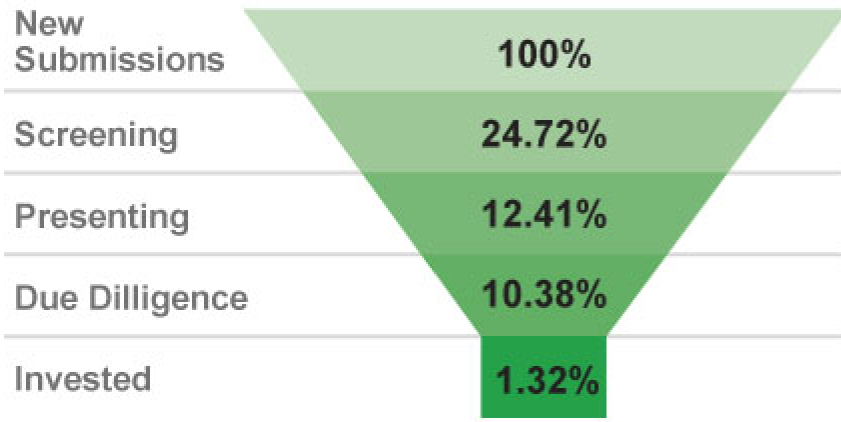
TOUCHED BY AN ANGEL

By Martin C. Zwilling, Startup Professionals, Inc.

Every new startup I know dreams of being touched by an Angel investor. Yet according to the latest data from AngelSoft, only about 1 out of 100 companies who initiate the formal request process actually get funded.

2008 Deal Funnel



What this chart indicates is that 75% of the interested companies never make it past the initial screening process. More than half of the remaining group are eliminated during live presentations and discussions, and another 10% are eliminated during due diligence.

What is this daunting process, and what can you do to optimize your chances of surviving it? Over the past 10 years, I have had the opportunity to see how the process works, several times from the startup side, and more recently from the Angel perspective (as a member of an Angel group Selection Committee).

Before you can understand how to make the process work for you, you need to understand a couple of even more basic questions – Who are Angel investors, and what do Angels really want?

Angels are typically high net-worth individuals who invest their own funds, unlike venture capitalists, who manage the pooled money of others in a professionally-managed fund. Angel investors are usually interested in investing for reasons that go beyond pure monetary return. These include the satisfaction of keeping abreast of current developments in a particular business arena, mentoring another generation of entrepreneurs, and making a positive impact through their experience and networks on a less-than-full-time basis.

They are most often the right alternative (or the only alternative) when the amount sought is beyond friends and family, but too low (generally $250K-$750K) for the venture fund radar, or the entity is too early-stage to attract even the early stage venture funds in the region. Yet Angels still expect progress well beyond the idea stage, meaning at least a prototype product developed, one or more customers, a management team in place, with evidence that the opportunity is there and the business model can work.

What they really want is to contribute to the success of an emerging company with all the right attributes, along the following priority lines:

- The management team is strong, balanced, and experienced.
- The market the company serves is already large and has great growth potential.
- The technology/product/service meets a compelling need in the marketplace.
- The company seems to have a defensible competitive advantage.
- The business plan is complete and executable by the management team.
- The valuation for investment purposes is reasonable and defensible.
- The potential rate of return is exciting.

Notice that your new product or technology is important, but is ranked lower in priority than the credentials of the management team, and the potential of the market served. In my experience, this is the most frequent disconnect between entrepreneurs and potential investors, whether they be Angels or Venture Capitalists.

So what should you do to prepare for this stage in your venture, and optimize your chances of making it through the process? Here is my list of <u>Ten Top Action Items</u> to best prepare you for success in achieving a funding event with Angels:

1. <u>Incorporate the business and finalize your plan</u>

   If you expect to require external funding, you should plan to incorporate as an S-Corp, C-Corp, or LLC, rather than the more expeditious sole proprietorship or partnership. The corporate entity lends itself best to the concept of "sharing" equity required by investors.

   Another point I am making here is that your startup should be beyond the "idea" stage before you initiate serious discussions with Angels. Before you have even registered your business, it's unlikely that you will be able to adequately address any or all of the priorities listed earlier, so don't jump the gun with investors. Remember there are generally no second chances, so you will only have one chance to make your best impression.

   Unless you know a candidate investor well, it is generally not a good strategy to use that investor as an early advisor on the basics of setting up your startup. There are many other professionals and consultants who can help you with specifics, and keep your credibility intact with the Angels you plan to approach later.

2. <u>Line up an experienced team of founders, executives, and advisors</u>

   Remember the old adage that "investors fund people, not ideas." That's why this item is so important, and is probably the biggest stumbling block I see in getting through the initial Angel screening.

   It is people that make companies successful, and people who have done it before, especially if they have special knowledge in your product area (domain knowledge), are worth their weight in gold.

   Of course, you also don't want your startup to be perceived as "top heavy." What I recommend is a Founder (CEO), financial person (CFO), and marketing/sales executive (VP Marketing), and perhaps two Advisory Board members with domain knowledge and operating experience. Investors understand that these positions may be part-time, and will likely be for no salary prior to a funding event. Yet you must show that all named executives and advisors are active players in your company, rather than just figureheads.

   If the company and product are your idea, but you have never run a company, you should recognize that it will be apparent to investors that the founder may not be the future CEO. A founder should admit this point up front and show that he or she is most interested in the company's success other than his or her power (maybe claim the CTO or Chief Creative Officer position).

3. <u>Reserve your Internet domain name and roll out a web site</u>

   In today's world, if you don't have a web site up and running, you will not be perceived as a real company. Investors routinely go to candidate web sites to get a feel for the tone and scope of the company, as well as its maturity and offerings.

   Your web site is essentially your "store front" to the world of customers and investors, so it should be done professionally and non-trivial in size and content (at least 8-10 screens). It should also show your brand and your logo, which investors and customers will compare with those of competing companies and web sites.

   Early on, as you pick a company name that is available, you need to make sure that the comparable Internet domain name is also available. Incorporating the company will reserve the name for legal purposes, the Internet domain name has to be separately reserved. Other key words and phrases need to be trademarked before they can be pitched to investors as a competitive advantage or "barrier to entry" for competitors.

4. File a patent and trademarks to define and protect your intellectual property

   Having a defensible competitive advance or “barrier to entry” is another critical step to funding, and another common stumbling block during all phases of the funding process.

   First, don’t make the mistake of asserting that your product is so good that you have no competition – savvy investors will quickly conclude that you either haven’t done the work to find them, or there is no market for your offering. Customers can always find alternatives to buying your product.

   Second, if you have some technology or process that you intend to patent, you must file the patent before you disclose it to investors, or your patent applications will be rejected due to early public disclosure. A provisional patent requires less work and cost, and will hold your patent position for one year, where that is appropriate. Trademarks are even less work, and are well worth the effort.

5. Build a prototype product that you can demonstrate

   A frustrating conundrum for many entrepreneurs is that they need money from investors to design and build a prototype product, yet most Angel investors expect to see at least a prototype before they invest.

   The solution for many successful entrepreneurs is to use personal funds, or investments from friends and family, to get to this stage. Having a product already developed will dramatically improve your “first impression” with Angels for these reasons:
   - It shows you already have proof of concept
   - It shows your commitment and bolsters your personal credibility
   - Angels like to see that the Founder has personal “skin in the game”

6. Find that initial customer who is willing to pay real money for your product or service

   This is really an even stronger extension of the previous point. All the conviction and market research in the world are no substitute for real customers paying real money. This is called “validating the business model.”

   Every investor I know has felt the inflated optimism of some new business founders, which is often characterized by the line from an old movie “if we build it, they will come.” The Angel community wants to see that you have a real strategy and plan for marketing and sales, they want to see that your prices appear to be realistic, and that your team is actually ready and able to execute on that plan.

7. Build an Executive Presentation and Executive Summary

All most Angels want to see for their initial screening is a one or two page Executive Summary sheet, similar to the "glossy" marketing collateral sheets that most companies prepare for new product announcements to customers. Remember to aim the content of this summary at investors, not customers. It must contain your "elevator pitch" to investors, as well as key points from the Executive Presentation, the Business Plan, and the Financial Model.

Right or wrong, a large percentage of funding requests are eliminated here, based solely on the content and quality of this summary sheet, so make sure it captures the Angel's imagination.

If you pass this first step in the process, you will be given the time and opportunity to review your Executive Presentation with one or more Angels to get their interest to the next level. As always, remember that Angels, like all professionals, have a short attention span and little appetite for long meetings and long presentations. Once you get access, the presentation must look professional, be crisp, carefully rehearsed and must provide explicit reasons why the Angels should be motivated to invest.

I recommend about 10-12 PowerPoint slides for the presentation, with no fancy videos or long demos, with a time budget of no longer than 20 minutes. Remember that this is not a product pitch, but a new business investment pitch. The first chart should highlight the problem or opportunity you are addressing, followed by only a single slide on your solution. That leaves the remainder of the time and slides for highlighting the team, competition, marketing/sales strategies, timeline/checkpoints, financial projections, exit strategy, and what's in it for investors.

Many investment professionals recommend that the Executive Presentation be distilled from the total Business Plan, but I actually recommend the reverse. I believe it is more effective to first build and hone an Executive Presentation, making sure your whole team is comfortable with it, and then flesh it out by building the Business Plan from it.

8. Document the Business Plan

Every entrepreneur and new business should document their Business Plan, whether they intend to seek investor funding or not. As a Founder, you may think that everyone understands your vision and plan from your passion and words, but it doesn't work that way. Write it down, so that even your most intimate business associates, as well as interested investors, have no confusion on the roadmap ahead.

A good and comprehensive Business Plan can be done in about 25 pages, certainly no more than 50. Make sure it covers in more detail all the items summarized in the Executive Presentation, and includes a table of contents and a dated cover page. In my experience, investors expect to find the most content here on the market opportunity analysis, competitive strengths and weaknesses, and an overview of the financial projections for the next five years.

The Business Plan gets the most attention for Angels once you have captured their attention with the Executive Presentation, and the Angel begins the due-diligence phase. At this point, it is critical that the details match in all documents and presentations, and that all the members of your team be able to communicate the same vision and plan, when interviewed during the due-diligence process.

9. <u>Finalize your Financial Model</u>

   Like the Business Plan, a Financial Model is required as much for your own use as to impress Angel investors. In most cases, an interactive Microsoft Excel spreadsheet is adequate, with projection formulas for revenue, costs, and cash flow over the next five years.

   Angels are quickly turned off by either very conservative or overinflated financial projections. Remember that these are professionals who typically have real world experience and domain knowledge in the business area you are stepping into, so do your homework and be realistic. They are looking for aggressive and optimistic entrepreneurs who believe they have found a market opportunity with real growth potential, and have an executable plan to get there.

   The financial model is also the key to setting the business valuation. There is nothing more frustrating than to see a good business model die because the founders positioned the company with a valuation that was too high and ultimately was not funded. Valuation of early stage companies is at best an “art,” but it is certainly not a science, and general rules should not be the sole valuation criteria. Basically, the value of a company is what anyone would be willing to pay for it, based on your progress and future outlook.

10. <u>Network to the maximum with investors and investor connections</u>

   The last and possibly most important action item I can leave you with is to build relationships with investors and friends of investors BEFORE you need their help in building your company. Remember that Angels, who are not usually professional investors, tend to invest in people more than they invest in ideas.

   Networking here works just like career networking, with suggestions like taking an active role in relevant technology groups, trade associations, university activities, and local business groups. If you are never seen in a leadership role in any context involving people as well as technology, it is highly unlikely that any Angel investor will be convinced to bet his hard-earned savings on your high risk plan to build a new and successful business.

In summary, being touched by an Angel can lead you to your dreams of a new and successful business, but it doesn't often happen without planning, hard work, many pitches. Don't expect anyone to swoop down and wave a magic wand.

Most Angel investors are seeking psychic as well as financial benefit from their investment. Many Angel investors are wealthy and could realize as good a return (on a risk/return basis) through other types of investments. Even the most professional private investor is seeking to at least stay informed and share in the "highs" of the growth of your new company. A good entrepreneur will be sensitive to this in both the courting process and after the investment has been made.

An Angel may be more willing to take risks with an emerging venture without a proven record. For an Angel, a failed venture may only mean a loss of capital, whereas a failure for a venture fund may affect its ability to attract future investors. Angels may also push less in the negotiating phase since it might affect the future working relationship. Remember, an Angel investment is not an adversarial process, but a process to set a win-win situation for both the investor and the company.

About the author

Martin C. Zwilling is the Founder and CEO of Startup Professionals, a Phoenix based company which offers startups a range of offerings and consulting services. He is a member of the Arizona Angels group, where he serves on the Selection Committee. He is a mentor to startups through the Arizona State University Technopolis program, and has done guest lectures on entrepreneurship in their MBA program. He is also on the Board of a half-dozen startups, and has an extensive technology background with IBM and other large and small companies. He may be contacted directly at marty@startupprofessionals.com *.*