration plan
  - Recurring business revenue and targeted prospects
  - Sales targets and recruitment and training plan
- An R&D plan
  - Product development and release milestones
  - Quality assurance, recruitment and training plan
  - Equipment plan

And so on.

There is nothing wrong with the entrepreneur admitting they need help to develop such a detailed plan, but you should delay making any substantial commitment until a proper business plan is in place, even if you help develop it. Only by getting down to this level of detail will you understand just how much finance and effort you need to contribute, but also, just how likely the business is to succeed.

Before committing to the investment, you should be able to review every part of the plan and see exactly what each manager will be doing to contribute to the overall plan. This should also be set out in an organisational plan (including recruitment and training) and plans for office accommodation, manufacturing and warehousing space, infrastructure and finance. A set of projected financial statements should be available.

An Angel should also be asking; ‘Show me exactly how these revenue numbers are going to be made?’ You might want to see a breakdown of forward revenue projections for both recurring revenue and new business. The recurring revenue should be supported by actual contracts with customers. The new business should be supported by a prospect generation and sales closure plan that targets specific customers or specific channels and so on.

The more the entrepreneur can show they really understand how to make the numbers and that they have the people, systems and processes in place to do so, the more convincing the plan will be.

At the same time, the growth plans may call for new management positions to be filled, in which case an executive recruitment plan should be included in the plan.

## Which business plan layout?

There are many examples of conventional business plan structures in textbooks and on the internet. Those offered by VC firms are good guidelines for the content. However, it is the way it is put together that is important. *Remember that the business plan for your evaluation should be about how you are going to meet your objectives, not how they are going to meet theirs.* In many cases you will need to ask the entrepreneur to revise their business plan with your specific requirements in mind.

For an insight into how a typical VC business plan might be structured, review the description provided on the British Venture Capital Association website in the document *A Guide to Private Equity* (see <http://www.bAngela.co.uk/>).

## 8 Entry and Exit Considerations

Once the initial potential investment proposal has been evaluated and the more extensive due diligence commenced, Angels should focus their efforts on resolving the two most significant attributes of the deal which will have the greatest effect on their return: the equity they will receive for their investment and the path they plan to take for getting their money back; the exit.

Entrepreneurs have always seen the initial valuation as the most important part of the investment process – as this can impact greatly on what they walk away with on exit. At the same time Angels see entry valuation as the key to the investment return – if they get too little equity they may not get a reasonable return on the exit if the venture is not overly successful. Thus valuation discussions can be stressful on both parties and often somewhat emotional. Finding a path through this discussion is critical if both parties are to proceed with the investment and still retain a positive working relationship.

Typically, few Angels have given the exit event much consideration, leaving this to be undertaken further into the investment when they have a better idea of the market and

the venture capabilities. But in fact, this is the critical event and should play a much greater part in the investment decision. A venture with a highly probable exit path should be a preferred investment.

## Valuation

Valuation of an existing business before VC and Angel funding and valuation of a business following VC and Angel funding has to be the most controversial topic in the venture capital literature. It is the greatest source of conflict between entrepreneurs and Angels, is plagued by emotion, misunderstanding, entrenched position taking and ignorance. It has often been said that 40% of deals fail to secure Angel funding due to a failure to agree a valuation. What is regrettable is that it is highly possible that many of these ventures could have made both the Angel and the entrepreneur considerable wealth.

Valuation is the process of estimating the monetary amount that the firm is worth based on its future expected returns. Valuation is a function of risk and return and considers:

- the expected return from an investment in the firm
- the expected returns from investments in other comparable firms
- the risks associated with the expected return
- any other relevant characteristics of the firm or the industry/geography in which it operates.

A more conventional definition of market value is: the price that would be negotiated between a knowledgeable and willing but not anxious buyer and a knowledgeable and willing but not anxious seller acting at arm's length within a reasonable time frame.

While this is probably not true of Angels, entrepreneurs often refer to venture capitalists as greedy, one-sided, 'vulture capitalists'. On the other hand, venture capitalists complain of entrepreneurs being unrealistic, unwilling to negotiate a fair value and ignorant of the balance between risk and return. No doubt similar tensions exist between Angels and entrepreneurs when it comes to setting an entry value.



## Valuation models

In the absence of an independent offer to buy the firm, the valuation of a private firm is a highly judgemental process. Valuation models are each designed with different purposes in mind. Like the problem of identifying cost, (historical cost, replacement cost, market price, incremental cost, inflation adjusted cost, depreciated cost) it depends what you want to use it for.

The major valuation models are:

- Earnings-based
  - Capitalisation of future maintainable earnings
  - Discounted future cash flows (DCF).
- Asset-based
  - Going concern value
  - Realisation value
- Industry-specific based
  - Market value
  - Rules of thumb.

In emerging businesses seeking venture finance, only the earnings based valuation models are relevant. Traditional earnings based valuation methods have been established to value existing business where historical data can be used to show revenue and profit trends and where established products have a market presence. However, most emerging ventures which seek Angel funding are of limited life, have little history and a somewhat speculative future. Thus while traditional methods of valuation don't really apply, the Angel should be familiar with their use as valuation discussions may involve them. In order to start any sort of meaningful discussion, the conventional approach to valuation for an Angel investment has been to write a forward projecting business plan and then to try to use this as the basis for discussion.

Most Angels will estimate a future (exit) valuation based on a four to six times earnings before interest and tax (EBIT) multiple of the projected profit at the time of harvest of the investment and then work backwards using an

internal rate of return (IRR) to reflect the risk in the venture to arrive at a post funding valuation. Early stage ventures may attract a 55% IRR with more advanced ventures attracting 20% to 40% depending on the expected risk. However, even this valuation is highly speculative as more funding rounds may occur, each setting a new valuation at the time of funding. To arrive at the equity percentage for the Angel, the investment required is deducted from the post-funding valuation and then the 'pre-money' valuation is arrived at. The Angel's equity percentage can then be calculated from the ratio of investment to post-money valuation.

Strategic trade sales require a different approach as the valuation is based on the expected earnings of the buyer in the first few years following the sale. However, a valuation can be applied to this stream of earnings to arrive at an exit value.

### **Capitalisation of future maintainable earnings**

Capitalisation of future maintainable earnings methodologies include:

- Price earnings ratio (PER)
- Pre-tax earnings multiples such as earnings before interest, tax, depreciation and amortisation (EBITDA), earnings before interest, tax and amortisation (EBITA) and earnings before interest and tax (EBIT).

Earnings-based valuations are used as a proxy for the Discounted Cash Flow (DCF) methodology.

The PER can be applied in two ways:

- Total value of the firm: PE multiple x net profit after tax (NPAT)
- Value per share: PE multiple x earnings per share (EPS)

The PER is applied to an estimate of earnings after tax. The value derived using a PER is a valuation of the ordinary shareholders' interest. This is described as an equity value.

Valuations based on EBITDA, EBITA or EBIT multiples calculate the Enterprise Value of the firm before factoring in the way it is funded. The Enterprise Value is typically adjusted for the following items to calculate an Equity Value:

- Interest-bearing debt
- Surplus assets
- Contingent liabilities
- Future capital expenditure

To further explain the difference between Enterprise Value and Equity Value consider the following example of somebody's house:

Item	\$	Value
Market Value	500,000	Enterprise value
Bank Debt	400,000	
	100,000	Equity value

Some sectors have well established valuation norms. These can vary with the economic cycles reflecting likely growth or depression trends. Multiples applied to mature industries with little likelihood of growth are generally lower than multiples applied to growth sectors. Firms which have experienced higher than average historical growth will usually command a higher multiple on the basis that future growth is also expected to continue at higher than average rates i.e. history is often used as a prediction of the future.

The assumption underlying the PER method is that the firm has stable or predictable earnings, that these will continue on a linear path for some years, the business will not change from its current business model and there is an appropriate debt/equity mix.

It is useful to set valuation expectations prior to going into a valuation negotiation. If the sector is currently valuing listed corporations at 10 times EBIT and the firm is seeking something higher, they have unrealistic expectations. If on the other hand they are seeking five times EBIT, you probably have a basis for negotiation.

The earnings used in a valuation need not be the actual historical earnings. Earnings should be adjusted for abnormal, extraordinary and non-recurring

items to determine a normal level of earnings. If the entrepreneur can show highly probable growth with achievable revenue and profit targets, future earnings might be used to calculate a market valuation. However, it is important to avoid double counting growth by using future earnings and applying a 'growth multiple'.

### **Discounted cash flow (DCF)**

A DCF has two elements:

- forecast of future cash flows of the firm for a number of years into the future
- discounting the forecast cash flows back to a net present value (NPV) using a discount rate which reflects the riskiness of those cash flows.

The preparation of a DCF can be challenging as it can be difficult to:

- accurately forecast cash flows for a number of years into the future
- select an appropriate discount rate.

The discount rate should represent the risks associated with generating the expected earnings of the firm. In many cases entrepreneurs and Angels will simply use the Angel's investment hurdle rate.

This method is somewhat more problematic. It is based on discounting future free cash flow to a present value. The free cash flow, or uncommitted cash surplus, represents the cash available to pay off the initial investment plus provide a return on that investment.

Most high growth businesses invest heavily in growth capacity. This might be R&D, sales force, promotion, channel expansion and so on. Few entrepreneurial ventures have spare cash.

The DCF discount rate in an Angel valuation is likely to be 35-40%.

When deciding on a valuation for a strategic exit, a value is arrived at for the exit price and then discounted to a NPV.

## **Fundraising alternatives**

It is useful to put Angel investment into context.

Let's say the entrepreneur wanted to borrow \$1 million. His choices are a first or second mortgage on his personal home, a loan secured on business property, a loan secured on inventory, or a loan secured against debtors.

Secured loans can normally be recovered by the lender as a market exists for the pledged asset. The lower the likelihood of recovery, the higher the interest rate and the lower the percentage advanced on the value.

Borrowing against the entrepreneur's home would possibly result in a professional valuation, which may be lower than the entrepreneur would willingly agree and a loan of probably not more than 80% of the valuation.

A bank is likely to seek higher rates of interest on a second mortgage to compensate them for the additional risk of the second mortgage. If scheduled repayments can't be met, the bank has the right to sell the home and recover their debt plus accumulated interest and costs.

Securing a loan on business property may be a little more expensive as business properties generally experience more fluctuations in value. A premium above a second mortgage on a house is likely.

Taking a loan on inventory is of much higher risk as the inventory may suffer from obsolescence or damage. Usually the recovery can only be made at an auction which itself often returns much lower values than in the normal course of business. So an advance of not more than 50% of book value may be made but with an interest rate higher than the above mentioned rates. A similar treatment may be applied to debtors except that it may be limited to 50% of approved debtors, perhaps only those aged 30 days or under.

Now let's consider the typical early stage entrepreneurial business, which will display some or all of the following attributes:

- uncertain cash flows
- few tangible assets

- some specialised equipment which typically becomes technically obsolete
- few debtors
- little inventory
- new and sometimes unproven products or services
- often an immature management team
- an emerging market which is yet to be stabilised
- no established market for shares, especially a minority holding
- uncertain timing of revenue and profitability.

So, unlike a secured investor such as a bank, the Angel investor has an illiquid market in which to sell the shares, is dealing with high levels of uncertainty in the business and the market and the management team has no security for the investment.

If a risk free rate in Government Bonds is yielding, say, 6% over a long term, what return should an Angel investment under these riskier conditions return over a portfolio of such investments? The typical Angel will invest across a range of ventures expecting to return, on average, approximately 5% above long-term share market returns. However, within this portfolio some investments can be expected to be written off, some may break even, some may make a reasonable return and one may make a sizable return. In order to achieve a 15-20% average pre-tax return, the Angel needs to set a pre tax hurdle rate of at least 25-30%. Angels with a technology, biotechnology or early stage investment focus tend to seek higher returns (potentially in the order of 35-40%) due to higher failure rates. Only a small percentage of the Angel exits will exceed 7 to 10 times their investment, thus the Angel may set a relatively high hurdle rate knowing that those investments which fail or have poor returns will pull down the average.

*Most entrepreneurs will accept this logic. So where is the problem?* The problem is in the often extreme views of the likely outcome. Entrepreneurs by their very nature are optimistic. Angels, while not being pessimistic, are cautious and have been conditioned by failed ventures, all of which started out looking very positive. In truth, it is the pursuit of the target value which often causes the venture to fail. If the Angel has to achieve a high value to exit their investment with a good return, the pressure is on the entrepreneur to push the

growth rate. It is often this pressure which creates the conditions for insolvency and failure.

At the same time, the gold medal for an Angel investment is an IPO, notwithstanding that the most common exit mechanism is a trade sale. This means ever growing revenue and profit targets. However, the successive yearly targets are inherently risky. The growth rate puts huge pressure on the organisation and the cash needed to fuel the investment in inventory, debtors, recruitment, training, accommodation, research and development, development of distribution channels, customer support and so on. Much of the investment is in growth preparation rather than in servicing the current customers.

Let's consider an example:

The business is achieving \$5 million in sales with 20 staff. It is currently making 5% net profit after tax (\$250,000). The business is valued at six times net profit after tax, therefore the pre-investment valuation is \$1.5 million. The firm raises \$1.5 million for 50% share giving it a post-investment valuation of \$3 million. The Angel expects to achieve an ROI of 25% with a planned exit in four years. Assume that revenue grows at 40% per annum and the revenue per head remains constant.

Year	Revenue '000	NPAT '000	Employees	Valuation \$ million	Angel share \$ million
1(a)	5,000	250	20	1.50	0.00
1(b)	5,000	250	20	3.00	1.50
2	7,000	350	28	2.10	1.05
3	9,800	490	39	2.94	1.47
4	13,720	686	55	4.12	2.06
5	19,208	960	77	5.76	2.88

Notes:

- (a) Pre-investment valuation
- (b) Post-investment valuation which includes \$1.5 million of surplus cash

- *The Angel's additional capital of \$1.5 million is used on capital expenditure to increase business capacity.*
- *Years 2-5 assume \$nil surplus cash and \$nil debt*
- *Assumes 5% net profit after tax in all years*
- *The Return on Investment is 17% which does not achieve the 25% target expected by the Angel.*

Imagine all the things which can go wrong over that five-year period: the market may change with new competitors, the market size may be considerably less than estimated, new technology may make the product obsolete, the firm may be unable to recruit quality staff at the rate needed and so on.

While size is not the only determinant of a company's ability to undertake an IPO, in the above example the growth rate would most likely be insufficient to create an IPO opportunity and therefore the Angel would need to pursue a trade sale as an exit mechanism. For the same firm to gain the level of sales and profitability to achieve an IPO, they would have to grow at a significantly higher rate.

The business risks associated with high growth rates are significant and require a massive change in organisation structure, processes, systems and formalised controls.

The executives who are capable of running a 20-person firm are probably unsuited to a 200-person firm. Very few entrepreneurs have the skills to make this transition.

The Angel who pushes an investee firm to an IPO may create the seeds of their own failure. Regardless of the product/market opportunity, very few management teams are capable of managing a high level of growth. Growing firms tend to require significant levels of working capital and investment into the business. Consequently, cash reserves are generally stretched and even a small mistake can result in rapid dilution of cash reserves sending the firm to the brink of insolvency. As Angels require an exit, in these circumstances some Angels may panic, replace management and probably push the firm into a fire sale to recover as much of their investment as possible.

The initial valuation may create the platform for future failure. The higher the initial valuation, the greater the pressure to grow and the higher the likelihood of failure.



To protect the Angel's investment from some of the risks mentioned above, the Angel is likely to push the initial valuation down so that they have a greater chance of gaining a final exit which will return the ROI needed. They also build in conditions which allow them to replace management if the team fails to achieve the milestones needed to keep them on track to reach the target exit valuation.

A lower valuation has the benefit of taking some of the pressure off the entrepreneur. Reaching a target ROI for the Angel investment is more likely, the intermediate milestones are likely to be more easily reached and there is not undue pressure on growth. The downside is that the entrepreneur will give up more equity at the lower valuation.

### **Which valuation should you use?**

Too many entrepreneurs produce five year forecasts based on assumptions which are, at best, educated guesses as to the state of the economy, the reaction of competitors and the behaviour of prospects. They then use complex formulae to work out a Net Profit After Tax (NPAT) over five years. From this profit forecast they calculate a valuation to four decimal places using an assumed discount rate. At the very best, it is one person's view of the future, but it fails to recognise that any other view might be equally valid.

In truth, no-one can accurately predict the future. The entrepreneur is generally going to be optimistic and the Angel somewhat pessimistic. Somehow they have to come to an agreement on a valuation or the negotiation simply never goes anywhere.

Entrepreneurs should be highly averse to high valuations. While they look good at the start of the venture, they place unrealistic expectations on the business to perform. Even the slightest slippage can lose the entrepreneur his business. Angels are not known to take shortfalls kindly. The problem is that they have their own investment to protect. Far better for both parties to agree a lower/negotiated valuation where the Angel can readily make his hurdle rate and the entrepreneur has a better chance of staying in control and making a reasonable return on his effort.

## Negotiated valuation

One method of arriving at a negotiated valuation is to consider what the valuation of the business may be at a future exit date and discounting this value back into today's dollars. This method also has more relevant application to strategic sales. The future exit valuation of the firm is highly speculative and is a metric that is of real interest to both parties. If it was known with some certainty, the current valuation could be more readily determined by using a discounted cash flow methodology. The discount rate could be adjusted for higher levels of uncertainty but it would still be a place to start.

So, for example, a firm with an exit valuation of \$10 million in three years with a discount rate of 40% would be worth \$3.64 million now. A \$1 million investment would thus gain the Angel 27.5% shareholding.

Possible alternative valuation scenarios to the above are:

- The Angel wanted some higher comfort factor. A higher rate of discount may be used, say 50%, which would result in a lower Net Present Value (NPV) of \$3 million giving the Angel 33% equity.
- The Angel wanted some higher comfort factor. A lower exit valuation may be used, say \$8 million, which would provide a NPV of \$2.9 million, giving the Angel a share of 34.5%.
- The entrepreneur is more optimistic than the Angel and believes that an exit valuation of \$20 million is likely. This would give a NPV of \$7.3 million and the Angel share of this would be 13.7%.

The real problem lies in the balance of risk and reward. If in fact a low exit value was achieved, both parties lose but the Angel is likely to be the one with the highest cash investment loss. The entrepreneur and his team will have put time and sweat in but probably much less cash.

At the same time, if a high value is achieved, both parties would seek the upside. The entrepreneur would most likely claim that he deserves the most credit because it is his vision, business model and leadership that are probably the key to success, not the cash from the Angel. The Angel would most likely argue that the business could not have achieved the high valuation without the cash injection from the Angel. The Angel of course wants the lower valuation

in case things go wrong and so the upside is much higher. The entrepreneur wants a higher valuation to limit the equity of the Angel if the venture proves very successful.

A solution for both parties lies in negotiating a valuation formula which both parties can live with. This could be a stated value at somewhere between the Angel valuation and the entrepreneur's valuation, or it could be a starting value but with equity adjusted up or down for different levels of success.

So, for example, the parties could agree a strike point which would determine initial shareholding. This could then be adjusted for higher or lower exit valuations. For example, the parties could take the two opposing valuations and use these as a basis for calculating the shareholding at exit.

#### **Negotiated valuation – Example 1**

- Angel investment is \$3 million for an initial 33% equity share.
- Exit after three years.
- The Angel estimates a \$25 million exit.
- The entrepreneur estimates \$50 million.

In this example the parties have agreed on the following:

- Angel's equity share will remain at 33% for all exit valuations below their expected valuation of \$25 million.
- The Angel's ROI on exit valuations between \$25 million and \$50 million are held at 40% thus giving the Angel certainty of returns.
- Where the entrepreneur's estimate of \$50 million is achieved, he retains a greater proportion of the equity (i.e. the Angel's share is reduced to 16.4%), but the return that the Angel earns is significantly greater than at lower valuations.
- Consequently in this example both the entrepreneur and the Angel share in the upside of higher valuations.

Exit valuation \$ million	Angel portion \$ million	ROI to Angel % per year	Strike valuation	Angel's equity share %
5	1.64	Negative		33.0
10	3.33	4		33.0
15	5.00	19		33.0
25	8.25	40	Angel exit estimate	33.0
30	8.20	40		27.3
40	8.20	40		20.5
50	8.20	40	Entrepreneur's exit estimate	16.4
80	13.10	63		16.4
100	16.40	76		16.4

### Negotiated valuation – Example 2

Alternatively, a much more aggressive model would see the valuations move in the Angel's favour with lower exit valuations and more security on the downside for the Angel. This acknowledges the need for the Angel to achieve their desired ROI. At higher exit valuations, the pendulum swings the other way, increasing the reward to the entrepreneur for outstanding performance.

In this example:

- Angel investment \$3 million.
- Exit after three years.
- The Angel estimates a \$25 million exit.
- The entrepreneur estimates \$50 million.

In the example set out below, the parties have agreed the following:

- Angel's equity share increases at low valuations thus providing more security on the downside.

- The entrepreneur retains a greater share of equity at higher valuations while still allowing the Angel to earn a significant rate of return.

Exit valuation \$ million	Angel portion \$ million	ROI to Angel % per year	Strike valuation	Angel's equity share %
5	5.0	Negative		100.0
10	8.2	19		82.0
15	8.2	40		55.0
25	8.2	40	Angel exit estimate	33.0
30	8.2	40		27.3
40	8.2	40		20.5
50	8.2	40	Entrepreneur's exit estimate	16.4
80	9.3	46		11.6
100	10.0	50		10.0

### Negotiated valuation – Example 3

For a smaller deal the model might look like this:

Angel investment \$3 million and an Exit after three years.

Exit valuation \$ million	Angel portion \$ million	ROI to Angel %	Strike valuation	Angel's equity share %
1	1.0	Negative		100
3	3.0	Negative		100
8	8.0	38.7		100
10	8.2	40.0	Strike valuation	82
15	9.0	44.0		60
20	10.0	49.0		50
30	12.0	59.0		40
50	15.0	71.0		30
100	17.0	78.0		17

This type of formula can be used over successive rounds of Angel or VC funding. Each round would put in place the formula for determining the share of the final exit valuation to the new investor.

The entrepreneur who is unwilling or unable to accept a lower/negotiated valuation, should consider seriously a ratchet where the entrepreneur earns additional equity for achieving certain pre-agreed milestones/targets. These targets could be qualitative or quantitative in nature.

Angels want to ensure that, at the very least, they don't lose any money on the deal. An Angel is much more sensitive to a loss than to a significant gain. There is considerable pressure on the Angel to push down the valuation. However, a lower valuation means the entrepreneur makes much less when they exit the business and therefore the Angel needs to find a valuation figure which strongly motivates the entrepreneur.

Angels can use a variety of techniques to achieve this balance. One simple technique is to set the return to the Angel at a specified rate of return. Any excess over this amount from the exit proceeds goes to the entrepreneurial team. Another technique is to establish the Angel investment as preference shares with an accumulating dividend. Since preference shares are paid before ordinary shares, the Angel will recover some or all of their money before other shareholders share in the proceeds. An Angel may also have some ordinary shares to give him a percentage of the higher exit valuations.

Some Angels use options to provide additional incentives to the entrepreneur and senior management to allow them to accumulate additional equity in the business. The options may be set against certain milestones or performance targets which represent higher potential exit proceeds. The entrepreneur gains a greater percentage of the proceeds as the options kick in at higher exit valuations.

An anti-dilution clause in favor of the Angel in an investment agreement has the effect of protecting some or all of their investment in the event that the valuation falls with a subsequent funding round. This clause adjusts the shares of the Angel so that their original investment retains its monetary value under the new valuation. In this situation it is the original founders who suffer the negative adjustment. However, this type of adjustment is typically not readjusted with a subsequent higher valuation.

## Exit Strategies

There are two major paths to a successful exit of the firm. One is to sell the firm. This might be to another business (trade sale), usually a corporation in a similar or related field or to another Angel or VC Fund (secondary buy out), or to a wealthy individual. The second path is to list the firm on the stock exchange, an initial public offering (IPO).

### Initial public offering

The requirements for listing a firm are quite onerous and expensive. Unless the listing results in a share price which can maintain a position at least as good as the sector index, the listing will not achieve an exit the shareholders

anticipated (assuming the shareholders hold shares in the listed company). Just having liquidity of the shares via a market listing does not in itself guarantee the value achieved by the shareholders will be greater than an outright sale to a corporation.

Some private companies undertake an IPO, or a back-door listing (acquire an existing but dormant publicly listed corporation), with the intention of using it to raise funds or to sell shares. Typically, back-door listings are done with smaller companies. However, unless the size of the shareholding in public hands is significant, generally thought to be above \$100 million, there is insufficient liquidity to create a market to sell shares.

The table below shows the types of characteristics which best suit an Initial Public Offering (excluding speculative ventures such as biotechnology and resource ventures).

<b>Attribute</b>	<b>Requirements for long-term attractive public listing</b>
<b>Revenue</b>	\$20 million plus (\$100 million plus the most successful).
<b>Net profit</b>	Profitable for three years with minimum of \$2 million in the year prior to listing. Projected profits growing over next few years.
<b>Scope</b>	National or international markets.
<b>Portfolio</b>	Range of products with some in different markets.
<b>Potential</b>	Major national leadership or global markets.
<b>Management</b>	Majority with public corporation experience and some with experience in larger corporations.
<b>Board</b>	Significant industry and public corporation experience.
<b>CEO</b>	Able to deal with market analysts, institutions and shareholders.
<b>R&amp;D</b>	Products in various stages of development to ensure continued market leadership.
<b>Cash</b>	Sufficient funds to meet forecast plans without further capital raisings.
<b>Funds use</b>	Funds raised to be used for market development, innovation, overseas expansion, acquisitions, working capital, repayment of debt.



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<b>Advantage</b>	Clear competitive advantage based on strong intellectual property and/or proven innovative business model.
<b>Public awareness</b>	Products and their benefits are easily understood by the public.
<b>Support</b>	Listed shares are large enough in value and number in institutional and public ownership to encourage market analysts to track the stock. Generally this means a market capitalisation of at least \$100 million.

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Since few companies in private ownership can meet these requirements, an exit strategy aimed at an IPO is not a viable option for most privately held firms. That is not to say the smaller companies cannot exit through an IPO, but the above provides the best foundations for success.

Generally it will take a minimum of \$500,000 in legal and accounting expenses for even the smallest and simplest IPO. According to KPMG Corporate Finance's 2004 Australian Capital Markets survey, the average cost of raisings up to \$10 million was 10.1%, falling to 4.7% for raisings greater than \$500 million. If only a small amount is to be raised, this cost is very high for the funds received. At the same time, an IPO usually involves significant work for the top executives. This has often been thought to be 50% of the CEO and CFO's time over the six months prior to the IPO. This is a very significant burden on the firm and requires the rest of the management team to bear the burden of day-to-day management during this time. A USA listing would be more expensive in annual expenses due to the greater disclosure requirements.

The overall consensus of private equity advisors is that only four factors are considered key to a successful IPO. The first factor is the venture should have a strong competitive advantage and sufficient growth potential to achieve a \$100 million capitalisation value within about five years of listing. Neither the current level of revenue or profit is considered significant compared to anticipated revenue and profit. This factor also goes a long way to explaining why low growth firms which have low margins either don't make it to the exchange or have to be significantly larger before they can.

The next major factor is the depth and experience of the management team and the industry experience of the Board of Directors. Again this is not surprising when you consider that the shareholders are backing a group of individuals to

take them to the size necessary to support the \$100 million capitalisation. A new management team or one which has significant technical depth but little management depth is not going to be received well.

Knowledge of the IPO process itself by the management team is a major factor. This demonstrates just how important the roadshow is to the brokers and the presentations are to institutional investors. Achieving significant share purchase commitments up-front is almost a necessary condition for a float. Knowledge of retail and institutional investor risk and return requirements and being able to convincingly show growth potential is an imperative. Investors are typically risk-averse and will quickly zero in on potential risks in the venture. The management team must be able to convincingly demonstrate knowledge of their business, their industry and how to mitigate possible risks.

Finally the firm must have the best possible advisors. The best advisors and investment bankers are expected to have the best due diligence processes, require the highest standards of preparation but also carry the highest level of credibility to the market. They are also very selective in who they represent.

Too many entrepreneurs see an IPO as a means of solving their own business problems rather than seeing it as a means where retail and institutional investors achieve a return on their investment. Without gaining the support of a significant number of retail investors and/or support from some institutional investors, the firm is likely to push themselves onto the market by satisfying the minimum listing conditions and then find that just being publicly listed does not solve their inherent problems. As we have seen many times – the market penalises those which don't perform. In many cases, these firms would have been better to wait until they had more robust growth potential before listing.

It may not be possible for the major shareholders to exit at the time of the IPO or even within some years. Markets are very wary of public issues where the key managers sell off their shares completely. In a situation where the results are not achieved subsequent to a sale of shares, the inside shareholders could also face legal charges of insider trading.

A firm which wants to undertake an IPO exit needs to build the IPO profile above. So, to the extent that it cannot meet the requirements within the

existing business, the additional attributes need to be developed or acquired. With 3-7 years to execute the IPO strategy and especially with Angel and VC financing, a firm may be able to achieve the necessary characteristics given the right starting point. Many companies which attract Angel funding have already identified strategic acquisition opportunities to bring economies of scale and growth to the company.

In some sectors, building a company via acquisitions is a possible strategy. Certainly in the years 2002 and 2003, firms in the biotechnology sector in Australia needed to undertake consolidation to gain additional resilience, product portfolio spread and more critical mass. Too many biotechnology firms were undercapitalised, had very narrow product ranges and too little revenue spread from licensing to longer-term production products.

Often in emerging markets there will be several firms with complementary products, often selling to the same customers or working with the same alliance partners. These could be brought together to provide a platform for an IPO vehicle. However, there needs to be an obvious and demonstratable synergy between the products and the firms. Just lumping a number of firms together to reach the revenue and profit targets is unlikely to convince the institutional investors they are investing in a sound platform of future growth.

At the same time that the underlying product portfolio is being built, the firm needs to construct a management team capable of running a growing public corporation. Public corporation experience, experience with larger corporations, deep experience in the industry and a good track record, are all essential characteristics for the IPO management team.

The IPO strategy needs to show, in considerable detail, how the IPO prospect profile will be achieved. Underpinning the plan should be documented representations from respected accountants, lawyers, bankers and brokers who are willing to work with the firm on building the IPO strategy.

## Trade sale

Most Angels exit or harvest their investment through a sale to another firm. This is called a trade sale.

Where possible, the Angel will seek a strategic trade sale to meet or exceed their return on investment (ROI) needs. A strategic sale occurs when the value placed on the business exceeds its fair market value (FMV). The FMV is most often determined by looking at the current business as an investment by an independent investor looking for a return on their money. The current profit is taken as indicative of the ongoing profitability of the firm and ROI. Since few owner/managers operate the business to maximise profits, this will normally undervalue the business.

A conventional sale based on an EBIT multiple would certainly be attractive to an Angel if a strategic sale was not possible. In that situation, attention needs to be given to increasing operating profit, decreasing risk and establishing a growth potential in order to secure the best price.

However, normally a strategic sale can be expected to achieve a sale price considerably above a conventional sale price. The key to a strategic sale is to find a corporate buyer which has a need for the assets and/or capabilities of the firm. This strategic fit can come from any number of possible areas:

- customer base
- distribution channel
- brands
- patents, trademarks, licences
- key employees
- access to specialised knowledge and so on.

Strategic buyers most often come from within the industry in which the firm is operating. They can be suppliers, customers, alliance partners, joint venture partners or competitors. Sometimes the sale will be to a corporation not in the sector. They may want to acquire a presence in a market/geography as a foothold or may wish to diversify.

The Proactive Sale Strategy developed by the author defines a process which can be used for financial and strategic trade sales. This methodology has five major components:

- alignment of interests
- due diligence and good governance
- creating value for the buyer
- selecting buyers
- building relationships with potential buyers.

**(a) Alignment of interests**

In order to be prepared for a trade sale, especially when there is time pressure to set up and consummate a deal, the various stakeholders need to agree on the possible outcome. There is little point in progressing a deal if the Directors cannot agree on what they want, or the shareholders cannot agree on a reasonable price. A negotiator cannot go into a meeting to secure a deal if the interests of the major stakeholders are unclear. Experienced Angels usually have the Board focused on exit strategies from the first Board meeting.

The major stakeholders who are critical to executing a deal are:

- members of the Board of Directors
- management
- Angel along with other shareholders
- key employees.

The Angel needs to ensure that all stakeholders are focused in regard to the two extreme situations: a forced sale due to decline in the viability of the business or a planned sale over a longer term. Once the CEO has a list of requirements, opinions, conditions and issues which need to be considered, he/she can start to bring all elements together to arrive at a strategy which could be followed in these two extreme situations.

**(b) Due diligence and governance**

Nothing kills a deal quicker than an uncertain or immeasurable risk. Many

people think the valuation on sale is due simply to revenue and profit. What happens in practice is the buyer conducts an extensive due diligence into every aspect of the firm's operations in order to uncover actual or potential problems, risk and liabilities. Since each of these requires time and funds to resolve, the offered price is likely to fall as the review goes forward. At some point the risk, time and cost to fix the problems become so great that a deal is not possible.

The task of the Board from a directional perspective together with the CEO from an operational perspective is to establish the firm and its operations to minimise risks to the buyer. This includes putting into effect such things as:

- Standardised and documented contracts with customers and suppliers.
- Industry standard terms of employment, benefits and entitlements.
- Full ownership and tracking of intellectual property.
- Full compliance with industry, health, safety and environmental regulations.
- Comprehensive reporting, budgeting and planning systems.
- Policies, procedures and processes covering critical aspects of the operations.
- Industry knowledgeable accountants and lawyers.

The key to passing a business to a buyer is to put yourself in the buyer's shoes and think through the integration and operations of the business after the acquisition. The task of the CEO and management team is to ensure that the business can operate effectively after the acquisition without imposing an undue burden on the buyer.

Included in the planning for a sale should be a consideration of the roles of the key employees. In most acquisitions some roles will change, some staff will be made redundant and some key employees are needed to ensure a transition of knowledge. How can you ensure that this process happens without disruption? This means determining retention terms for some, redundancy packages for others and incentives for all staff to make the transition happen as smoothly as possible.

### **(c) Creating value for the buyer**

In a financial exit, the firm needs to create value through the generation of future net earnings. Preparation for sale would focus on improving internal processes, reducing expenses, increasing revenue and margins, adding revenue growth and then seeking out opportunities for potential growth.

Strategic acquisitions occur because a corporation has a need for some asset or capability which the firm has. Generally this is something which the firm already leverages to create its own competitive position. As part of the Strategic Sale Strategy, the Angel needs to think carefully through the operations of the business and isolate those things it has and those things it does which could be used by a large corporation to resolve a threat or generate significant new revenue.

Assets or capabilities which create strategic value should be based on one, or several, of the following characteristics:

- difficult or time-consuming to copy
- protected by patents, trademarks or copyright
- only available through licensing or registration which is limited in supply
- unknown due to confidentiality or trade secrets
- requires specialist knowledge to acquire or utilise

### **(d) Selecting buyers**

Financial buyers are often corporations undertaking a roll-up or consolidation strategy. They are looking for well managed firms in their sector which can add revenue and profit to group earnings.

A strategic buyer is a corporation which is prepared to pay a premium over fair market value because the business solves a critical problem for them or offers them a good opportunity for additional revenue and profit. The best strategic buyers are ones which can exploit an opportunity by offering a unique product on a much larger scale than the firm is able to with its limited resources. The Angel should look for corporations which can overcome whatever constraint is holding back the business.

Buyers normally come from within the industry, so start by listing companies in the same industry as the investee firm. You then need to select those companies which have the capacity and experience to do the deal. Corporations with experience at acquisitions and which have ample size and funding are much easier to deal with. The ideal buyer will typically be at least 8 times the size of the seller.

### **(e) Building relationship with potential buyers**

Trade sales are mostly made between parties which already have some knowledge of each other. This could be informally through networking functions, between prior colleagues or could be a formal trading relationship such as a partner or distributor. Other relationships can exist through Boards of Directors or Boards of Advisors or equity participation. The key to a trade sale for an Angel-funded company, as with any other company, is to be prepared.

Any early stage venture is going to experience some turbulence and not everything will go according to plan. In terms of exit preparation think of the situations you may experience.

#### **1. You need to sell**

Not everything is going to go according to plan. Sometimes market conditions change and the business is no longer capable of reaching the targets initially set or may no longer be viable. Rather than let the firm become insolvent or bankrupt, the exit plan should be established early so that there is little delay in executing a trade sale. This way the maximum benefit can still be extracted from the failing business.

Often time is against you. If the management team has not put an exit strategy in place, they will have little time to prepare or to initiate discussions with potential buyers. If they have not set up the relationships in advance, especially with overseas buyers, it probably is not going to happen the way you would like. Without planning, the ability to attract a buyer who will pay a premium value for the company is significantly constrained.

By setting up relationships in advance and by knowing why the corporation would want to buy the firm and who to deal with inside the potential buyer,



management can execute the acquisition discussion quickly. As long as the firm has several potential buyers, competitive tension in the deal can still result in a very attractive sale price.

## **2. The firm is approached with an offer to buy**

Many Angel-funded firms are targets for acquisitive corporations. However, when the offer comes management may be unprepared. They are often unsure of an appropriate price. If management is unprepared and needs to go through extensive due diligence, this not only takes considerable time, but it uncovers risks to the buyer. Instead of closing a good deal the firm will end up with a disrupted business, staff who are stressed due to uncertainty and a price the shareholders would normally not have accepted. Management may also have talked themselves into the deal. Management will have taken their eyes off the ball and will have much to do to recover.

How much better would the situation be if the firm had already lined up several possible buyers? They can now announce that they are prepared to sell and take on all offers. Management will have prepared the due diligence files and can execute the deal quickly with little disruption. The staff understand the process and have incentives to ensure the best deal is done. The exit strategy should be canvassed with staff from an early stage so they understand the objectives of an Angel as a shareholder in the company.

## **3. You and management decide to sell**

Experienced Angels and good management should already know of the best potential buyers and through business operations should already be in a position to actually know those parties. If management have prepared the company for sale over many years, they are best placed to drive the exit process rather than have it drive them. The Angel and management simply need to decide on the timing.

It is a highly desirable characteristic of Angel funding that the Angel exits the investment within a relatively short period. Few Angels like to have their funds tied up for more than five years in a venture. If the prospective investee firm articulates a viable and well-articulated strategy for a trade sale going

into the funding negotiations, it will greatly improve their case and the Angel's confidence for achieving the Angel's exit objectives.

With the trade sale exit strategy outlined here, you can be reasonably assured that you will gain the best price you can and know that the corporation doing the buying will make more money out of it in the future. If you have a very good idea of the trade sale exit opportunity, you can spend the time assisting management to develop the business and build a strong case for the buyer. This focus makes it easier for the Angel and the entrepreneur to work together since they have clearly defined common objectives.

This process is well proven. If you think of the firms you have seen sold at large premiums, you will always find they created significant value for the buyer.

## 9 Agreeing the Investment

**M**ost formal Angel evaluations follow a similar staged process. This approach is commonly used by an experienced Angel with many investments and by Angel syndicates and Angel Groups. Individual Angels often go by their gut feel or a 'seat of the pants' judgement; however, fewer mistakes are likely to be made with a more systematic and comprehensive process. Also, if other Angels are investing at the same time, the individual Angel doing the evaluation would be better able to later justify and defend an investment recommendation if a more formal process was followed. Given the high level of Angel syndicate investments over the past several years, the process set out here will apply to an Angel co-investment situation.

The purpose of the staged process is to eliminate, at the earliest possible time, those investments which fail to meet the criteria established by the Angel syndicate for investments. Each successive stage involves higher levels of expenditure on time and professional services and investigation expense. Only very few firms progress to the later stages.

The overall duration of the process will vary according to the complexity of the proposal and the ease with which the detailed investigations can be completed. Larger Angel syndicates will possibly have more formal processes and perhaps more sign-off stages. It is unlikely that funding would be provided in less than three months with the average taking closer to six months.

**(a) Initial contact**

Angels prefer to receive their initial contact through a referral. However, whether it comes with a recommendation from another Angel, professional services firm, personal contact or simply through the mail, the initial review of the proposal will be a quick read of the executive summary to see if the size of funds required, the stage of investment, the industry and the geographical location are of interest. If interested, the Angel will ask the entrepreneur and one or two members of the senior management team to come to a brief meeting where the proposal will be discussed.

**(b) First formal meeting**

The purpose of the first meeting is for the Angel to evaluate the entrepreneur and the management team. The Angel should set the expectation that the management team should come prepared to answer detailed questions about all aspects of their business. They may be asked to do a formal presentation on the business opportunity for 10-30 minutes.

**(c) Exchange of information**

If the initial meeting goes well and both parties are interested in going forward, the Angel should request a business plan (if the management team has not already provided one) as well as contact details of other executives in the firm, names of referees, key customers, suppliers and distributors. The firm may be unwilling to provide confidential information at this stage but should provide sufficient information for the Angel to decide if they wish to expend more time and expense on evaluating the investment.

**(d) Informal due diligence**

The Angel would normally then conduct a limited investigation into the market, the firm and the business proposition. This will often involve contacts with industry executives they already know or with other Angels or VCs active

in the sector. The Angel might also visit the offices of the firm and interview the key executives and key employees. The market analysis would normally include an investigation of competitors and some validation of the customer benefits associated with the products or services offered by the firm.

**(e) Term sheet negotiated**

The Angel would then brief the firm on the evaluation of the proposal and the terms under which an investment would be undertaken. During this discussion the Angel and firm agree a valuation or valuation formula, discuss costs and fees and decide on the equity to be taken by the Angel(s).

**(f) Angel quality review**

Before proceeding to issue a term sheet, the Angel syndicate may wish to have the proposal presented to them with a justification of the investment to be made. This is an internal check to ensure that due process and adequate product/market opportunity evaluation has been carried out. The presentation would normally include a limited financial model of the business over the likely term of the investment. Additional analysis may be required following the discussion and before individual Angels or the Angel Fund issue the term sheet. Larger deals may require more extensive and expert investigation. In these situations the Angel may outsource part of the work to professional services firms and specialist market analysis consultancies.

**(g) Term sheet issued**

Once the initial due diligence has satisfied the Angel that the investment should move forward to a detailed investigation, the Angel would issue a formal offer in the form of a heads of agreement called a term sheet. This sets out the terms and conditions under which an investment will be made if the proposal satisfies a more detailed and formal due diligence investigation. The term sheet is not binding on either party at this point. However, the Angel may expect the firm to deal exclusively with them during the detailed due diligence period.

**(h) Investment approval**

Once the term sheet has been issued and accepted by the firm, a more extensive financial modelling exercise may be undertaken to help other Angels understand the risks and opportunities in the deal. This analysis would look at

the likely investment returns under different risk conditions. Exit strategies will be formulated under different performance assumptions. Once this additional work has been undertaken, the proposal will again be reviewed, perhaps by a larger number of Angels. Larger Angel syndicates will have a formal authorisation process for the detailed investigation. This protects the syndicate from an over-enthusiastic Angel or syndicate manager and allows a wider range of expertise and experience to review the proposal before the syndicate incurs the expense of a detailed due diligence investigation.

**(i) Formal due diligence**

Upon signing the terms sheet, the Angel and their professional advisors will examine the company's corporate structure, assets, intellectual property, financial statements, material contracts, employment agreements and any actual or threatened litigation. Technical specialists may be hired to review R&D results and plans, specialist equipment or foreign market plans.

**(j) Formal approval**

Once the detailed due diligence has been completed the proposal is reviewed again to ensure that risks have been adequately assessed. If the Angel syndicate is still comfortable with the investment and the ability for the lead Angel to manage it, formal approval will be given to go forward with the investment.

**(k) Legal documentation**

Upon completion of due diligence, parties typically prepare and sign the following formal legal documentation:

***Subscription agreement:*** which sets out the number and price of shares, funding tranches and dates of subscriptions, detailed warranties concerning the company, rights attaching to shares and conditions precedent to funding. Subscription agreements may also cover future subscriptions by the Angel, the founders, other shareholders or key staff and ratchet mechanisms to re-allocate shares in the event of over or under performance by the business.

***Shareholders agreement:*** which sets out the ongoing relationship between the shareholders and the company as agreed in the term sheet.

**Intellectual property acknowledgment deeds:** is an acknowledgment by other parties that they have no rights to any intellectual property which they develop and assigns all such creations to the company.

**Executive service agreements:** will bind 'key' employees to the company for a period (usually two or three years), and will set out the employees' terms of service, remuneration and bonus entitlements.

*Source: <http://www.oznetlaw.net/facts.asp?action=content&categoryid=226> Accessed 31/12/04*

Once the final documents are signed, the Angel will issue the first tranche payment to the firm. Follow on payments will be made under the terms of the agreement, but may be subject to performance achievements.

Normally the investee would be expected to reimburse the Angel for all the expenses associated with making the investment if the investment is made. If an investment is not made, only where the firm has misrepresented material facts or withdraws after the due diligence costs have been incurred will the Angel expect to recover their investigation costs.

Where an investment is made, the firm would normally reimburse the Angel for the external expenses incurred in the due diligence process. This would include professional fees and external consultant's costs and will occur with or without a transaction proceeding. Even on a small investment these can be expected to be \$50,000 to \$70,000. For a larger deal, it could easily exceed \$250,000. Some funds charge an advice fee if they have helped to structure part of the deal with external parties. If the venture is relatively small and the product/market issues are straightforward, it may be sufficient for the Angel to undertake a limited due diligence and use a regional or local professional services firm thus cutting down on the costs.

An Angel is normally appointed as an external Director to the firm and the company would normally be expected to pay a Director's fee, in most cases it would be around \$15,000 to \$25,000. Larger companies will incur higher Directors' costs.

Some Angels charge an annual management fee which might vary but often can be around 1% of the amount invested.

## Term Sheet and Deal Structure

The term sheet sets out the terms and conditions of the Angel investment in the firm. Term sheets can vary in length and complexity but would normally contain, at least, the following clauses:

- The number and price of the shares in the company to be purchased. These are normally set up as preferred shares with cumulative dividends (where declared). The preferred shares would normally be paid out in full prior to any payment to ordinary shareholders in the event of the liquidation or sale of the firm. This section would also state what other shares are issued as well as the capitalised value of the business. The value of the business is then used to calculate the percentage of the shareholding that would be owned by the Angel subsequent to their investment. The preferred shares are normally converted to common shares on liquidation or exit. However, in the event of failure, the preferred shares are entitled to first call on the liquidation proceeds. The Angel would normally be entitled to at least one seat on the Board of Directors and would have certain veto powers or power of approval over:
  - the capital expenditure budget
  - the annual operating budget
  - any debt or asset lien over a specified value
  - appointment of CEO, CFO and senior executives
  - remuneration and employment conditions of senior management
  - any issue of additional shares
  - a change in the number of Directors
  - any dividend
  - any major change in structure, assets, merger, acquisition or disposal
  - the use of the invested funds.



- The Angel may require their percentage of the total capital of the firm not be reduced in a subsequent share offer at a price lower than the one they came in on (anti-dilution rights).
- The Angel will be entitled to 'piggyback' the registration of their shares with other shares being registered for sale.
- If at least 75% of the shareholders accept an offer to sell the company the balance of the shareholders agree to the same conditions of sale ('drag along rights'). This may be extended to enable an Angel to 'drag along' the other shareholders where the Angel accepts an offer to sell shares after an agreed period of time.
- The Angel has the right to purchase shares in any new issue of shares in the same percentage as their holding.
- If a founder has an offer to sell his/her shares, the Angel has the right to participate by selling the same percentage of their shares ('tag along rights').
- The Angel can require their shares be purchased plus accumulated and unpaid dividends after a specified date in specified stages (redemption rights).
- The offer to invest will be conditional on adequate due diligence and the production of various documents.
- The offer is confidential and will only be open for acceptance for a specified period of time.
- Each party will be responsible for its own professional fees.

The term sheet is an offer to invest. Until accepted, any terms and conditions can be negotiated, although many of the terms and conditions are standard and are unlikely to be varied since they protect the Angel in the event of the business failing to meet their objectives.

In most circumstances term sheets are not legally binding, but provide guidelines on matters to be documented in subscription and shareholders agreements.

An example of a term sheet is provided by the British Venture Capital Association under the title *Example of a Term Sheet for a Series A Round* (see

www.bvca.co.uk). While these are local UK legal documents, the terms are very similar to those which would be present in most other legal jurisdictions. Another example is given at:

[http://www.angelblog.net/The\\_One\\_Page\\_Term\\_Sheet.html](http://www.angelblog.net/The_One_Page_Term_Sheet.html)

In most cases the term sheet is issued prior to the completion of due diligence. As such the Angel will usually reserve the right to amend the terms of the term sheet should anything of concern be found during the due diligence process.

## Due Diligence

Once the Angel has issued a term sheet and this has been formally accepted, the Angel will proceed to a full analysis of the investment opportunity. At this point commercial analysts, lawyers and accountants acting on behalf of the Angel will undertake a due diligence investigation. The Angel will incur considerable costs in this investigation and will want to ensure that the firm is acting in good faith during this period. To protect himself, the Angel will normally request the firm execute an exclusivity agreement where the firm agrees not to seek investment from any other party during the due diligence period. A penalty may be agreed for a breach of this condition.

One objective of the due diligence process is to investigate the firm to see if the business itself has any major problems which have not been identified in the information already provided to the Angel. The due diligence process will undertake a validation of all aspects of the existing business as presented in the business plan. This would include most of the following:

- background checks on the key executives and key employees
- review of all financial information and additional investigations where necessary to validate key numbers
- inspection of all key contracts
- interviews with major customers, suppliers and distributors
- verification of costs, expense levels and purchase commitments.

This process will check the integrity and honesty of the firm as well as provide a view on how well the business is managed and on the adequacy and accuracy

of the information which is being used in the business. It will also uncover how well the key executives understand their own business and the ease with which they are able to access and provide additional details necessary to the analysis.

A key part of the due diligence process is for the Angel to identify anything which would incur additional costs, create delays or expose the business or the Angel to actual or potential liabilities not identified in the information provided to the Angel. Items which frequently create problems include:

- non-standard customer contracts
- non-standard supplier agreements
- harsh lease conditions
- loose IP agreements
- overly generous reward and remuneration systems
- generous health or vacations benefits
- shareholders' rights, legal structures, joint ventures, option schemes and anti-dilution arrangements
- poor reporting systems
- out-of-date equipment
- poor quality products or services
- personal use of company funds or resources
- pre-existing obligations, rights, commitments or restrictions
- non-standard rights of existing debt holders.

A business which is effectively and efficiently run, has good customer, distributor and supplier relationships and has good internal reporting systems which monitor performance, ensure adherence to compliance regulations and protect the business from mistakes, should have few problems in satisfying the Angel.

After the firm has satisfied the Angel with regard to its current operations, the Angel will examine the business projections and other planned targets and milestones which underpin the business plan. This is the area which exposes the Angel to the greatest risks. This investigation will review the following:

- the identification of the prospective customers and the quality of the benefits the customers gain from the product or service
- the size and growth rate of the prospective market
- the size, strength and strategies of current and potential competitors
- the quality of the intellectual property underpinning the business plan
- the quality of the sales, marketing and distribution strategies proposed
- the likely ability of the management team to be able to execute the business plan
- availability of executive and specialised staff needed to grow the business
- the quality of the exit strategy proposed
- the likely cash flow over the expected investment period.

To the extent that uncovered risks reduce the probability of achieving the desired outcome or delay the time to execute, the value of the potential investment declines. In some cases problems can be overcome by installing additional controls, renegotiating agreements and putting in place alternative strategies. However, these may result in additional costs or delays in executing the business plan. To the extent that problems cannot be easily resolved or the entrepreneur is reluctant to make changes, the investment will incur greater risks. At some point the Angel will decide that the risks are too great and will decide not to make the investment.

If the investigation results in an agreement to proceed with the investment, the firm will most likely incur the costs of the due diligence plus the legal fees associated with the preparation of the investment agreement. Fortunately, emerging businesses are often quite small and the amount of investigation needed to understand their current operations is also small. Due diligence costs should be reasonable relative to the size of the investment.

Part B of this book sets out an ideal Operations Development checklist against which the current business can be measured. Start-ups and early stage firms are unlikely to have sophisticated control and reporting systems in place, but these can be introduced over time as the business develops. The Operations Development checklist can form a guide to the development of the governance and operations management within the firm as it prepares for

its next stage of growth. Firms which anticipate accessing venture capital or expect to undertake an IPO will need to score highly across all elements of the Operations Development Index.

## The Role of the Professional Services Firm

Angels typically invest several times a year and usually have 4-10 concurrent investments. Most will have built up a good working knowledge of the legal requirements surrounding this form of investment but few would want to undertake the preparation of legal documents or do the due diligence legwork themselves, especially when it comes to tax, compliance or regulatory matters. The Angel forms a relationship with local accounting and legal professional services firms to provide advice on such matters and to assist with document preparation and due diligence activities. The Angel normally works with professional advisors who participate in these transactions on a regular basis.

### The professional accounting and advisory firm

The type of advice and help which a professional accounting firm can provide includes assistance in the following areas:

#### **Valuation**

If the firm has already prepared a valuation of the current business and projected valuation of the business at the proposed exit point, this will contribute considerably to the equity share discussion with the Angel. The advisory firm can review the financial projections for the Angel, check the completeness and accuracy of the information and review the underlying assumptions and values.

#### **Checking the business plan**

The business plan is the foundation document which will be used by the Angel to evaluate the investment. It is important that the business plan be prepared thoroughly, be properly explained and contain the information needed by the Angel to undertake due diligence on the opportunity. The advisory firm can review the business plan and show where additional information is needed.

### **Reviewing financials**

Current financials need to be prepared according to generally accepted accounting principles and presented in a conventional format which allows easy analysis. The accountant can ensure that the statements are prepared correctly and the accompanying data fully supports a detailed investigation.

### **Advice on use of debt and equity structures**

The business may be able to support some level of debt as well as an investment by the Angel. Using debt should reduce the equity share which the firm would give to the Angel. The advisors may also be able to show where cash may be better managed in working capital, accounts receivable and accounts payable to reduce financing needs as well as provide independent advice on debt fees and terms.

### **Helping with introductions and referrals**

Well-established advisory firms participate regularly in transactions involving VC funds. This would include investments, acquisitions, trade sales and IPOs. They are, therefore, in a good position to know most VC funds on a personal basis and certainly by reputation. If the business can support a co-investment from a VC fund or if VC funding is anticipated in the future, the advisory firm can assist with preparing information on the firm for a VC proposal and assist with VC introductions. An accounting firm can help short list the VC funds to approach and can help with introductions or referrals. Since many VC funds only deal with referred proposals, this can make a big difference in accessing quality VC funds. It can also assist in getting an opportunity to the top of the pile as advisory firms act as a pre-reader of opportunities and provide a deal flow which expects a timely responses from the VC Fund.

### **Reviewing term sheets**

While term sheets are typically set out in a conventional format, the Angel may wish the advisory firm to review the term sheet before it is sent to the entrepreneur.

### **Assisting in negotiations**

The Angel who is represented by a well-established and respected advisory

firm is likely to be better prepared for the negotiation. At the same time, the Angel should expect that the entrepreneur will be equally represented by their own advisory firm who should be familiar with private equity transactions. The terms and conditions of the investment should be reviewed by a knowledgeable party. If this is not the case, the Angel should counsel the firm to seek expert advice as it is important that, going into the relationship, the entrepreneur knows that the terms of the investment are reasonable and standard. This should result in more productive discussions and is likely to be better for the ongoing relationship between the parties. Angels prefer to deal with entrepreneurs who are represented by a professional firm as they know that the entrepreneur will not need to be educated about the investment terms and conditions, the required rate of return, management controls and exit requirements of the Angel.

### **Due diligence**

Due diligence will be carried out by the Angel as part of the initial evaluation of the investment opportunity. This is mostly a product/market evaluation to see if the business environment can support the projections of the firm. After the term sheet is issued, the Angel will carry out an extensive review to further assure he has a thorough understanding of the business and the management and has uncovered any data discrepancies and investment risks. The professional advisory firm can assist in this due diligence investigation to identify any problems, risks and deficiencies.

### **Advice on pensions, options schemes and remuneration**

The professional advisory firm can review these before an investment is made to ensure the current remuneration and benefits are fair and reasonable and provide the most positive basis for the planned exit.

### **Tax advice**

The firm can expect to change significantly over the period of the Angel investment and beyond the exit. Their current tax planning may not be suitable for such changes. The accountant can review their current business processes for compliance, tax collection and reporting.

### **Exit strategy assistance**

A well-articulated and probable exit strategy needs to be prepared as part of the business plan. If this has not already been prepared by the entrepreneur, the advisors can later help to define strategic value, identify strategic buyers and/or show how the firm is best positioned for an IPO or a trade sale exit.

### **Commercial review of agreements**

The accounting firm can review legal agreements to ensure they are commercially acceptable. This review should also be done in conjunction with the firm's legal representatives.

## **The professional legal firm**

The type of advice and assistance which a professional legal firm can provide includes the following:

### **Prepare share purchase agreement**

The share purchase agreement would normally be prepared by the Angel's lawyers. This is a complex legal document which few entrepreneurs will have ever seen and certainly few would understand at any depth. The professional legal firm can prepare the document and then assist the Angel to explain the terms and conditions to the entrepreneur and work with the entrepreneur's legal representative to finalise the agreement.

### **Review warranties and indemnities**

The firm would normally be expected to provide warranties, representations and indemnities to the Angel investor. The professional legal firm can review the warranties and representations and indemnities documents for the Angel.

### **Prepare new employment agreements**

The Angel should expect the key executives to enter into employment agreements and the Angel should expect to have significant control over their remuneration. Those agreements would normally contain restraint of trade and/or non-compete clauses. The professional legal firm can prepare these agreements.



### **Review disclosure letter**

The firm should be prepared to disclose any issues which may affect the decision of the Angel to invest. It should also identify any potential risks of the business. The professional legal firm can review the types of disclosures and advise the Angel of any risks or issues that he may need to deal with in the negotiation.

### **Review corporate documents**

As part of the preparation for Angel investment, the professional legal firm will review the corporate documents which authorize the firm to undertake business to ensure that it meets the requirements of the Angel. This review would normally extend to board minutes, shareholder agreements, option schemes and any material contracts the firm has entered into.

The Angel should plan for 5-10% of the money invested to be spent in professional services fees, noting that smaller deals are likely to have a larger percentage of advisor's fees.

Not all professional services firms have the necessary experience to undertake this type of work effectively. An individual making their first Angel investment should not assume that their current professional services provider has the expertise to properly advise him in this area. Before starting to incur costs for this service, the Angel should undertake some due diligence and investigate the extent to which the firm has a track record of success advising Angels or VCs. Asking for references would not be unreasonable and they also should be asked for a list of transactions which the firm has participated in and some details of the work performed for the clients involved. The Angel should also ensure that the expertise is still with the firm and ask to be allocated an advisor with personal experience in these types of transactions.

## 10 Managing Your Investments

**A**ngels typically invest in start-up or early stage businesses and normally before they become very sophisticated in their management and governance processes. While many early stage ventures are started by ex-corporate executives, their personal experiences of working with enterprise-wide performance setting and monitoring systems is likely to be non-existent. Even entrepreneurs who have managed ventures before may not have experienced a well-designed reporting system. This is the one area where the Angel can make a significant difference to an emerging business.

Of course, many Angels themselves do not have this experience. Just because they have high net worth, or because they have sold their own venture or have held a senior corporate job, does not ensure that they have personal experience with a quality performance setting and monitoring system across an enterprise or with the workings of a Board of Directors. Yet these are the major deficiencies in early stage ventures which the Angel is going to have to deal with.

Look at the typical firm in which an Angel invests:

- start-up or early stage ventures
- immature products or products still at design or prototype stage
- ventures in emerging markets
- a management team which may not have senior management experience
- gaps in the management team experience
- almost certainly a lack of formal management reporting systems
- lack of key performance indicators, lead indicators, individual targets and budgets
- probably a business plan but a lack of operational detail.

The Angel on the other hand has some issues which they must deal with:

- limited time to spend with each investee firm
- they are normally only a minority investor
- they are not running the business on a day-to-day basis
- they may not be experts in the underlying technology or marketplace
- they don't have the time or the knowledge to make operational decisions.

While they may be regarded as 'hands on' investors, this is not the same as day-to-day management. Without adequate performance setting and monitoring systems, they are effectively working in the dark. No doubt they have chosen a specific investment because they do feel comfortable with the marketplace and with the potential of the business and no doubt have also taken into account where they can add real value to the product/market or other aspect of the development of the business. But they are still not there day-to-day making the decisions.

The Angel also has a major role in preparing the business for a number of possible outcomes, additional rounds of investment from other Angels or a VC, a trade sale, an IPO or for independent growth. In order for the business to be successful, each one of these outcomes really needs the business to be running effectively and efficiently. It is in preparing the business for these possible

outcomes that the Angel has his most important mission. This is the critical value that he brings to the table – steering the development of the business at a strategic level and guiding the management in establishing and working with proper controls.

As the business develops and the number of employees grow, the task of monitoring at an operational level will become increasingly more complex. This is where a range of guiding mechanisms and controls help. While the business is small and everyone is working closely together, the amount of information which needs to be formalised is light, but as the business develops and grows, no one person is able to assimilate all the different activities of the business and so ever more information about what is happening inside and outside the business needs to be collected, understood and acted upon.

The task of the Angel in most investee firms is to anticipate these needs, educate management, help select new systems which are needed and assist in planning the necessary changes. Nothing can be more damaging to a growing business than to find itself without adequate planning and operational control systems.

At an operational level, the following activities and financial reports may be considered:

**Stage One – Up to 10 employees**

- Monthly cash flow reports
- Monthly creditor and debtor reports
- Monthly list of priorities for each manager
- Monthly action plan for each manager
- Monthly review against action plan
- Monthly review of critical KPIs
- Quarterly budget performance
- Quarterly financial statements
- Quarterly Board meetings
- Annually, a revised business plan.

### **Stage Two – Up to 30 employees**

- Monthly financial statements
- Monthly budget performance
- Bi-monthly Board meetings
- Major topics reviewed at each Board meeting
- Quarterly revised business plan
- Quarterly report on lead indicators
- Job descriptions for all managerial and supervisory positions
- External advisor on employment terms and conditions and compliance issues
- Part-time CFO.

### **Stage Three – Up to 100 employees**

- Weekly creditor and debtor reporting
- Weekly sales performance reports
- Weekly project completion progress reports
- Job descriptions for all employees
- Formal annual performance reviews for all employees
- Training of senior management in employment compliance issues
- Full-time CFO.

Early stage ventures are sensitive to cash more than anything else and yet they often lack the knowledge and discipline to manage it carefully. Traditional financial reports are not designed for this purpose and, in any case, making profits is not the same as having enough cash to be solvent. Thus part of the discipline that an Angel should insist upon is rigorous and detailed cash flow analysis. Every member of management should be involved in the analysis of cash flow since every activity within the firm has an impact on cash availability. Management should be sensitive to how cash is being generated and used as well as the impact of their own actions and decisions. Only by working with the detail will they assimilate this information. It is the area of greatest risk to the emerging venture.

One way to bring this lesson home to an inexperienced management team is to have them prepare a worst case cash flow report. This report sets out the cash projection of the business using different layers of cash inflow and outflow. The initial layer has only committed cash flow; that is, only cash inflows which the firm can reliably count on and only cash outflows which the firm is committed to in the foreseeable future. The report is usually prepared over individual weeks for three months and then monthly for a further 6-9 months depending on the horizon for projects under management.

*Worst case cash inflows would normally include:*

- cash at bank
- aged accounts receivable (expected date of payment)
- work in progress completions (date of invoice plus collection period)
- recurring payments on customer agreements (support fees, royalties, etc).

*Worst case cash outflows would normally include:*

- aged accounts payable (expected date of payment)
- purchase order commitments (date of invoice plus expected payment period)
- recurring administration, office, payroll, tax and expenses (excluding aged payables).

This should produce a cash flow balance (surplus or deficit) for the planning period. A shortfall may be met with an existing line of credit or bank overdraft and the use of credit cards and personal loans from shareholders. A deficit should result in an examination of customer accounts to see if any payments can be pulled forward through follow-up activity, early payment discounts etc. Work-in-progress payments might be pulled forward by early completions by bringing forward invoicing. Payments to suppliers may be delayed where this can be arranged with the supplier.

Added in the next layer are the most likely additional sales to customers. This may be actual named prospects or additional work for existing customers. Alternatively, in a high volume business, it could be the minimum level of repeat business the firm experiences at that time of the year. On the expenses side, the report would start to layer in discretionary expenses, cash permitting. This may

include new employees, new equipment, office expansion, additional product and market development costs and so on. Additional layers of less probable revenue and less urgent discretionary expenses are added to gain a complete picture of the business under worst, most likely and best case scenarios.

Every business has a critical time horizon for new business. If the cash inflow looks weak and it cannot be improved in the short term, management and the Board are warned well in advance and they can start to take corrective action. This may include switching resources to income generation, cutting back on expenses, deferring some projects and making staff redundant.

Other reports should be developed within the business to focus on critical areas. These may be for sales lead tracking, quality control, project completion and so on. Every business has aspects of its activity which provide an early warning of problems to come, either too much activity or too little. These lead indicators are the monitoring points within the business. The Angel needs to help management identify lead indicators and help them design monitoring systems to track them. Policies can then be developed for when management and/or the Board need to be informed and action taken.

Part of the contribution which an Angel makes to an investee firm is to help them work with external investors. Entrepreneurs who have been used to making their own decisions, deciding on their own priorities and setting the direction of the firm without having to gain approval from a third party, will find this very challenging and confronting. But if they wish to grow the business and bring in additional external funding or take the business public, this is an environment and a discipline which they need to learn. The Angel can help by leading the way, showing them how a Board works and how they can make positive use of their Board.

Many firms implement standard financial reporting for the Board but fail to adequately deal with strategic or risk issues. The Angel should develop a schedule of major issues to be dealt with at Board level. I have set out below a possible list of topics. Some may be more appropriate at later stages in the growth of the business.

The Angel is mentor, coach, consultant and sounding board for the management team. But the Angel also represents minority investors, external

investors and, hopefully, future investors. Establishing the right systems, setting the right direction, building the right culture and developing the right disciplines is an important contribution which the Angel makes to the emerging business.

## Proposed strategic topics for board meetings

### 1. Strategy

- Review of overall direction of the business.
- Where do we want to be in 12, 24 and 48 months?
- What are the major changes in the organisation which we should be planning for?
- Summary of a SWOT analysis for each product/market. What are the major changes we should be making at that level?

**Input:** Strategy paper from the CEO.

**Output:** Approved strategic initiatives.

### 2. Acquisitions and integration

- Review of landscape.
- Check on current criteria for targets.
- Review of targeted acquisitions and whether the firm is at the stage of building relationships and/or discussions.
- Review of likely acquisitions and or gaps which would be useful or are needed to be filled.
- Review of integration issues with current acquisitions.
- Discussion of integration capacity and policies.

**Input:**

- Review of marketplace in each of the firm's major sectors. Which companies are operating in each one? Where are the possible targets that conform to the acquisition criteria?
- Update on relationships with approved targeted businesses.
- Update on negotiations of those businesses approved to proceed.



- Review of integration issues and problems associated with acquired businesses.
- Criteria for acquisitions.

**Output:**

- Changes to integration resources and policies.
- Identification of target markets and possible target businesses for analysis.
- Approval to proceed with relationship building.
- Approval to proceed to acquisition discussions.
- Update on acquisition criteria.

**3. Budgets**

- Discussion of major assumptions underlying budget preparation.
- Review of performance statistics across the business.
- Review of capital expenditure, product, market and staff development plans.

**Input:**

- Proposed budget with current year-end forecasts. Including pro-forma year-end balance sheet and income statement compared to current year forecast and projected cash flow on monthly basis.
- Proposed major changes to budget from prior year with justification.
- Capital expenditure proposals with justification.
- Product development proposals with justification.
- Market development plans with justification.
- Staff development plans with justification.

**Output:** Approved budget.

#### 4. Risk assessment

- Review of all insurance coverage.
- Superannuation/pension review.
- Review of internal controls including a report from auditors with recommendations for changes.
- Market risk assessment.
- Business risk and disruption assessment.

##### ***Input:***

- Review of insurance coverage across the business with recommendations for changes.
- Auditor's report on internal controls plus recommendations.
- Internal review by CFO and recommendations.
- Market risk assessment by CEO.

##### ***Output:***

- Approved changes to insurance coverage.
- Approved changes in internal controls.

#### 5. Organisational review

- Review of Board of Directors' performance, including individual contributions, gaps in skills and changes in Board composition.
- Review of roles and responsibilities of Board members.
- Review of Directors' compensation, allowances and support.
- Review of senior management compensation.
- Succession planning across the business.
- Review of the use of options, profit share, bonuses, allowances and other incentives for the business.
- Methods of performance measurement and rewards.
- Review of turnover, sick leave, absenteeism and health statistics.
- Review employee survey.
- Review customer survey.

***Input:***

- Survey of Board members on personal experience of the Board meetings and suggestions for improvement.
- Independent review of Directors' compensation and recommendations.
- Proposals from the Board Chairman on composition, roles and responsibilities.
- Independent review of senior management compensation with recommendations.
- Assessment of the performance of CEO, CFO, Company Secretary and senior management by the CEO in consultation with Board members.
- Review of current staff incentives with recommendations.
- Review of current performance measurement methods with comparative statistics of performance with industry standards and across units, with recommendations for changes.
- Review of statistics across the group on turnover, sickness, absenteeism and health issues, by business units with recommendations.
- Employee survey results.
- Customer survey results.
- Succession plans to supervisor level across the business.
- Succession plans for critical employees (R&D, sales, etc.).

***Output:***

- Approved changes to compensation for Directors and senior managers.
- Approved changes in options and other incentives to staff.
- Actions to be taken with respect to succession issues.
- Actions to improve staff morale, retention, health and performance.
- Actions to improve customer satisfaction.

## 6. Compliance and regulatory requirements

- Review of health and safety regulations which impact the business.
- Review of tax reporting, statutory filings and financial reporting.
- Review of policies with regard to bullying and harassment, sexual and racial discrimination, equal opportunity and maternity leave.
- Assessment from corporate lawyers and auditors on compliance performance and recommended actions.
- Annual General Meeting (AGM) preparation including approval of dividends, changes to constitution, Board membership, etc.

### Input:

- List of regulatory requirements and regulations which impact on the firm with current compliance experience and recommendations.
- Incident reports on any staff compliance problems.
- Report from corporate lawyers and auditors certifying that the firm has complied with all reporting and filing requirements over the last year.
- Recommendations for AGM.

### Output:

- Approved changes in internal procedures and policies.
- Actions required to bring the business up-to-date with statutory requirements.

## 7. Division/business unit reports

In addition to the strategic topics identified above which will be dealt with at each Board meeting, it would be useful for each of the major business units to have an opportunity to present their current business plans. These should include:

- description of the business.
- organisational data (locations, size in revenue and staff).
- organisation structure.
- principle activities.
- competitive landscape and how they compete for business.

- achievements, wins on the board, successes etc.
- problems, challenges, issues.
- recommendations.

Reports should be presented by a senior manager who is not a Director to give them the opportunity to meet the Board and gain some feedback from the Board.

## 11 Conclusion

**A**ngel investing is neither for the faint-hearted nor for those who need ready access to their investment. While the returns to Angel investing over a wide portfolio and over a lengthy period, say 8-10 years, have been attractive, there are certainly no guarantees. With a failure rate close to 50%, even the most experienced Angels will admit they don't always get it right. Potential Angels with little to invest may shy away from this form of investment as they may not be able to achieve a portfolio spread to raise the probability of a positive return. Those with more to invest and with an acceptance that all might be lost, should approach Angel investing cautiously but with excitement and energy. Successful Angels have great passion for their activities and really enjoy the work they do with entrepreneurs and the contribution they make to early stage businesses.

Angel investing is more than just putting the money to work. It is active participation in the birth and growth of new businesses. Clearly it is not without its risks, it can be stressful at times, but few who have been involved would have it any other way. For many, it is the continuation of an entrepreneurial career but this time giving back to younger

entrepreneurs, applying the wisdom of years of experience and being willing to take higher risks with a small portion of their wealth once they have made it themselves.

But that's not to say they have to give the money away. Smart Angels want to work with smart entrepreneurs and innovative businesses and play a part in a venture which has a reasonable chance of success. Putting in the time to seek out and evaluate the better deals and then constructing the right agreement for the investment is simply prudent management of their wealth.

For Angels to dramatically increase their probability of success, they should be seeking ventures which have the following characteristics:

- a well-articulated and highly probable exit strategy within 3-5 years
- a detailed plan to achieve the exit conditions
- an experienced executive team who can deliver on the plan
- a product/market opportunity which has sufficient competitive advantage that it has a high probability of reaching the exit conditions
- an initial valuation and a likely exit valuation which will provide the Angel with a 25% plus ROI.

The entrepreneur and the management team of the investee firm need to accept at the outset of the relationship with the Angel that there is a high probability that the exit will be by way of a trade sale, in which some of the executive team may be made redundant. Even if an IPO strategy is planned, the probability of reaching it is low and a trade sale is highly likely.

The smart entrepreneur who is seeking Angel funding will create a business opportunity which meets the objectives of the Angel, not the personal ambitions of the executive team. The entrepreneur should recognise that, while the Angel is prepared to contribute towards the development of the business and the commercialisation of inventions, the principal focus is simply to invest the funds and work with the firm towards an exit when they expect to gain a high rate of return for their money and contribution. Their personal remuneration is tied to that of the business and especially to the exit event, not in being an open line to finance or necessarily being nice to the entrepreneur or keeping the business going.

Angels enjoy what they do. They are well rewarded for the risks they take and their contribution to emerging businesses. They help create jobs and wealth for their communities. They are an essential part of a business community and provide a much needed financing gap to young companies. If you have a desire to get involved as an Angel and you feel that you can make a contribution – then go for it!



# **PART B**

## **Angel Investing Indices**

## Part B Introduction

**A**ngels typically invest in start-up or early stage ventures where the business is somewhat unsophisticated, management often inexperienced, products are in development or in their early release stage and internal systems are poorly developed. In these circumstances it is unrealistic to expect that the business will be as 'investment ready' as it would be for an expansion stage or late stage venture capital investment. Therefore, instead of measuring the business proposal against that yardstick, the Angel is better to look at the management team and the underlying assets and capabilities of the business and try to measure whether it has the potential to emerge into a profitable, sustainable, growth business or a strategic value business which could provide the Angel with the exit they desire.

Anticipated development of the business should provide the potential of taking the firm to an 'investor-ready' state if further capital injections are required. At the same time, the Angel should be preparing the business for a trade sale, since this is the most likely exit for the Angel. An IPO is unlikely, but possible; the Angel should keep this in mind as they investigate the business and help it grow and develop.

Part B sets out pre-investment selection criterion of the prospective investee firm. The first evaluates the alignment of the investee shareholders and management and then there are two major development charts; the first assists the Angel to evaluate the venture potential and the second provides a means of guiding the development of the internal governance and management processes and systems which will be needed for an effective exit.

The Awareness and Alignment Index (AAI) has been designed to capture the attitudes and preparedness of the entrepreneur, shareholders and management team of the business to a possible injection of Angel capital.

Once the Angel is convinced that the firm understands the nature of Angel investment and the impact it will have on the current managers and shareholders, the Angel will then use the Venture Potential Index (VPI) to measure the quality of the investment proposal. The VPI provides a systematic method of measuring the quality of the business concept in terms of its ability to support development of the business sufficient to take it to an ideal 'investor ready' state. An investor ready business is generally regarded as one in which a Venture Capital (VC) fund would be keen to invest. The list of attributes has been refined in consultation with a number of successful entrepreneurs who have raised venture capital, a number of private equity professional advisors as well as a number of venture capital general partners.

The VPI also keeps in mind the potential for a trade sale exit and assesses whether the venture has the potential for either a financial or strategic exit.

While the Operations Development Index (ODI) should be used as a checklist in evaluating the investment proposal, its primary purpose is to provide a guide for the development of governance and operations management once the investment has been made. A business which scores more highly on the ODI would be better positioned for a VC investment or a trade sale. Certainly those firms which achieved a higher score on the ODI will be more effectively and efficiently managed and so allocating resources to improve their situation according to the ODI would benefit day-to-day operations.

Each attribute of the Indices helps to define the state of readiness of the firm either for investment or exit. It is unlikely that any firm would have an ideal

position on every item; however, the scoring will indicate where improvements can be made or problems addressed. The AAI will show the Angel where the firm is currently in their preparation for Angel investment and could be used to advise the entrepreneur on additional work which needs to be done before progressing with the proposal.

The VPI can be used to undertake an initial evaluation of the investment proposal and then later to guide development of the business from an investor ready or exit objective. Finally, the ODI will help identify just how well developed internal processes of governance and operations management monitoring systems are and guide development work on their implementation and improvement. In many cases, specialist assistance will be required to implement changes needed to reach higher Index scores.

The purpose of the Indices is to help the Angel evaluate the investment. The Indices provide the Angel with a comprehensive and systematic way of investigating the proposed investment and should help isolate any serious deficiencies in the proposed business. Each question or attribute will provide an insight into the business and the work which will be needed to develop its potential.

Angel investing is a process not an event. Too many Angels think that they can rely on their gut feel or on their evaluation of the entrepreneur and a quick walk around the firm's offices to judge the quality of the investment proposal. While these factors are important, a systematic and comprehensive review is more likely to catch fatal flaws and problems.

In many cases, the effectively managed firm will score highly on an attribute. In other areas, where no attention has been given to preparing the business for an external investment, little will have been done. By scoring these attributes, you will find out the status of the business and identify what needs to be done to develop its potential. Alternatively, you may find out something which will cause you to reject the proposal, even if you feel good about the entrepreneur and the products.

The Indices are constructed with an ‘attainment’ or ‘achievement’ scale of 1-5. To complete an Index, you should circle the description which is closest to the current position.

<b>Nothing done</b>	<b>Little progress</b>	<b>Reasonable progress</b>	<b>Significant progress</b>	<b>Fully attained</b>	<b>N.A.</b>
1	2	3	4	5	

*N.A. = Not applicable*

Once you have identified where the firm is on the attribute, you will be able to see from the later descriptions the actions which you might need to take to turn this venture into one that you would be happy to invest in.

## **A** Awareness and Alignment

**A**ngel investment is beneficial for many businesses, but it is not for everyone. In fact, it may directly contradict some shareholder's plans for the business. At the same time, the venture may be inappropriate for an external Angel investment. What is clear is that the shareholders and senior management team should understand the domain and objectives of the Angel investor and seriously consider whether they are willing to meet the conditions and obligations inherent in that type of investment. The business which is able to show the potential and growth performance sought by an Angel investor would stand a good chance of gaining Angel investment, but the conditions which come along with the investment may still be unacceptable to the business. Thus some education in this area is certainly beneficial for anyone considering this type of investment.

Once the nature of an Angel investment is understood, there still needs to be a clear understanding on the part of the shareholders and management as to the objectives to be achieved through the investment. Those objectives need to be aligned closely with those of the Angel investor.

## **A1. Majority shareholders agree on Angel financing strategy**

The obvious implications of an Angel investment are:

- A dilution in existing shareholders' equity.
- Some constraints on executive decision-making, especially with regard to the issue of shares, extensions of debt and executive remuneration.
- Management will be expected to agree to various performance targets. Failure to achieve those may result in a loss of voting rights, termination of management contracts and the business being sold.
- Internal systems will become more formal and a higher emphasis will be placed on record keeping, governance and compliance.
- A formal Board of Directors will be required (if it does not exist already) and the Angel investor will almost certainly want at least one position on that Board.
- An exit strategy for the Angel investor will most likely have to be achieved within 3-7 years. This may be in the form of a buyback, trade sale or IPO.
- Additional rounds of capital injection may be required from Angels or a VC.

The majority shareholders need to seriously consider the implications on their own ownership positions and, where appropriate, their roles as managers and directors. The majority shareholders need to agree on the need for the Angel investment for there to be an effective plan to proceed to raise the investment.

### *Self-assessment*

1. No discussions have been undertaken with or between the major shareholders.
2. Majority shareholders have talked about taking on an Angel investment but have not taken the discussions seriously or established any consensus about timing.

3. The shareholders have agreed on raising Angel capital but as yet have not decided on a strategy.
4. The majority shareholders have agreed how they will approach the project of raising Angel capital and have formulated a strategy but have not taken professional advice on whether the strategy has a reasonable chance of success.
5. The majority shareholders have refined a strategy in conjunction with a professional advisor.

## **A2. Managers and owners agree on use of funds**

Any approach to an Angel investor should be able to show how the use of the investment funds will directly contribute to the development and growth of the business and to achieving the objectives of the Angel investor. Too often applicants seeking Angel and VC investment are focused on solving business problems, refinancing an ailing business, buying out a shareholder or trying to build a cash buffer, rather than directing their attention to providing the external investor with an outstanding opportunity. Even where there is an obvious investment opportunity, there may be disagreement among the managers and owners over how the growth and profit objectives are to be achieved.

Angel investors are rarely experts in a specific business, especially when a business works with complex technologies or is based on specialist knowledge. Thus the investor is reliant, to a large extent, on the managers of the business to come up with a resilient plan to achieve the growth objectives needed to satisfy the investment objectives. Unless the management have taken the time and effort to develop such a plan, disagreement is likely to occur in the management team as the investor digs into their intended strategy. Nothing is likely to kill off a deal faster than an investor being exposed to a lack of agreed strategy or a team which clearly is not in synch.

The management team needs to be able to show the Angel a robust business plan which incorporates the use of the investment funds and shows the expected growth of the business and how the objectives of the investor can be achieved. This needs to be endorsed by the majority shareholders and by the current Board of Directors. To ensure the plan is consistent with the requirements of the Angel investor, it should be presented in a way that the Angel can evaluate it



and build an investment proposal for discussion with any co-investors. It would be helpful to the Angel if the business plan had been reviewed by professional advisors who work frequently with Angel investors. This would be helpful to the Angel as the professional advisor's recommendations for layout, style and detail and any changes they advise on the use of the funds could be agreed with management and majority shareholders and incorporated into the Angel business plan before it is sent off to the Angel for evaluation.

### *Self-assessment*

1. Senior management and majority shareholders have not discussed how any investment would be used.
2. Discussions have been held by senior management but there is no consensus on how or where the funds will be used.
3. Managers and majority shareholders are agreed on the priorities for the use of investment funds but have yet to integrate this into a proposed Angel investment business plan.
4. A detailed Angel investment business plan has been created which shows how an Angel investment would be utilised and has identified the results which would accrue to that investment; however, professional advice has not been sought as to whether this would meet the needs of the Angel.
5. Professional advice has been sought on the use of the funds and adjustments have been made to the Angel investment business plan to incorporate that advice.

### **A3. Entrepreneur and key managers are committed to the venture**

Without the entrepreneur and the key management team the venture is unlikely to be successful. The Angel needs to see a commitment on the part of the key individuals to ensure they will put their best efforts into the venture. The Angel is not a full-time member of the management team and so is reliant on the entrepreneur and the management team to take the business forward. The business has to be operated on a daily basis by those most committed to it, even if the task becomes onerous or stressful. The Angel wants to see that

these individuals have something at risk if the venture fails and much to gain if it is successful. The Angel needs to have some assurance that members of the team won't bail out when things go wrong or when they need to step up their commitment to see the venture through hard times.

A condition of many Angel investments is to have senior management share in the risks as well as the rewards. This may be through an equity stake, employee options, generous bonuses on successful completion of milestones and/or a bonus on a successful exit. A business which does not reflect this balance of risk and reward for key individuals will need to implement ownership and bonus structures which provide the Angel with an assurance that the key individuals are committed to making the venture successful.

### *Self-assessment*

1. The firm has not considered this issue. Some key individuals do not have equity or options and bonus systems are not in place to motivate long-term commitment.
2. Most senior management have equity but, for some, their allocation is not at a sufficient level to ensure long-term commitment. Small bonuses are possible on achieving individual objectives.
3. Each of the senior management team has adequate incentives in the form of equity and/or options to be committed to the venture. Other key employees have bonuses for personal achievement.
4. Senior management and key employees have equity and/or options sufficient to motivate them to stay committed to the venture. In addition to personal bonuses, there are corporate-wide bonuses for major milestones. The system of rewards has not been reviewed by a professional advisor to ensure it would be sufficient to support an Angel investment.
5. The allocation of equity and options and the system of bonuses have been reviewed by a professional advisor and adjusted to assure an Angel that it provides a good basis for key executive and key employee commitment to an Angel investment.

#### **A4. Key shareholders are familiar with Angel exit conditions**

Angel investors are faced with a lack of liquidity when it comes to recovering their investment in a private business. Generally few investors wish to hold a minority position in a private company as they have little control over the events of the business and generally are unable to recover their money when they need it, especially if the business gets into trouble. Thus the Angel investor imposes on the firm a series of conditions which will effectively force the business to undertake a liquidity event within a reasonable period of the investment, say 3-7 years, in order for the Angel investor to recover their money and hopefully achieve a reasonable return on their investment.

The exit conditions are mainly as follows:

- If an offer is received for the business, the Angel investor may force the shareholders to accept it.
- If the shareholders wish to sell their shares, they will not be able to do so without selling those of the Angel investor.
- The business may need to undertake an IPO within a set period or, failing that, be put up for sale.
- The existing shareholders may be required to buy back the shares of the Angel investor after a certain period where failure to do so would result in the sale of the business.
- Failure to achieve agreed performance targets may result in the Angel investor taking control over the business. Once this is achieved, the Angel investor might decide to sell the business in order to liquidate their investment.

#### ***Self-assessment***

1. Key shareholders have little or no knowledge of Angel investment conditions.
2. Key shareholders are agreed which the firm could be sold if they fail to meet targets but are unaware of how this would work operationally.
3. The key shareholders are aware of the different conditions that will be imposed on them in terms of the performance requirements of the

Angel but senior management and majority shareholders have not discussed how this will work or how they will manage the business to meet those targets.

4. Senior management and key shareholders have developed an Angel investment plan, with events and targets which senior management believe are achievable, will meet the management and exit requirements of the Angel and still leave them in control during the investment phase.
5. The firm has engaged a professional advisor to brief them on the investment conditions of the Angel and has reviewed the Angel investment plan to ensure that management has a reasonable chance of meeting the Angel conditions.

#### **A5. Cost and time for raising funds is understood**

Few entrepreneurs appreciate the level of time, effort and costs which they will incur during the process of raising Angel investment. Those who have been through the process estimate that 50% of the CEO's time and much of the CFO's time over a period of three to nine months will be consumed with preparation, presentations and negotiations. In addition, the due diligence activity can easily consume many months of staff time. During this process, the business has to be directed and managed without impacting on revenue and profit – a very tall order indeed.

Better preparation can considerably ease the burden on the executive team and administration staff. This may include compilation and update of due diligence files, a periodically updated business plan, regular and comprehensive monthly management reports, compliance audits and performance reviews based on key performance indicators and budgets. By working with knowledgeable advisors during preparation for the Angel investment, the time to find the right investor will be cut and the discussions streamlined as the executive team will be better prepared for the negotiations.

An Angel investor will want to spend time with the senior executives to get to know them and to develop an understanding of the business. This will take

most senior executives away from the business for significant portions of time. The business needs to have a plan in place so that the rest of the executive team can carry on without undue disruption to the flow of activity.

### *Self-assessment*

1. Senior management and majority shareholders have not discussed the time and resources required to raise Angel investment.
2. The firm has some idea of the time and effort required but has yet to allocate these or consider how the business will operate while senior management is diverted into that activity. The cost incurred to raise funds has not been estimated.
3. Advice has been sought on the process of raising Angel investment and the amount of time and effort has been clearly identified but responsibilities for activities and succession plans have not been planned or agreed. The cost incurred to raise funds has been estimated.
4. Responsibilities for the investment raising activity have been allocated but responsibility for managing the ongoing operations has yet to be clearly allocated and assigned.
5. A plan has been agreed with senior management and subordinates with respect to roles and responsibilities for undertaking the investment activities as well as the running of the day-to-day operations. A budget has been allocated for the costs associated with raising the investment.

## **A6. Board of Directors accept authority limits of an Angel investment**

Many immature businesses seeking external investment have little experience with formal Boards of Directors and will find the process of setting up a Board and handing over authority for significant strategic decisions very uncomfortable and often frustrating. No longer can the executive team meet whenever they feel like it and make a decision which materially affects the shape of the business. More developed firms which have constituted a Board of Directors may have friends and family on the board and perhaps a trusted family advisor, such as a local lawyer or accountant. With the introduction of the external investor, the role of the board will change markedly and the existing

executive directors will have to justify their actions, defer major decisions to the Board and allow the Angel to have the final say on a number of strategic activities. This can be very confronting to the entrepreneur who is used to having the Board rubber stamp his or her actions.

The investment agreement will specify that a number of activities can only be taken with the approval of the Angel director. This would almost certainly include issuing new shares, declaration of a dividend, changes in senior management remuneration, changes in levels of debt and approval of capital expenditure. The following descriptors refer to the Board of Directors prior to an investment by an Angel.

### *Self-assessment*

1. The Board of Directors have little understanding of the authority limits imposed under an Angel investment.
2. The Board of Directors understand that there will be some constraints on decisions they make but are unfamiliar with the type and extent of such limits.
3. The Board of Directors has reviewed a list of the limits on authority which will be placed on them by an Angel investment but have yet to translate these into operational or strategic impact.
4. The Board of Directors understands and accept the limits on their authority imposed on them by an Angel investment but have yet to translate this into operational details and procedures.
5. The Board of Directors have reviewed the authority limits imposed by an Angel investment with a professional advisor and has implemented various limits on the authority of management and established procedures for how issues relating to those items will be handled in Board meetings.

## **A7. Post-Angel investment management roles and responsibilities accepted**

Experienced Angel investors place great emphasis on having the right management team in place. This reflects the wisdom of having an experienced team with the right mixture of qualifications, skills, networks and industry experience but also the lessons learned over the years by Angels that few plans are implemented as expected. The experienced entrepreneurial team adapts to changing circumstances and copes well with unforeseen events. The current management team will be thoroughly scrutinized and gaps exposed. The Angel investor may well suggest (and impose) management changes either through a new alignment of roles and responsibilities or the introduction of new executives.

Clearly it is in everyone's interest to have a successful venture. The business which sees Angel investment as an opportunity to introduce new talent into the business will be well received by the Angel investor. Finding experienced executives who have experienced growth to the level the venture needs to achieve can make all the difference in the success of the venture. At the same time, the entrepreneur will need to acknowledge that some of his current team may be inappropriate for the new growth plan. Regrettably that means that some of the current executives may lose their jobs or be relegated to more junior roles. Understanding that such changes may occur and being willing to work through them to find the best overall solution, will be critical in securing Angel investment.

### *Self-assessment*

1. Senior management and majority shareholders are not aware that any changes could or would be made to their senior management team or their responsibilities.
2. Senior management have reviewed their management experience and functional expertise and experience and have determined that they have some gaps but are yet to develop a plan to address them.
3. Specific skill gaps have been identified in the management team. Senior management and majority shareholders have acknowledged

that the Angel investor may require changes in responsibilities, a new organisational structure or some new senior executives. However, this has not been accepted by senior management and they have not accepted that it might be a condition of the investment.

4. Senior management and the majority shareholders have acknowledged and agreed that they lack a number of skills, the organisation structure may need to be changed, an Angel investor may require some new executive talent and their current roles and responsibilities are most likely to change.
5. A professional advisor has reviewed the management team, organisation structure and responsibilities and proposed changes in structure and roles. The advisor has also helped the firm to develop a proposal for filling gaps in the management team which has been included in the Angel investment plan. The current management acknowledge that an Angel investor may have a different view and the new structure and roles will need to be negotiated and agreed with the Angel investor.

### **A8. Angel valuation models are understood and accepted**

Many deals are never concluded or, in fact, never proceed to substantial business negotiations because the majority owners have quite unrealistic views about what the business is worth. It is important that the firm seeking Angel investment have some understanding of valuation methodology. While it is always possible for valuation formulae to be used which are based on performance, it is unlikely that this will be agreed in the early stages of the discussion.

It is important that each party accept the valuation norms of the Angel investment sector prevailing at the time they are seeking investment. This way valuation does not get in the way of the negotiations proceeding. Variations to the norm can then be negotiated based on how future risks may be translated into equity share. The process set out here provides a basis for negotiating value but it starts with an understanding of conventional valuation techniques. From that point, the entrepreneur or Angel can argue for a variation which perhaps better reflects the risk tolerance of each party.



Few entrepreneurs have current knowledge of what is happening in the Angel investment sector and this is where access to knowledgeable advisors can be a great help. The advisor can provide the entrepreneur with information on current transactions and also work with the firm to develop a valuation which could be used in the investment discussions. An Angel investor will recognise that the entrepreneur has sought professional advice and will be expecting that the valuation proposed will be close to the final negotiated value.

In the case of a potential strategic trade sale, the entrepreneur or the Angel may have some view on the value to the potential buyer and this may be used as a basis for a valuation discussion.

### *Self-assessment*

1. The firm has no appreciation or knowledge of how an Angel will establish valuation and equity arrangements.
2. The firm understands conventional valuation formulae and anticipates that this will be used by the Angel as a basis for negotiation but has no real understanding of how the final valuation and equity share will be determined.
3. The firm has some familiarity with valuation techniques used by the Angel investment sector and some knowledge of how equity will be structured following an investment but does not have a good understanding of how this might be applied in their venture.
4. The firm has built a valuation model based on conventional Angel valuation methods and has determined what they believe will be a reasonable basis for valuation and equity share but has not had this validated by a professional advisor.
5. The firm has engaged a professional advisor to assist in the development of a valuation and equity share model which would be acceptable as a basis for negotiation with an Angel investor.

## **A9. Level of finance required is realistic**

What can go wrong will go wrong. Perhaps not – but this is the view which most Angel investors take when evaluating the level of investment required to provide a firm basis for development of the venture. Under-funding during the critical growth stages can place the business in a desperate situation where product development is not quite finished, cash flows are not yet positive or market development has not reached a critical turning point. Typically, the only option firms have at this point is to seek a further injection of cash. Unfortunately this can often only be achieved at a valuation lower than the one established when the initial Angel investment was made. Angel investors will negotiate hard to avoid this situation.

A realistic view of the funds needed can only be achieved through a thorough simulation exercise of the venture. Various scenarios need to be created across a range of possible outcomes which include worse case, most likely and best case situations. In this way, the sensitivity of the venture to the level of funding needed and the estimated return to an Angel investor can be ascertained. With this knowledge, the firm can better negotiate the investment. It may be possible for the investment to be taken in tranches to reflect funding needs and for the equity position to be adjusted accordingly. The Angel investor can then set aside the maximum likely investment funds but recognises that not all of it may be needed.

### *Self-assessment*

1. Senior management has not undertaken any rigorous analysis of the financing requirements of the business.
2. The funding requirements of the current business are well known and understood but this has not been reviewed in light of the ROI requirements of an Angel investor.
3. The firm has considered the ROI requirements of an Angel investor and has considered the impact this might have on the business strategy and but has yet to translate this into the business plan.
4. The ROI requirements have been worked into the business strategy and into the operational business plan, establishing the level of funding

which would be required from an Angel investor, but this has not been reviewed by a professional advisor.

5. A professional advisor has reviewed the funding requirements, requested a sensitivity analysis on the strategy and assisted the firm to establish the level of funding they believe an Angel investor would be expected to provide in order that the investor's desired ROI has a reasonable chance of being achieved.

## Awareness and Alignment Index

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A		
1	2	3	4	5			
Item	Attribute	1	2	3	4	5	N.A
A1	Majority shareholders agree on Angel financing strategy						
A2	Managers and owners agree on use of funds						
A3	Entrepreneur and managers are committed to the venture						
A4	Key shareholders are familiar with Angel exit conditions						
A5	Cost and time for raising funds is understood						
A6	Board of Directors accept authority limits of an Angel investment						
A7	Post-Angel investment management roles and responsibilities accepted						
A8	Angel valuation models are understood and accepted						
A9	Level of finance required is realistic						

## [ B ] Venture Potential

**T**he essence of any Angel investment evaluation is the quality of the management team (as discussed in Awareness and Alignment) and the quality and viability of the business concept itself. That is, how and where is the money made and how does the investor get a return on their investment? The Angel is looking for a set of attributes which, in a holistic manner, provide a strong and compelling business case for an investment. Each attribute should lead to a high probability of a successful outcome. Any attribute which has a weak situation leaves a gap in the plan and can lead to failure or erosion of the business by an internal or external weakness or threat.

We need to differentiate in our evaluation of a potential investment between those ventures which are being prepared for a financial exit, a financial trade sale or an IPO, from those which are destined for a strategic exit. In a financial exit, the robustness of the business concept and its ability to generate growth in revenue and profits are critical. In a strategic exit, what we are seeking are strategic value assets or capabilities and a management team to take the venture to a strategic trade sale. Since the buyer will be providing the horsepower

to take the product or service to market, capabilities to drive revenue and profit growth may be of little consequence in the proposed venture.

Many of the attributes listed in this Index are those which have been found to have the most significant impact on the success of financial ventures. While they apply to all financial businesses, later stage businesses may already have moved past the point where they can substantially change their market position, however, they should have proven revenue and profit to show a viable business concept. Many of the product/market attributes are also critical for strategic ventures.

The Angel will not expect to find a venture which scores highly on all attributes, but since they are constantly seeking investment opportunities, each possible deal must compete with other investment opportunities which the Angel has reviewed. The Angel is looking for those ventures which have the greatest potential and the highest probability of success. It is almost certainly the case that assistance from an Angel would improve the business, after all, this is what the Angel is looking for – an investment where they can add value through their knowledge. The Angel may be able to find additional executive talent to fill out the team, connect the firm with strategic customers or alliance partners or secure a strategic supplier.

In evaluating the venture potential, it may be that the Angel, with superior knowledge of a particular market, may see greater potential than has been evidenced by the entrepreneur. For example, the Angel may know a strategic partner relationship which can be readily secured or a potential acquirer for the business. This information needs to be factored into the evaluation of venture potential.

## **B1. Business and economic conditions support the venture**

Ventures which are most likely to succeed are driven by significant change, whether this is in technology, legislation, consumer values or the economy. New technology often solves problems which were previously not able to be addressed or significantly enhances productivity or reduces cost in solving existing problems. Obvious demographic trends create new needs in housing, aged care, infrastructure, travel services and so on. New legislation often creates new opportunities in compliance training and auditing.

Angel investors look for the problem the business is solving. The more obvious the problem and the greater the imbalance between demand and supply, the more urgent the need is and the higher is the likelihood that the business will be successful. Businesses need to solve a problem or meet a need and the entrepreneur should be able to show the source of that need and the size of it. This should be able to be validated with independent data.

### *Self-assessment*

1. Evaluation has not yet been undertaken.
2. There are changes that appear to support the venture but evaluation has not been undertaken. The proposal is based on personal opinion.
3. There are clear indications of changes which support the venture in external independent information. Validation has not been undertaken of the strength or likely duration of the need or to what extent the need is currently being satisfied.
4. Business and economic conditions which support the venture are well documented and supported by externally validated data. Informal research shows that the business need is unsatisfied and a strong demand for a solution exists.
5. Business and economic conditions strongly support the venture either through legislative changes, strong demographic changes, major shifts in consumer values, major changes in technology or major economic shifts. The proposal is strongly underpinned with validation data, expert opinion of customer needs and the lack of a currently available solution.

## **B2. Well articulated, focused vision of the purpose of the venture**

More successful ventures have focus. They clearly know the problem they are solving and have a very good description of their customer. They are able to articulate why they exist, often in very simple terms. The purpose of creating a short, focused vision of the venture is to ensure that all parts of the business are heading in the same direction and are supporting the various parts and not undermining it. Decision-making should become easier, actions are more targeted and results can be measured in terms of where the business should be heading.

Few Angel investors have the technical knowledge to evaluate the technical merit of a range of diverse business ventures. However, they can appreciate a clear non-technical statement of what the business does and the need or problem it is addressing. Nothing is more off-putting to an investor as the entrepreneur who has a product that solves everything, which will be available everywhere and should be bought by everyone. Nor do they appreciate the venture team that can't decide which of the many problems they are going to address first or which market they are targeting. A clear, focused vision statement which has been carefully crafted, matches the competitive advantages of the venture and is agreed to by the venture team, is an essential part of the investment request.

In the context of a strategic venture, the vision of the venture may simply be to prepare the business for sale. However, the venture needs to see its vision in terms of the way in which the buyer would see the vision of the acquired firm. Thus a clearly articulated vision of product/market positioning is still important.

### *Self-assessment*

1. The venture does not have a vision statement.
2. The vision of the venture is stated in broad terms, lacks focus and may be overly technical or lengthy.
3. The vision is brief but is overly technical, too long or fails to clearly state who the customer is or the problem being addressed. The vision may be stated in terms of a product for sale rather than a problem being addressed.



4. The vision clearly states the target customer, the problem being solved and is well focused and brief but is overly technical. The vision may be focused on a single product rather than a range of problems which may be addressed within a complimentary set of products or services which could be developed and delivered over time.
5. The venture has a well-articulated vision of the business concept including the problem being addressed and the solutions which are and will be offered. The vision is brief and to the point and is stated in terms that an educated non-industry investor can clearly understand.

### **B3. Innovative product, process or business concept**

A business which does the same as every other business in the sector will ultimately be forced to compete on price. If the product or service is the same as others in the market, then without a competitive cost advantage over the major expenses in the business, the venture has little chance of growth and certainly is not going to reach the levels of revenue and profits which the Angel investor is seeking. Cost advantages rarely drive significant exit values. What the Angel should be seeking are products or services which are differentiated sufficiently so they can command a premium price in a niche market.

The Angel investor looks for an edge. What is it that this business has or does which will provide it with a competitive advantage? This almost certainly is driven by an innovation in product, process and/or business concept. The size or impact of the innovation is a metric which conveys information about the likely competitive advantage. A substantial innovation which significantly changes the cost structure of an industry, greatly improves customer value or opens up solutions to formerly unsolved problems, provides the underpinning for high rates of growth.

Obviously, the more unique the innovation and the more the customers value the impact, the more it adds to the potential competitive advantage of the venture. Innovation which does not add to customer value may in fact detract from the worth of the venture. If the innovation adds costs to the product but fails to add additional customer value, the venture is unlikely to

succeed. Innovations which add costs but at the same time significantly improve customer value can create a solid foundation for a business.

### *Self-assessment*

1. The product or service is the same as many others in the market.
2. The product offered has only minor differences to the competition.
3. The product has clear differentiation from others in the marketplace but the differences are not sufficient to necessarily capture customers from competitive offerings.
4. The product has major differences from competitive offerings and customers will value those differences. Products have a strong competitive advantage.
5. The product has breakthrough advantages which clearly separate it from competitors. Customers highly value the advantages and this will create a leadership position. Products are the only offering in a new emerging market or are the only products able to solve the target problem.

## **B4. Clear and compelling customer need**

Clearly the most desirable position for any firm to be in is for their product to be needed desperately by a set of customers. This does not mean something they desire or would like to have, or even something they want to have. This refers to something they must have and, better still, must have now! You may well argue that few products can ever be so compelling but in fact many basic products would fit that need. Each person has a need for food and water, basic accommodation and security. Without electricity, water and sewage services, life in urban areas would be impossible. This is possibly the major reason why these services are regulated. Food is of course satisfying a basic need although there are many alternatives. But the compelling need is still there.

Some conditions do create compelling needs. Virtually all regulations have compliance requirements and associated penalties for non-compliance. A product or service which stops you from being fined or going to jail has a high compelling need to buy. Products and services which neutralise or reduce physical or psychological pain and suffering easily fall into the class of products

which have a compelling need to buy. However, products which have little impact if not purchased, have many near substitutes or can be indefinitely delayed have a low compelling need.

Some products, such as designer labels, well established and trusted brands and products with high repeat-purchase attributes have a higher score on compelling need to buy.

### *Self-assessment*

1. The product or service has many competitive and substitute offerings and is highly discretionary or optional. Customers regard the purchase as a nice to have rather than a must have.
2. The product satisfies a clear customer desire but it is neither urgent nor pressing and can be satisfied by a large number of alternative solutions or products. Customers can decide not to buy without being overly concerned.
3. There is a clear need, but satisfying the need can be deferred as it is not an urgent need to satisfy. Customers have a strong preference to purchase and would be concerned if they were not able to. There are some acceptable near alternatives.
4. The need is obvious and of high value to the customer but may be temporarily deferred or can be partly satisfied by poor alternatives. Customers have a strong desire to purchase and would be seriously concerned by deferring the purchase.
5. There is a compelling need to purchase to avoid high physical or psychological pain, to avoid severe penalties or costs or to obtain/maintain competitive advantage. Deferment is not really an option, nor are there any substitute solutions.

## **B5. Sufficient, willing, funded, identifiable and reachable customers**

A great number of businesses target 16-25 year olds, time poor executives, free thinkers or people with a desire to feel young at heart. The problem with this approach is that it is difficult to be proactive, to actually reach out and connect directly with the target customer. These businesses are highly dependent on passing traffic for business. It is far better to have a clearly identifiable target customer who you can directly and proactively approach. You need to offer something for which you know they have already expressed a need. For example, a product for registered dentists, members of a gym or subscribers to a journal are easily approached with an offer to purchase.

A clearly reachable, identifiable customer is one you can get in front of with your product or service message. Potential customers must be identified with a location where you can deliver your message. This also needs to be cost effective, thus a TV advertisement aimed at registered dentists does not make a lot of sense when a trade journal, a dental conference or a direct sales visit to a registered dental surgery would have a higher conversion rate.

An important attribute of the target market must be that they have the willingness and the ability to spend on the product or service. Furthermore, the business needs customers in sufficient numbers in order that the business can make enough revenue and profit to be a viable entity.

In a strategic sale, it will be the ability of the buyer to reach a customer base which will be critical to new revenue generation but the need to have a clearly defined customer is still important for the strategic buyer. The definition of the customer profile will often provide the key to the identification of the potential strategic buyers. The customer/market definition required in a strategic sale is that of the potential buyer. That is, which large corporations have a large customer base of the target customer and have the capability and capacity to sell the venture's products or services into their customer base.

### *Self-assessment*

1. Numbers of customers, their defined attributes and locations and whether they are willing and able to buy have not been established.
2. Customer definition is reasonably clear but no attempt has been made to establish whether they can be approached proactively, are willing to purchase or are in sufficient numbers to make the venture attractive.
3. A clear definition of the customer exists, intention to purchase has been established but the size of the market has not been established nor has a program been developed to proactively reach them.
4. The size and location of a clearly defined existing and/or potential customer market has been established. The size of the market has been established and the level of buying intention has been estimated.
5. A clearly identifiable and reachable existing and/or potential customer market has been defined and validated. There is a clear intention to purchase the specific product of the firm and the size of the market would support the projected revenue of the venture.

## **B6. Obvious and meaningful competitive advantage**

If you have a product or service in a marketplace which is simply littered with comparable offerings, you can have very little hope that your venture is going to be successful. If everything you do to be different can be readily copied with little effort, clearly you are in a business which has little chance of success. Only by finding a strong point of difference in an attribute that the target customers value will your own products or services carve out a segment of the market. The most desirable position to be in is to have a product which not only fully meets the needs of the target customers, but has no competitor or near substitute and has significant barriers to entry.

For a competitive advantage to be meaningful it needs to be validated by actual or potential customers. The difference must be meaningful and sufficiently important to the target customers that they have a clearly expressed preference for the product or service you are offering. Validation is also needed to ensure that a close alternative product is not available. A competitor analysis is necessary for you to validate your competitive advantage.

### *Self-assessment*

1. A competitive analysis has not been undertaken.
2. The firm knows of a number of competitors but has not done any systematic analysis of their position relative to the competition.
3. A competitive analysis has been undertaken and shows the firm has some differentiation which should appeal to potential customers.
4. The firm has a clear competitive advantage in its target market and has validated this with potential customers who value the differential features.
5. The firm has outstanding differentiation which is highly valued by the target market or there are no obvious competitors and there are significant barriers to entry.

## **B7. Well protected sustainable attributes**

While the firm may have established a competitive advantage with its product or service, this is really only beneficial if it can sustain and/or protect it over the long term. Sustainability can be achieved from registered intellectual property (IP) such as is the case of patents or copyrights. Protection may lie in the fact that the firm has certain rights which are exclusive or limited such as mining or forestry rights or a licence to practice. Expert knowledge, if hard to acquire, in limited supply or requiring extensive experience or training, may provide the basis for a sustainable advantage.

Protection can be legal rights which attach to patents or licences. Products and services can be protected by being difficult, expensive or time consuming to copy. A business may protect itself by controlling elements of the market such as preferred outlets, distribution channels or essential components. Other firms may be effectively locked out of a market through customer or supplier agreements or by controlling the source of an essential resource input. The ability to defend encroachment is an essential factor in maintaining protection. The firm which cannot defend a patent infringement, for example, has little protection against a large well-funded predator.

The value achieved in a strategic sale is directly related to the level of exploitation of the venture's products or services by the buyer. Therefore, the buyer is keenly interested in the level and sustainability of the competitive advantage which will be passed to them by the seller.

### *Self-assessment*

1. The venture has not been able to establish any long-term protection for its products or services.
2. Products or services have short-term protection but this can be eroded by a determined competitor or anticipated new products in the market.
3. Products have some level of long-term protection but only through an aggressive product development process, strong customer service and/or features which appeal to a niche market.
4. The firm has strong intellectual property protection through patents, copyright or registration rights but these may be overcome or eroded by a determined and well-funded competitor although this would take some years to be effective.
5. The firm has very strong intellectual property protection through patents, strong branding, high customer loyalty or highly specialised and difficult to acquire knowledge. Significant funding and/or strong alliance partnerships are present to defend IP which can be expected to deter copying.

### **B8. Resources and channels to distribute are in place or able to be acquired**

Great products or services which cannot be placed where customers can see them, try them or buy them are simply not going to generate revenue in any volume. A business which has an intention to grow, especially one wishing to grow aggressively, has to find channels to market which will put its products in front of the intended target customers in sufficient numbers for growth to be achieved. There are many possible channels to market and the business needs to choose those which are most appropriate for the type of product or service being offered as well as the type and purchase preferences of the target customer.

Some products suit direct sales or telemarketing and/or telesales, so capacity must be built within those channels. Can the business acquire, afford and train sufficient skilled numbers of staff to handle the intended volume? If the product suits a high volume distribution channel, can that be acquired or contracted at a price which is cost effective? Is the business able to utilise alliance partners or joint ventures to take the product to market? Many small firms lack the distribution reach to effectively scale their business and need to find partners to help them get to market. Is the business able to clearly show how the target volumes will be achieved through the chosen distribution channels and is it able to show that those channels are available, willing and affordable?

In the case of a strategic sale, it is the buyer who will provide the channels to market. The assessment of the venture potential will measure whether the product or service being developed can be readily rolled into the potential buyer's distribution channel. If it can, then the venture can easily satisfy this attribute.

### *Self-assessment*

1. Distribution channels are not in place.
2. The firm is constrained by limited in-house distribution capabilities, lack of access to distribution partners and/or powerful distribution channels which control the interface to customers.
3. The firm has a well-defined distribution strategy but lacks an exclusive presence, incentives for distribution channels to put above average effort into the products or a lack of capacity to handle significant volumes.
4. The distribution strategy is well defined, is effective in reaching the target customers and can handle the volume of sales anticipated but lacks robustness to be able to adapt to disruptive events or shifts in channel commitment.
5. The distribution strategy is able to directly connect with the target market in an arrangement which provides the firm with excellent and timely exposure to the customer. The channels are highly motivated



and incentivised and have the depth and scope to cater for changed circumstances and can readily support the volumes required to meet financial objectives.

## **B9. Sales price and cost model provides robust achievable margins**

The business needs to be able to validate both price to customer and expected costs of goods sold as well as fixed costs at each anticipated level of output. Prices might be established relative to competitors, perhaps supported by marketing survey data. Cost data may also have been established through competitor information or perhaps through a cost build-up model using quotations for external costs and cost allocation for internal costs. For established products, prices and costs should have already been validated through existing sales.

The business model will need to show that reasonable levels of profit can be achieved within a short period of time. Alternatively, a business which cannot move into reasonable profit must have a reliable source of continued subsidies to allow it to stay in business. The financial model should also be tested across a range of possible business conditions to see if the business concept is robust under worst, most likely and best case scenarios.

In the case of a strategic venture, the price and cost modelling must be sufficient to encourage the strategic buyer to go ahead with the deal. If the buyer can see a significant revenue opportunity with good margins and can readily justify the acquisition, this will make it easier for the firm to be sold.

### *Self-assessment*

1. Sales price and costs have not been established.
2. Sales prices are estimated and costs have been partly established but neither validated.
3. Sufficient information on prices and costs has been ascertained to establish that the products can be sold for a profit. However, a sensitivity analysis has not been undertaken.

4. Prices and costs have been established and margins have been determined to be attractive. Volume sales show that profit targets can be reached, however, sensitivity analysis to cost variation or price variation has not been undertaken.
5. Sensitivity analysis has been undertaken across a range of possible price and cost scenarios and over worst, most likely and best cases and all scenarios produce acceptable levels of profit achievement.

### **B10. Integrated volume operations (development, manufacturing, logistics, support and infrastructure) are achievable**

Many products or service businesses look great when the volumes are small. This is often because the founders take special care over the development and delivery of the customer solution and the customer is given additional assistance to ensure a satisfactory outcome. However, when the business grows, volume production requires a level of planning and control which is not required or needed when volumes or outputs are small. Logistics need to be much better integrated, quality needs to be controlled throughout the entire value chain and the business needs to have purchasing, human resources, marketing, administrative and IT infrastructure to support complex operations.

Businesses which can handle 10 or 100 transactions need to be massively redesigned when the volumes reach hundreds and thousands. How will the business cope if it needs to manage multiple locations? Does the business have the right people, structure and resources to build a larger, higher volume business?

Scalability and/or replication are critical to a strategic sale. The venture needs to be able to demonstrate that, in the hands of the buyer, significant volumes will be able to be produced with stability in quality and reliability in timing.

### *Self-assessment*

1. Assessment of volume operations has not been undertaken.
2. An operations plan has been produced but a detailed operations plan has not been constructed to see if the plan is achievable.
3. The operations plan has been established at a low level of detail but supporting plans for staff recruitment, training and infrastructure have not been established.
4. A detailed operations plan has been compiled which fully supports the growth plans of the venture. Supporting detail shows infrastructure, staff and resource requirements, however, sensitivity analysis has not been undertaken in areas where delays, variations in productivity or shortages might occur.
5. A detailed, integrated, robust operational plan has been prepared which includes all support operations. The plan has been reviewed under various risk conditions and contingency plans have been developed to mitigate or negate likely risk situations.

### **B11. Management team is experienced, complete, committed, capable and entrepreneurial**

Experienced investors know that business plans are very rarely implemented as written. Every plan is based on a number of assumptions and those often prove to be unfounded or are invalidated by economic, environmental and industry changes. The business may not develop in the manner in which it was originally planned. Experience tells the investor that the best solution to this problem is to have a proven management team which has the experience to cope with the changes that inevitably will occur. They look for an executive team which has the qualifications, experience, mix of skills and industry networks to implement the original plan but can also react to changing conditions and is still likely to achieve reasonable results.

In the case of a venture being prepared for a strategic sale, the management team, in conjunction with the Angel, must have the ability to undertake the sale preparation process. This may include completing product development,

establishing trial customers, building relationships with potential buyers and engaging professional advisors.

In the case of a financial venture, it takes more than industry knowledge and a capable management team to grow a business over time. Very few markets are stable over many years, being impacted by new inventions, new entrants and changing business models. Any business which grows over an extended period of time must have an entrepreneurial capability. This is the ability to see opportunities where others don't, an ability to construct different business models, a strong sense of timing about market changes, a willingness to have a go in the face of incomplete or ambiguous market data and the acceptance that some projects will fail.

Driving a business forward in the face of changing conditions also requires leadership and good judgement. A strong vision, a sense of partnership and involvement and a sense of personal achievement and growth are all characteristics of a positive work culture. A business grows over time, not by doing the same thing all the time, but by evolving to take advantages of opportunities in the market place. A business which is open to new ideas, willing to try new approaches to doing business and encourages people to try small experiments will proactively generate avenues for growth.

Whether the intended exit is financial or strategic, Angels know that they work in start-up and early stage ventures where the passion, drive and energy of the entrepreneur and the management team are critical to success. A good product or service, by itself, will not be sufficient to provide the traction necessary to drive the business to success. The Angel needs to see indications of what the team members have achieved individually and collectively; that they have the ability to take initiative, be proactive and creative and have the determination to succeed in this venture. The Angel also wants to see that the executives are committed to the venture. This may occur through their own personal financial investment, time invested in the venture or the fact that they have put their personal reputations behind the business. Where there are missing skills, the investor wants to see these are acknowledged and a proposal put forward to recruit the necessary talent.

### *Self-assessment*

1. Assessment of the current management team has not been undertaken or no team has yet been assembled.
2. The current management team lacks some key skills, experience and knowledge and plans are not yet in place to recruit to fill the gaps. The current team has not acknowledged any deficiencies which need to be filled. It is not obvious whether the team will stay with the venture if the going gets tough. The team has not demonstrated entrepreneurial activity.
3. The current management team is highly competent in most of the key areas and has the skills and experience to take the venture forward. Key gaps have been identified but a plan has not been developed to fill the gaps. Some members of the team have made personal financial or time commitments. Individuals within the team have shown entrepreneurial activity but they have yet to demonstrate this as a team.
4. The management team has the experience, capability and knowledge to take the venture forward and have plans in progress to recruit some key individuals as part of the growth planned. Succession plans have not been developed. The team has made significant financial, time and/or reputation commitments to the venture. The team demonstrates an entrepreneurial capability.
5. The management team is experienced, has the necessary range of skills, experience and entrepreneurial capability to grow the venture and has an organisational plan for both growth and succession. It is clear that the team is very committed to the venture and will put in the time and effort even if the venture proves to be more difficult than expected.

### **B12. Financial projections show robust acceptable ROI**

The business concept should to be tested across multiple scenarios to ensure that a reasonable financial return can be achieved even in the most unlikely circumstances. When possible funding is added to the financial forecasts, the forecasts should show that the Angel is able to achieve very good results. Robust financial forecasts should declare and test the validity of the basic assumptions. By changing basic assumptions to different possible situations,

the model can be tested for robustness. Those assumptions which have the greatest sensitivity can then be addressed with counter measures or additional activities to minimise their impact.

Within the period of the investment where survival and operational performance are critical, financial projections should include income statements, balance sheets and cash flows. A breakeven analysis should be shown. These various financial projections should be created under several possible scenarios including worst case, best case and most likely case.

Estimates of exit values should be undertaken to show that the business is able to achieve the rates of return desired by the Angel under all possible exit scenarios. Remember that in the case of a strategic exit, revenue and profit growth may not be relevant. What is important is to produce something which the strategic buyer wants.

### *Self-assessment*

1. Financial projections have not been prepared.
2. Financial projections have been prepared but are at a high level of aggregation and are based on assumptions which have not been validated. Detailed cash flows are not available.
3. Detailed financial projections have been prepared which show acceptable levels of profits (if relevant) and ROI but some assumptions are questionable and a scenario analysis has not been undertaken. Detailed cash flows are available.
4. Detailed financial projections have been made which show acceptable levels of profit and revenue growth (if relevant) and ROI. Underlying assumptions have been validated and are acceptable. Scenario analysis has not been undertaken.
5. Detailed financial projections with worst case, most likely case and best case have been undertaken. Underlying assumptions have been validated. Projections have been validated by an independent professional advisor. Profit and ROI targets are robust and achievable under all scenarios.

**B13. Risk analysis shows resilience to possible delays, shortages, competitive retaliation, quality issues, failure to recruit the right staff, etc.**

Most simulations of financial projections concentrate on changes in revenue levels but fail to take into account other risks which may be equally damaging to the venture. The Angel needs to isolate those factors within the business which can have the most disruptive impact on desired targets. It is only by undertaking such an analysis that the Angel can uncover the likely risks which can severely impact target achievement.

Once a risk assessment has been undertaken, those risks can be subjected to their own mitigation planning exercise. A business plan which anticipates potential problems can build contingency plans and take steps to avoid, mitigate or reduce the impact of possible negative events. Risk analysis may result in strategies being developed which change the order of introduction of products, the timing of selected capital expenditures or planned targets.

*Self-assessment*

1. Risk assessment has not been undertaken.
2. Some major risks have been identified but a plan has not been developed to deal with these when they occur.
3. Major risks have been identified and plans have been developed to deal with them when they occur, but mitigation or avoidance plans have not been implemented.
4. A risk analysis across the enterprise has been undertaken and plans have been put in place to counter, mitigate or avoid them.
5. The business strategy has been developed and implemented to take into account those risks which would have a damaging effect on the business achieving its objectives.

## **B14. A robust and well-articulated exit strategy for the Angel has been defined**

Angel investors need to see a path to liquidity for their investment. Few Angels invest for dividends; most will be investing for capital gains. However, whether they invest for dividends or capital gains, they still need to have a mechanism for releasing their original investment. The normal form of harvesting is either a sale to another business (trade sale) or a listing on a public stock exchange (an initial public offering or IPO). Many investment proposals use such exit phrases as 'sell to a corporation in 3-5 years' or 'list on the stock exchange in five years' with no substance behind the statement. They have neither identified who the potential buyer might be nor how they would be an ideal candidate for an IPO.

The business proposal needs to demonstrate to the Angel a well-articulated exit strategy which is meaningful. A trade sale strategy should have identified potential buyers and have convincing arguments as to why the selected corporations should buy the business. An IPO strategy should show how similar businesses, with comparable products, services and growth patterns, were able to list on the target exchange.

### *Self-assessment*

1. An exit strategy has not been identified.
2. The exit strategy is very general and lacks detail or validation.
3. A possible exit strategy has been articulated which looks feasible but lacks detail and resilience.
4. The exit strategy is very detailed, seems highly probable and includes estimates of timing, resources required and costs for professional services.
5. Professional advice has been received to validate the exit strategy and adjustments have been made as a result. The exit strategy is highly probable and resilient. Alternative exits are capable of being executed depending on market circumstances.



## Venture Potential Index

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A				
1	2	3	4	5					
Item Attribute				1	2	3	4	5	N.A
B1	Business and economic conditions support the venture								
B2	Well articulated, focused vision of the purpose of the venture								
B3	Innovative product, process or business concept								
B4	Clear and compelling customer need								
B5	Sufficient, willing, funded, identifiable and reachable customers								
B6	Obvious and meaningful competitive advantage								
B7	Well protected sustainable attributes								
B8	Resources and channels to distribute are in place or are able to be acquired								
B9	Sales price and cost model provides robust achievable margins								
B10	Integrated volume operations(development, manufacturing, logistics, support and infrastructure) are achievable								
B11	Management team is experienced, complete, committed, capable and entrepreneurial								
B12	Financial projections show robust acceptable ROI								
B13	Risk analysis shows resilience to possible delays, shortages, competitive retaliation, quality issues, failure to recruit the right staff, etc.								
B14	A robust and well articulated exit strategy for the Angel has been defined								

## [C] Operations Development

**T**he Operations Development Index (ODI) has been designed so that an Angel can measure the quality of governance and operations management within the investee firm. It can be used to evaluate the potential investment as well as provide a tool for measuring the progress of development of internal systems once the investment has been made.

A business can only be run effectively if it has the measurement and reporting systems in place to set targets and review performance. The use of KPIs, budgets and proper reporting systems are critical. Governance issues deal with compliance and risk management and can be seen in good relationships with customers, suppliers, bankers and so on. Operational excellence should be an objective of the Angel as this can positively contribute to the value of the business at the time of sale or as preparation for an IPO.

As part of the initial due diligence of the firm, the ODI can help the Angel assess potential risks in the investment. When an Angel enters into an investment, they are exposed to the trading risks of the investee company. They are also exposed to any current or contingent liabilities, current and

potential employee disputes, customer issues and supplier disputes. Once the investment has been made, these risks will be managed through management oversight and restrictions on how monies can be used and what loans can be incurred.

The Angel should also have arrangements in place where they can more actively intervene and sometimes take complete control if the business fails to perform to agreed schedules and targets. However, this is little comfort to an Angel who is reliant on the management team to operate the business. Pre-existing conditions may be underwritten somewhat through warranties and representations and failure of the business to perform may be somewhat compensated for by a share dilution formula which adjusts the Angel's percentage of ownership, but this is little comfort to the Angel who has invested in a lemon.

The Angel investor needs to establish the level of risks associated with the investment before they do the deal, not after. So an extensive investigation will often be undertaken to uncover any skeletons which may lie in wait for the unwary investor. Depending on the size and complexity of the firm, this process can take many months and be very expensive. While this cost is usually absorbed by the Angel, it is almost certainly factored into the valuation or use of the investment funds. In some cases it may be underwritten or reimbursed by the investee company.

The Angel will be trying to estimate the costs and time needed to be devoted by the Angel, executives within the firm and external advisors to bring the investee company up to the quality needed for an ongoing stress-free operation. As items are uncovered, the Angel will need to estimate the time and cost that will be incurred to resolve the issue. Of course, some may not be that simple, cheap or quick to resolve. Other items may be serious and there may not be an easy way to estimate the likely damage or cost to resolve. This is particularly true with contingent liabilities, intellectual property ownership doubts and unclear customer obligations which have not been fulfilled.

At some point, the Angel may simply decide that the level of risk is too high to proceed, or they might decide that it will take too long and be too expensive to establish the level of exposure in the outstanding issues.

Clearly a firm which appreciates the concerns of the Angel investor and has closely managed its operations, managed its risk exposure and ensured that it has fully complied with industry regulations, is a good candidate for Angel investment.

The ultimate due diligence test which could be used by an Angel is the following:

*Can I leave the investee firm alone to continue managing its operations without incurring any unreasonable level of risk?*

*Can I achieve my required ROI in the investment by devoting my effort to where I can add the most value without being distracted with having to clean up problems first?*

Not all issues will be resolved by the firm in advance of an Angel investment, but the more the firm can do prior to the investment, the easier it is for the Angel to complete the due diligence investigation and move to consummate the investment arrangements. A firm which is prepared for due diligence is a major advantage for an Angel.

The initial investigation can provide the Angel with a checklist to be used after the investment to drive improvement in the governance and operations management of the firm. An Angel keen to see a trade sale or an IPO within a few years of his investment should be sensitive to the positive impact a clean bill of health on the ODI will have on the potential exit value of the firm.

In a trade sale situation where the potential buyer is a corporation, aspects of the acquirer's due diligence will deal with the actual integration of the two companies. This will involve reviewing the costs, problems and delays of merging the acquired business into their own organisation and will involve such things as personnel systems, benefit systems, IT infrastructure and so on. The only way the firm can prepare for this possibility is to ensure that they use industry standard processes wherever possible.

## **C1. Monthly financial and key performance indicator reporting exists**

The existence of a comprehensive reporting system is important for several reasons. These are:

- It demonstrates that the firm is well run.
- It shows that the management is effective.
- It shows attention to detail.
- It demonstrates that an underlying infrastructure is in place.
- If comprehensive, it should show that problems are identified early and addressed.

The financial reporting systems should produce balance sheet and income statements, cash flow projections, aged debtors and aged creditor reports.

More sophisticated systems go beyond monthly financial reporting. Every business has key performance indicators (KPIs) which demonstrate health and competitive alertness. Reporting systems should be able to demonstrate that the company is operating efficiently in all major areas of operations. For example, in sales, reporting systems might examine tenders received, tenders sent, contracts under review, contracts received and revenue to estimates. In production, it might refer to actual production versus planned production, overtime hours worked, rework hours, inventory levels and so on.

In a due diligence investigation, the Angel will be attempting to estimate the level of intervention that is to be put in after the investment. To the extent that good management systems are in place, this should considerably reduce the Angel's concerns.

### ***Self-assessment***

1. Internal reporting systems are unsophisticated and incomplete.
2. Monthly financial reporting exists but is not comprehensive.
3. Monthly reporting exists but few KPIs are tracked.
4. Monthly reporting systems and KPIs are tracked but have not been audited for completeness and effectiveness.

5. Comprehensive monthly financial and KPI reporting exists. Professional advice has been taken to ensure completeness and effectiveness.

## **C2. A formal business plan has been prepared and is updated periodically**

Most business people would agree that business plans are outdated as soon as they are printed. However, the discipline of preparing the business plan captures the holistic nature of the enterprise. This is one of the few times where management have the opportunity of rethinking the vision, goals and strategy of the firm. It is by pulling it all together that they will gain insights into areas of weakness and opportunities where the business can be improved.

For the Angel, a good business plan provides insights into the business. For example:

*What is the vision and how is this translated into strategy?*

*What are the competitive assets and competencies of the firm and how are these being leveraged into competitive advantage?*

*Which markets do they compete in and how are they placed?*

*What are the assumptions behind the numbers and have these been validated?*

*What risks are present in the business and how are these being addressed?*

*What is the worst case scenario?*

*Do they understand their underlying cost and revenue structures and has this been translated into a breakeven analysis and a breakdown of recurring and new business?*

*Can they demonstrate clearly where the business comes from and why?*

*Do they have clearly articulated marketing and sales plans with identified targets?*

*Has business growth been translated into a headcount plan and a funding plan?*

The business plan demonstrates that the management team understand what it takes to be successful. It should be more than a spreadsheet, it is an explanation of why the business is successful and should be backed up with validation of assumptions.

The question that should be asked by the Angel is:

*Can this business be run successfully without me having to intervene to make it work?*

It may not be the Angel's intention to leave the business the way it is, after all, part of the reason for selecting a specific investment is to leverage the Angel's knowledge and contacts. However, he should be trying to estimate the level of effort he is going to have to put in to improve their operations management. If the business can be left alone to run itself for some period of time, the Angel can concentrate on future plans for the business without having to shore up normal operations.

The business plan may also indicate where additional potential lies for the firm. This helps the Angel to evaluate the opportunity and perhaps see how the opportunity may be developed with additional resources or assistance from the Angel.

### ***Self-assessment***

1. A business plan does not exist.
2. There is a business plan but it is out-of-date and/or incomplete.

3. There is a comprehensive business plan but it simply projects past trends and is not a strategy document.
4. A comprehensive business plan exists and is up-to-date but does not have the depth or validation needed to provide a good explanation of strategy or how the business might perform in the longer term.
5. A very comprehensive business plan exists which is of professional quality and fully explains the business strategy, the capabilities and the likely outcome of the business in the longer term.

### **C3. A formal budget is prepared and actual performance is monitored against budget**

The preparation of formal budgets (profit & loss, cash flow and balance sheet) serves a number of purposes including:

- quantification of formal business plan.
- identification of projected profit and loss and cash flow.
- a basis for financial discussions with external parties such as debt and equity provider.
- a basis for monitoring the actual performance of the business against the business forecast.
- a basis for performance evaluation of key staff and departments.

The budget should provide the basis for monitoring actual performance against budget and should link the formal business plan to the actual performance of the business.

Budgets should be prepared and monitored on a monthly basis. Budgets should be prepared on a geographic and department basis in order to properly assign responsibility and facilitate the management of variances.

Preparation of a formal budget and analysis of actual performance against budgeted performance should provide the following benefits to the business:

- assist in identifying under or over performance against budget
- enable timely actions to be taken where actual performance is



significantly different to forecast performance

- ensure key financial information is monitored at various levels throughout the business
- promote accountability of key individuals and departments.

Evidence of regular budget to actual analysis by the business will provide the Angel with greater comfort that the business has been actively monitored and proactively managed and that business risks are being assessed on a regular basis.

### *Self-assessment*

1. A budget is not prepared and analysis of actual results to budgeted results is not performed
2. There is a budget, but it is out-of-date, or not regularly monitored.
3. There is a summary budget, but it is not detailed enough, does not link to the business plan, does not ensure accountability of key staff/ departments and is not regularly monitored.
4. A budget exists which partly assists in monitoring actual to forecasts of the business (including accountability of key staff/departments).
5. A comprehensive budget exists which supports the formal business plan and is a major tool in the ongoing monitoring and assessment of business performance including monitoring accountability of key staff/ departments.

## **C4. Full compliance with regulatory issues (e.g. environmental, health and safety)**

The Angel should be investigating the health of the business in terms of the quality of its underlying systems. These will include all the compliance areas. These will vary from industry to industry but may include:

- tax reporting (income, payroll and sales tax (BAS, VAT, GST, etc))
- company financial reporting
- corporate governance (shareholder tracking, board minutes, etc)

- employment law reporting
- mandatory insurance
- health and safety practices and accident reporting
- environmental compliance
- industry-specific regulations.

These areas are critical in a review as they can point to weak management, lack of concern for potential exposure and the possibility of litigation and penalties. The exposure may not only be for ongoing practice, but may be retrospective in more severe cases such as environmental issues.

### *Self-assessment*

1. Compliance is not treated seriously and is inconsistently implemented.
2. The firm is concerned about compliance and has some systems in place but a comprehensive program does not exist to ensure compliance or to ensure completeness of coverage.
3. Compliance is treated seriously but is left up to individual managers and there is no system in place to ensure that all areas are covered and full compliance is occurring.
4. A full list of compliance issues exists, responsibilities are defined and some areas have reporting systems to ensure that compliance is being adhered to. Professional advice is being sought to undertake an audit in order to put a comprehensive reporting system in place.
5. Compliance reporting is comprehensive and effective and is audited by professional advisors on a periodic basis to ensure completeness and effectiveness. No outstanding or anticipated litigation exists.

## **C5. Customer relationships are managed to minimise litigation**

Litigation and potential litigation occur when aspects of the business are not conducted fairly, transparently and according to accepted standards of good conduct. It is not sufficient to hope that external and internal relations are managed well. The Angel should examine whether the firm has policies, procedures and systems in place to ensure that they are doing so.

In the case of customers, the firm needs to conduct its business so that customers clearly understand the obligations of the firm, customer expectations are clearly understood and performance to documented and implied contractual conditions is monitored. Products and services need to be fit for purpose, of merchantable quality and sold with clear explanations of intended use. The firm should be prepared to assist customers to ensure that effective intended use can be readily achieved. Failure to understand the customer's needs and intended use exposes the firm to potential complaints, wasted resources and possible litigation.

The firm should have in place fair and reasonable contracts or agreements with customers, effective complaints handling processes and monitoring systems to ensure obligations are met.

Angel investors need to be concerned about potential risks. Poor customer handling and poor internal processes suggest exposure to potential litigation, workplace unrest and/or loss of customer respect and retention. These seriously damage the company as a place to work or do business, potentially threatening the viability of the business. The Angel investor does not want to inherit problems which may distract from achieving the Angel's objectives in the investment. A firm with underlying potential litigation can severely disrupt the firm and will probably exclude it from a successful trade sale or IPO. The Angel may be better off to walk away from the investment than to take the risk.

### ***Self-assessment***

1. Special effort is not taken by the company to avoid litigation in external customer relationships. Accounts are not reviewed for current or potential problems on any systematic basis. An escalation process does not exist to deal with unresolved issues.

2. The firm acknowledges that it can do better. Staff have been advised of the implications of unresolved customer issues. A complaints system is in place.
3. A formal customer complaints system is in place with proper escalation procedures. Formal agreements exist with customers which deal with outstanding problems.
4. Professional advice has been taken on establishing formal systems of dispute resolution, complaints handling and problem escalation. Contracts have been reviewed by professional advisors. Relationship management training has been given to staff where appropriate.
5. Formal review systems are in place for all agreements with customers. The firm is proactive in dealing with customers to ensure that expectations are set correctly and are monitored on an ongoing basis. Formal complaint handling systems and dispute resolutions systems are in place with staff trained and advisors available. Professional advisors review any serious disputes and provide advice on problem resolution.

## **C6. Supplier relationships are managed to minimise litigation**

Good supplier management is essential for the efficient operations of a business. Litigation and potential litigation occur when aspects of the business are not conducted fairly, transparently and according to accepted standards of good conduct. It is not sufficient to hope that external and internal relations are managed well. The Angel needs to verify that the firm has policies, procedures and systems in place to ensure that they are doing so.

Some suppliers are more critical than others where they supply essential parts, where there are no effective substitutes or the switching costs of moving to another supplier is high. Managing supplier relationships is essential for the health and ongoing effective operation of the business. The firm should have fair and equitable agreements with suppliers and these should be industry standard wherever possible. Supplier relationships should be managed by people in the company who understand that relationships are more than simply placing purchase orders and negotiating the best price.

The firm needs to be able to demonstrate to the investor that goodwill exists in those relationships, the business values their suppliers and issues and complaints are dealt with in a timely and reasonable manner.

Angel investors are always concerned about potential risks and disruption. Poor supplier relationship management and poor internal processes to resolve problems suggest exposure to potential litigation, workplace unrest and/or potential loss of key suppliers. Failure to monitor payables and resolve disputes may also affect credit rating. No Angel likes to inherit problems which may distract them from achieving the potential in the investment. An investment in a firm with underlying potential litigation can severely disrupt both the firm as well as the Angel who may have to become involved to resolve the situation.

### *Self-assessment*

1. Special effort is not taken by the company to avoid litigation in supplier relationships. Accounts are not reviewed for current or potential problems on any systematic basis. An escalation process does not exist to deal with unresolved issues.
2. The firm acknowledges that it can do better. Staff have been advised of the implications of unresolved issues. A complaints system is in place.
3. A formal complaints system is in place with proper escalation procedures. Formal agreements exist with suppliers to deal with outstanding unmet obligations and disputes.
4. Professional advice has been taken to establish formal systems of dispute resolution, complaints handling and problem escalation. Contracts have been reviewed by professional advisors. Relationship management training has been given to staff where appropriate.
5. Formal review systems are in place for all agreements with suppliers. The firm is proactive in dealing with suppliers to ensure that expectations are set correctly and monitored on an on-going basis. Formal complaint handling systems and dispute resolution systems are in place with trained staff and advisors available. Professional advisors review any serious dispute and provide advice on problem resolution.

## **C7. Employee relationships are managed to minimise litigation**

The Angel should establish that good management practice systems and fair and reasonable workplace conditions are in place for effective employee management. Employees should understand clearly what is expected of them, be provided with opportunities to provide feedback on their experience and be given performance appraisals to ensure they understand how they are meeting expectations. Processes should be in place to deal with harassment and discrimination in the workplace. Only through effective and systematic performance monitoring and corrective action can the firm adequately deal with dismissals without creating situations which might lead to unfair dismissal claims and possible litigation.

Every business is dependent on its employee's goodwill and motivation. If the workplace conditions are not fair and reasonable at a minimum and if justice is not done and seen to be done, this creates a poor working environment. It is inevitable that the firm will go through a series of changes of management, systems and direction after the Angel investment. This is going to take a lot of goodwill and support from existing staff. An Angel doesn't wish to start off this process at a disadvantage. In addition, poor performance management processes expose the company to claims for unfair dismissal or discrimination. No Angel wants to be exposed to potential unquantifiable future litigation costs and damages. Contingency liabilities are normally the death of a future trade sale or IPO.

### *Self-assessment*

1. Special effort not is taken by the company to avoid litigation in employee relationships. Workplace issues are left to local supervisors and local management to resolve. There are no full-time or dedicated employees responsible for compliance or to assist in resolving workplace relationship issues. A systematic process does not exist to set and evaluate performance.
2. The firm acknowledges the need to introduce more formal processes. Job descriptions are in place for most of the employees and an evaluation process is used for performance review and setting pay increases.

3. Performance targets and formal reviews of achievement are in place. A member of management is responsible for compliance. Management has been briefed on workplace issues of harassment, discrimination and performance review documentation and dismissal processes. However, these are not systematically followed.
4. Formal processes exist for defining job descriptions, setting and assessing performance targets and dealing with employee workplace issues. Management has been trained on all aspects of compliance and workplace performance and dismissal processes. No external professional advice has been sought to audit the quality of the processes.
5. Systems and procedures are fully documented and audited to ensure full compliance with best practice in performance reviews, dismissal handling and workplace incident handling. The company has professional internal staff and/or external advisors to assist with any serious incident.

## **C8. Credit worthiness with suppliers is excellent**

The quality of external relationships is often an indicator of the quality and integrity of the management team and the culture of the firm. As the business grows some level of disruption to the business is likely to occur. During this period the goodwill of suppliers is going to be necessary so that additional problems don't create crisis events. By reviewing credit payment performance information and interviewing suppliers, the Angel can obtain a measure of the way in which management has dealt with issues in the past.

Few companies are able to avoid fluctuations in their cash flow. However, problems can often be mitigated by good relationships with suppliers. Suppliers who are normally paid promptly and dealt with fairly are often willing to extend additional credit for short periods during difficult times. This is especially true if the firm has dealt with them honestly and shown past behaviour of bringing situations back to prompt payment.

Those firms which keep their suppliers informed, proactively tell them about impending issues and show good management skills in correcting problems

promptly, are much more likely to be given extended credit to cover short-term situations. A review of supplier credit performance will help the Angel gain an independent measure of the quality of management and their culture and values.

### *Self-assessment*

1. The firm deals with suppliers at arms length and makes no special effort to value their relationship. The firm makes no special effort to keep in regular touch with them or to keep them abreast of business issues.
2. The firm is sensitive to dealing with suppliers and pays when possible on agreed terms. However, suppliers are only contacted when payments are already late.
3. The firm has processes for reviewing credit with suppliers and keeps them informed of any issues where extended payment may be taken. The firm has a member of management who meets with them on an informal basis when the occasion arises.
4. The firm actively informs suppliers of account status and will pay early if cash permits. Suppliers are kept informed of the level of likely business which will be placed with them. When payments have been delayed, senior management will personally contact the supplier to review the situation.
5. Professional advice has been sought on credit worthiness best practice and systems implemented. Senior management keeps suppliers informed of any payment issues well in advance and before payments are overdue.

## **C9. Banking relationships are excellent**

The quality of a firm's relationship with their bank is a very good indicator of the way in which they conduct most of their business. External relationships are often an indicator of the quality and integrity of the management team and the culture of the firm. With any significant business development, which can be expected after an injection of Angel capital, some level of disruption to business is likely to occur. During this period the goodwill of suppliers, customers and bankers is going to be necessary so that additional problems don't create crisis



events. By reviewing formal and informal contact with the bank, the Angel can determine the manner in which management has dealt with issues in the past.

Few companies are able to avoid some fluctuation in their cash flow. However, problems can often be mitigated by good relationships with suppliers and by working closely and honestly with the bank. Those firms which keep their bank informed, proactively tell them about impending issues and show good management skills in correcting problems promptly, are much more likely to be extended a line of credit or a loan from the bank to deal with short-term fluctuations. By examining how the firm has dealt with issues in the past, the Angel can gain an independent measure of the quality of management and of their culture and values.

### *Self-assessment*

1. The firm deals with its bank at arms length and makes no special effort to value the relationship. The bank is simply treated as a facility and the firm makes no special effort to keep in regular touch with the bank or to keep it abreast of business issues.
2. The firm is sensitive to dealing with its bank, however, the bank is only approached when a need arises.
3. The firm has processes for reviewing its pattern of business with its bank and keeps it informed of any issues where cash flow might be seriously affected. The firm has a relationship with a named bank officer and meets with them on an informal basis when the occasion arises.
4. Informal arrangements are in place with the bank to review business performance and banking requirements. The firm also has periodic formal meetings with the bank to review their banking arrangements and banking facilities.
5. The firm has established formal meetings with the bank on a regular basis where current and future banking requirements are reviewed. Senior management of the firm are known to the bank and informal social relationships are encouraged by the firm.

## **C10. Customer interaction, contracts and agreements are industry standard**

A firm incurs problems and costs when obligations under contracts are unclear, incomplete, harsh or generous. Risks escalate when procedures for handling disputes, complaints, claims or clarification are not clear or not followed. When customers can make claims on the company which cannot be substantiated internally, where the obligations are not clearly set out and where the terms of payments are unclear, the firm can be exposed to potential litigation, loss of resources or significant under payments.

A situation in which contracts can be customized to suit the customer becomes an administrative burden. Few firms have the processes in place to track individual contracts where obligations and terms vary from one contract to another and so the likelihood of making a mistake in this situation is very high. Problems can be greatly exacerbated if contracts are voluminous or held at a place away from where activity is being undertaken.

Angels want to see a smooth administrative operation. If the contracts are not standard or vary from contract to contract, costs increase. Risks may occur if personal undocumented knowledge is required to manage the relationship. If the person with that intimate knowledge leaves, so does the ability to handle issues which arise.

Policies for dealing with customers should be clearly set out and staff trained in the various activities which require interaction with customers. Errors are easily made where inconsistencies in processes are allowed to occur.

### ***Self-assessment***

1. Interaction, contracts and agreements with customers are informal and vary in approach, terms and conditions.
2. Staff are advised on how to deal with customers but this is not formally supervised or reviewed. Contracts and agreements with customers are mostly written but variations exist and these are not well documented. Formal sign off of customer contracts is not in place where complex projects are undertaken.

3. Staff are trained to deal with customer issues. The firm has policies in place for most customer interaction but these are out-of-date and compliance is not reviewed formally. Formal contracts and agreements are used with customers but variations are common. Variations are well documented and agreed by both parties. Formal progress monitoring is in place and sign off occurs at key stages in projects.
4. Formal policies are in place for interaction with customers and staff are trained on these. Compliance is monitored and issues dealt with promptly. Standard contracts and agreements are in place with customers and progress on long-term projects is monitored. However, steps have not been taken to ensure that contracts are industry standard and best practice for monitoring are in place.
5. Professional advice has been taken and recommendations implemented to ensure that contracts with customers are industry standard and that progress monitoring and sign off procedures are in place and being followed. Periodic audit of customer contracts and progress tracking are in place. Formal policies for dealing with customers are in force and are regularly monitored.

### **C11. Supplier contracts and agreements are industry standard**

A firm incurs problems and costs when obligations under supplier contracts are unclear, incomplete, harsh, or generous. Risks escalate when procedures for handling disputes, complaints, claims or clarification are not clear or not followed. When suppliers can make claims on the company which cannot be substantiated internally, where obligations or the terms of payments are unclear, the firm can be exposed to potential litigation, loss of resources or significant over payment.

A situation in which contracts can be customized for each supplier becomes an administrative burden. Few firms have the processes in place to track individual contracts where obligations and terms vary from one contract to another and the likelihood of making a mistake is very high. This situation is exacerbated if contracts are voluminous or held at a place away from where activity is being undertaken.

Angels are looking for efficient administrative operations. If the contracts are not standard or vary from contract to contract, smooth operations are not possible. Further risks may occur if personal undocumented knowledge is required to manage the relationship. If the person with that intimate knowledge leaves, so does the ability to handle issues which arise.

### *Self-assessment*

1. Interaction, contracts and agreements with suppliers are informal and vary in approach, terms and conditions.
2. Staff are advised on how to deal with suppliers but this is not formally supervised or reviewed. Contracts and agreements with suppliers are mostly written but variations exist and these are not well documented. Formal sign off of supplier contracts is not undertaken where complex projects are undertaken.
3. Staff are trained to deal with supplier delays, missing or incomplete orders, quality issues and relationship problems. The firm has policies in place for most supplier interaction situations but these are out-of-date and compliance is not reviewed formally. Formal contracts and agreements are used with suppliers but variations are common. Variations are well documented and agreed by both parties. Formal progress monitoring is in place and sign off occurs at key stages in projects.
4. Formal policies are in place for interaction with suppliers and staff are trained on these. Compliance is monitored and issues dealt with promptly. Standard contracts and agreements are in place with suppliers and progress on long-term projects is monitored. However, steps have not been taken to ensure that contracts are industry standard and best practices for monitoring are in place.
5. Professional advice has been taken and recommendations implemented to ensure that contracts with suppliers are industry standard and that progress monitoring and sign off procedures are in place and being followed. Periodic audit of supplier contracts and progress tracking are in place. Formal policies for dealing with suppliers are in force and are regularly monitored.

## **C12. Contracts can be assigned to an acquirer**

Companies which are expected to be sold must have the ability to assign the rights under their contracts, licenses and agreements to the new buyer. Agreements which do not allow this inhibit the ability of the new owner to operate the business. Some agreements have clauses which allow assignment only with the permission of the other party. This agreement should be obtained prior to going into an acquisition discussion.

Many agreements do not allow for assignment to a competitor. This is not an unreasonable condition if such a change could potentially harm their business. In this case, the firm needs to have a contingency plan to be able to replace that part of their business if it is critical to their operation. Where such an agreement might stop the acquisition from happening, the best action is to terminate the agreement and replace it prior to preparing to sell.

### *Self-assessment*

1. The firm is not aware of this requirement and does not know what the status of its various agreements are in this regard.
2. The firm acknowledges that this would be desirable but has not reviewed the contracts for compliance.
3. Contracts have been reviewed and those which do not allow assignment have been identified and responsibility given to an executive to renegotiate this condition.
4. Contracts have been renegotiated (where possible). The firm does not see any situation which would inhibit an acquisition. Contracts have not been reviewed by professional advisors.
5. Contracts, licences and agreements have been reviewed by professional advisors and no critical impediment remains to assignment of rights.

### **C13. Intellectual Property is able to be traded and is appropriately protected**

Intellectual property (IP) covers those knowledge assets of the company which can be sold independent of the people who created that knowledge. Knowledge in the heads of employees which is not documented cannot be sold without the employees who have it. Documented knowledge, where the ownership may be in dispute or where ownership is unclear, cannot be effectively traded. Other IP rights which are purchased and are critical to the operation of products or services, need to be able to be sold or assigned to a new owner. Any contractual impediments to the use of internal or purchased IP will seriously inhibit a firm's ability to exploit the IP and may seriously damage the potential of a sale of the business.

Many acquisitions are targeted at acquiring competitive advantage through the acquisition of firms which hold patent rights. Patents which have considerable revenue generating potential can attract litigation over ownership rights if this has not been carefully managed from the outset of a research and development project as any employee who has worked on the project could potentially claim an ownership share. The only way for the firm to protect itself from such a claim is to have employees assign all rights of any inventions, or those relevant to their workplace, to the firm. Alternatively, rights could be assigned to the firm with acknowledgement of an ownership share, this leaves the firm in a position to have full rights to exploit the patent subject to a royalty based on an agreed formula.

Another aspect of IP is that the firm must ensure the IP was adequately managed throughout the development process. IP management must ensure that IP does not infringe any other IP rights, that the IP is appropriately registered and that rights are kept current. Since many IP rights require registration in other countries, the firm needs to have documentation of the extent of the registered rights and be able to show how these may be further protected in any future acquisition negotiation.

### *Self-assessment*

1. An IP management program does not exist.
2. The firm acknowledges the importance of IP management but has no formal system to register or protect it.
3. IP management is considered important and the firm has registered various IP but the ownership trail is incomplete and may be subject to dispute by current and/or past employees.
4. Formal IP management processes are in place. Rights are registered in countries deemed appropriate for the business. Employees are required to sign over IP rights as a condition of their employment. IP acquired externally and used in the business will be able to be traded by a new owner.
5. The firm has undertaken an audit by a professional advisor and implemented systems and procedures recommendations to ensure full protection of its IP rights.

### **C14. Post acquisition changes in employment are planned for**

Detailed consideration of the organisation structure following a possible future acquisition will indicate which roles will need to change and which roles will be redundant. Rather than leave this issue for the new owner to resolve, the firm can negotiate potential changes with those employees who are likely to be affected and put in place agreements which will smooth the transition.

A future buyer will almost certainly be confronted with the need to make organisational changes. These will involve changes of management, redundancies, roles and reporting lines. Many of these changes could potentially effect compensation packages. Effecting these changes and avoiding unrest, disruption and de-motivation will be challenging. The potential for litigation is present where current conditions of employment are at odds with the new situation. An employee who feels he or she has been misled or feels constructively dismissed through the changes, may feel compelled to seek legal advice.

Managing expectations, providing acceptable options for employees who are effected and preparing staff for the likely change, is all part of preparing to sell the business. Some employees may decide to take early retirement or seek alternative employment. Others may see the change as beneficial and want to stay on. Key employees need to be retained and need to be handled carefully so that there are incentives for them to stay during a transition period. Others may need to be given incentives to leave where their roles are being changed significantly or where they are being made redundant.

In anticipation that the business will be sold in the future as part of the strategy agreed with the Angel, the firm should put in place employment conditions which will ease the path to sale and transition across to a new owner. For example, current terms and conditions of employment may include the option for the business to make the employee redundant on transfer of ownership and state the level of compensation to be paid. Alternatively, a retention bonus may be specified for key employees to encourage them to stay. Benefits may be able to be changed on sale of the business.

### *Self-assessment*

1. Attempts have not been made by the firm to implement changes in employment conditions to facilitate the future sale of the business. Discussions have not been had with employees about post acquisition roles.
2. The firm has reviewed its organisation structure and determined those positions which are likely to be changed, made redundant or are critical to the transition. Some informal discussion at management level has occurred. Formal changes have not been made to employment conditions.
3. The firm has constructed a post acquisition scenario and identified employees who will be affected. Retirement, redundancy and key employee incentives have been constructed. Employment conditions have been changed to reflect the possible future sale of the business.
4. Key employee conditions have been discussed with key staff and as a result their conditions of employment have been changed to incorporate a retention bonus. A termination package has been incorporated into all



employment agreements to cater for redundancies. Bonus, commission, profit schemes and share purchase arrangements have all been modified to lapse on change of ownership. Professional advice has been sought on the arrangements.

5. Changes and incentives necessary to ensure a smooth changeover to a new owner have been reviewed by a professional advisor and fully implemented.

### **C15. Employment conditions, salaries and benefits are industry standard**

Following any future acquisition of the investee firm, employees of the acquired firm will normally be integrated into the employment, health benefits and bonus systems of the parent company. When this happens, any deviations between the two schemes will have to be resolved. This is normally a time of considerable change in the acquired firm with employees fearful of their jobs. The less change that is imposed, the smoother this transition will be.

Where remuneration systems are industry standard, few problems tend to arise. Staff are neither paid too much nor too little. If the health insurance is standard and bonuses are in line with industry standards, these can normally be continued or transferred. However, if (say) vacation entitlements are overly generous, this can create problems where they need to be curtailed or need to be continued alongside fellow employees who receive less.

#### *Self-assessment*

1. Little or no effort has been made to ensure employment conditions are industry standard.
2. The firm has no formal process for setting pay scales or for performance evaluation. They believe they are paying reasonable levels to attract and retain employees.
3. The firm recruits employees at competitive rates but internal procedures for advancement are not checked with industry norms.
4. The firm is familiar with remuneration in their industry and tries to follow industry norms. An external review has not been made of their practices.

5. The company uses an outside firm of specialists to assist in setting pay scales and conditions of employment.

### **C16. Option schemes and benefits are compliant with stock exchange regulations**

Many smaller firms offer incentives to attract and retain key employees. These include options, share purchase schemes, bonuses, share allocation and so on. Often these deals are done privately between the owner and the new employee. Sometimes advice is not sought on the long-term implications of these schemes on a possible sale of the firm.

Share purchase schemes and option schemes have attracted attention by both the financial reporting agencies and tax authorities around the world and so there normally exists a vast body of regulations governing these schemes. While a scheme might be legal and even appropriate for a small unlisted firm, the same scheme might be non-compliant for a listed company. Since most acquisitions are by listed companies, this can be a real problem for a future sale of the firm to a listed corporation. An employee will not be happy losing benefits and may well resist any such change if they have a contract in place which protects their benefits.

#### *Self-assessment*

1. Little or no effort has been made to ensure option schemes and benefits are compliant with stock exchange requirements.
2. The firm is familiar with the need to have compliant schemes but has made no effort to have their own schemes checked for compliance.
3. The firm has sought professional advice to check the degree of compliance of their schemes and to advise of changes which may be necessary.
4. The firm is implementing changes to their schemes to bring them into compliance.
5. Option and benefit schemes are compliant with stock exchange requirements.

## **C17. Due diligence files are complete and up-to-date**

The purpose of due diligence is to check the health of the firm and to identify any potential risks. It also checks that the information provided by the firm is complete and accurate. Checks will include:

- supplier and customer contracts
- licences, patents, trademarks and IP management systems
- leases, distribution agreements and hire-purchase agreements
- employment contracts, health insurance and bonus systems
- complaints processing, dismissal processes and warranty systems
- quality control systems
- financial reporting systems, aged debtors and aged creditors
- reference checks with customers, suppliers and professional advisors
- background checks on key executives
- R&D, manufacturing and distribution processes
- banking relationships and loan conditions
- shareholder agreements, option schemes and share-purchase schemes.

The information required for a due diligence investigation is extensive and very time consuming to collect and collate. Often there are documents missing or incomplete. However, it is through this process that the Angel will uncover internal and external risks which can cause problems with their investment and may create problems in a later trade sale or IPO. A check of the documents themselves can often be a long and exhaustive process. Every contract, lease and agreement is sometimes checked to ensure that it does not overly expose the investor or acquirer. To the extent that professional advice from industry-knowledgeable legal and accounting firms has been used, this process can be dramatically shortened. Sometimes only a sample needs to be reviewed.

### *Self-assessment*

1. The firm is not conversant with a due diligence process and preparations have not been made.

2. The firm is aware of the requirements of a due diligence process but does not have internal policies to ensure that records are complete and up-to-date.
3. The firm has a policy of maintaining complete and up-to-date files but has not had this process audited or checked compliance with this policy.
4. A professional audit of the accuracy and completeness of records has been conducted and recommendations are being implemented.
5. A complete and up-to-date file has been assembled to enable a full due diligence audit to be undertaken.

## Operations Development Index

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A		
1	2	3	4	5			
Item	Attribute	1	2	3	4	5	N.A
C1	Monthly financial and key performance indicator reporting exists						
C2	A formal business plan has been prepared and is updated periodically						
C3	A formal budget is prepared and actual performance is monitored against budget						
C4	Full compliance with regulatory issues (eg. environmental, health and safety)						
C5	Customer relationships are managed to minimize litigation						
C6	Supplier relationships are managed to minimize litigation						
C7	Employee relationships are managed to minimize litigation						
C8	Credit worthiness with suppliers is excellent						
C9	Banking relationships are excellent						
C10	Customer interaction, contracts and agreements are industry standard						
C11	Supplier contracts and agreements are industry standard						
C12	Contracts can be assigned to an acquirer						
C13	Intellectual property is able to be traded and is appropriately protected						
C14	Post acquisition changes in employment are planned for						

### Operations Development Index (Cont.)

Nothing done	Little progress	Reasonable progress	Significant progress	Fully attained	N.A		
1	2	3	4	5			
Item	Attribute	1	2	3	4	5	N.A
C15	Employment conditions, salaries and benefits are industry standard						
C16	Option schemes and benefits are compliant with stock exchange regulations						
C17	Due diligence files are complete and up-to-date						