
Best Practice Guidance for Angel Groups – Deal Structure and Negotiation

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Structuring the deal is a key aspect of completing an angel round of financing. It is critical to ensuring that management, employees, past investors, current investors and future investors are all satisfied with the company under its new capital structure. As a result, negotiating and structuring the deal can be the most complex aspects of angel investing.

“Often times the best negotiated deal is the deal in which each party feels like they could have done a bit better – or simply put, nobody got everything they wanted.” – James Geshwiler of CommonAngels

Valuation

Angel investing groups generally aim to take 20 to 50 percent ownership stake of early-stage companies. Therefore, structuring the deal and negotiating the terms begin with the valuation of the company. The valuation of a company represents its price tag, wherein the pre-money valuation is the value of the business before it receives investor funds and the post-money valuation incorporates the amount of investor funds raised. For instance, a company has a pre-money valuation of \$2.5 million, then it receives an angel round investment of \$0.75 million to result in a post-money valuation of \$3.25 million.

Typically angel investor groups look for less than \$5 million pre-money valuation and as low as \$500,000; however the investment range varies by groups. Many times the different investment opportunities available to the investors at a given time are taken into consideration. That is, all other factors equal, \$500,000 invested on a pre-money of \$1.5 million is a more attractive percentage ownership for an investor than \$500,000 invested on a pre-money of \$3.5 million.

“We have to be careful of valuations that are too high because if there’s too much dilution, then we won’t make money. We also look at the type of capital requirements of a company. The semiconductor and pharmaceutical sectors are almost impossible to do low cost development. They require huge amounts of capital unless the company gets lucky and gets bought out at an early stage. So it almost never makes sense to invest at the angel level. Clean technology is also capital intensive so also hard to invest in. Software and services are less capital intensive.” – John May of New Vantage Group

The angel investors will often feel that the valuation of a company is less than what the entrepreneur has proposed. However, investors will work with the entrepreneurs' financial projections and use various valuation methods to arrive at a valuation. Such valuation methods include transactional value, market value, and return as a multiple of investment. The valuation methodology most frequently used is backing into it from the exit value. For example, if the company is expected to be worth \$50 million in five years, the company needs to raise a single \$1 million round to reach that valuation, and the investors will require a 10X cash-on-cash return upon exit, the investors' share must be worth \$10 million in five years. Thus, the investors would need to own 20 percent of the company, which implies a \$4 million pre-money valuation and \$5 million post-money valuation. (Note: this presumes no further dilutive capital is needed.)

"The discounted cash flow method is difficult to use when there are little to no cash flows," – Catherine Mott of BlueTree Allied Angels.

"Factors that affect valuation include management experience, the size of the opportunity/addressable market, size of the round, intellectual property or other barriers to entry, need for future rounds, industry comparables and exit opportunities," – Stephanie Hanbury-Brown of Golden Seeds.

It is common to see angel investors take the next round of financing into consideration when the valuation is determined. The angel investor will calculate the valuation as a discount to the valuation of the next round of financing, whereby it may be a fixed percentage or a sliding scale based on the next round of financing.

"Put down a small amount of money at first; invest more in each new round." – John May of New Vantage Group

"With pre-money valuation, lower is better so that the company can meet milestones to increase the next rounds' valuation." – Bill Moore of LORE Associates

Taking into consideration future rounds of financing allows angel investors to account for such factors as the time that elapsed to the next round of financing or whether milestones were achieved prior to the next round of financing. With staged pay-ins such as milestone payments, however, the milestone achievements should be easily and objectively assessable. Also, keep in mind, what should happen if adverse events occur to the company even though the milestones are achieved.

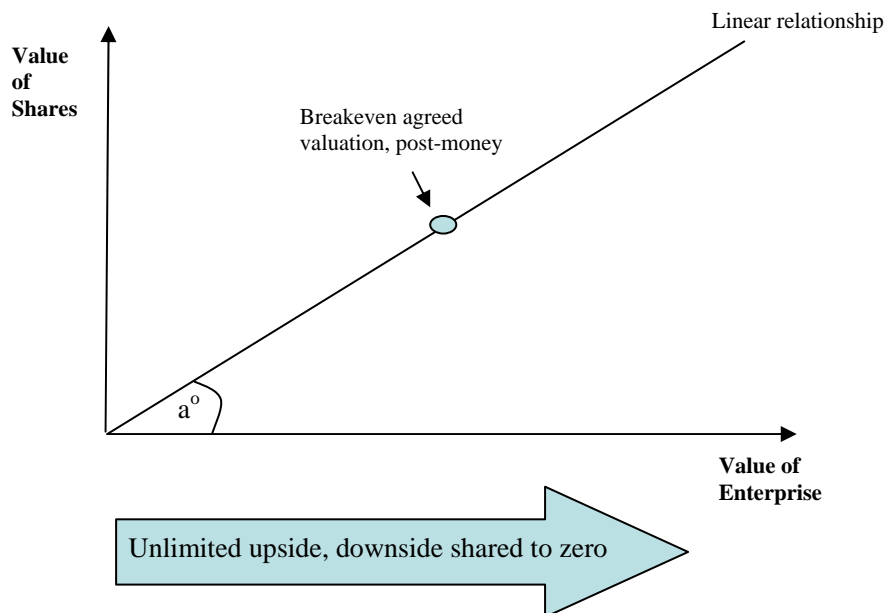
"How knowledgeable, experienced, flexible and, dare say, desperate, the entrepreneur is can be quickly assessed from how flexible the entrepreneur is to negotiating the valuation." – Tom Jones of BlueTree Allied Angels

The valuation of a company is a critical component to whether the deal occurs or not. How the entrepreneur approaches the valuation is very revealing about the management and can make or break the deal. The tone of the relationship between the angel investors and the entrepreneurs is frequently established early on and if there is no mutual consent to the valuation then there is slim likelihood that a deal will proceed.

Structuring the Deal

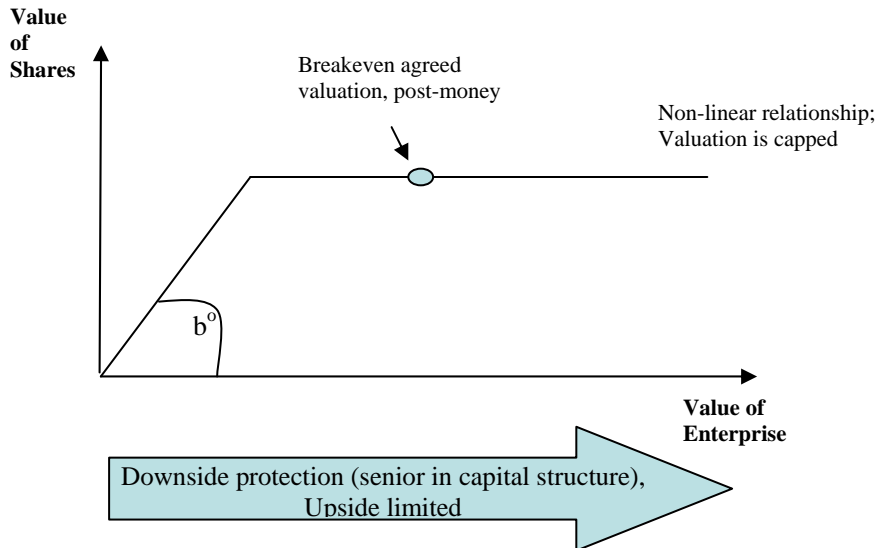
Part of structuring the deal entails defining the ownership. Equity ownership structures commonly used are common stock, preferred stock, participating preferred stock, and convertible notes. Preferred stock is distinguished from common stock when the company goes bankrupt or undergoes liquidation. Then the preferred stock holders have priority in getting their invested capital back, along with any unpaid dividends (known as a preferred return), before the common stock holders receive any distributions. In contrast to preferred stockholders, participating preferred stockholders will be repaid their original investment plus any unpaid dividends upon liquidation, and then share in the remaining assets as if they held common stock. Thus, the participating preferred stockholders still earn a return, even if common stockholders realize little or no return.

Common Shares

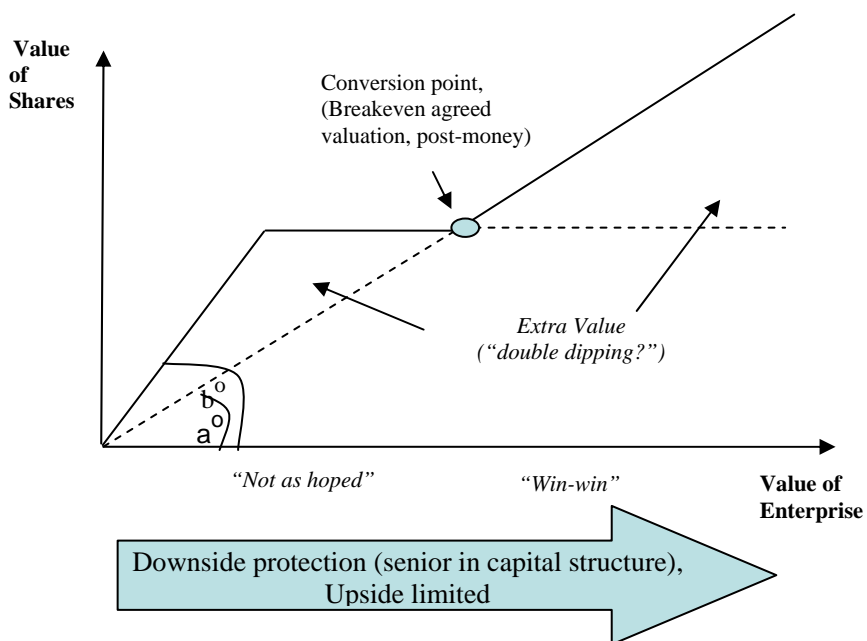


Convertible preferred shares are able to be converted to common shares at a predefined conversion rate. They perform like a note by providing downside protection for the investor because they have preferred status, and the option to convert to common stock provides upside. The strike price is the exercise price of the conversion privilege. In the event of an IPO or the sale of the Company, returns on convertible preferred can be quite attractive. However, large quantities of convertible preferred issued at a low strike price can be highly dilutive to follow on investors in later rounds. In many cases, the notes will be structured in a manner to allow the notes to convert at a discount to the next round. This also enables entrepreneurs to raise money at a very early stage without having to establish a specific valuation when the Company's prospects are unclear.

Preferred Shares



Convertible Participating Preferred Shares



In contrast to convertible preferred, participating preferred sees a return of capital invested, accrued dividends, and participates in the upside through conversion into common stock. However, many entrepreneurs see participating preferred as “double dipping” because if the

stock is liquidated, then the participating preferred stockholders will be repaid their money as well as any unpaid dividends, then get to share in the remaining common stock. In the case of an exit at a low valuation, the participating preferred stockholders would realize a return on their investment whereas the common stockholders get little to no return. (NOTE: this is applicable if the founders have not invested cash money.)

Convertible Notes

In contrast to all of these, Convertible Notes are debt instruments and are preferred by some angel investors and entrepreneurs. Typically convertible notes contain the right to convert into equity upon the occurrence or non-occurrence of specified events (specified event is usually the raising of a minimum specified amount of equity at a minimum value).

Convertible Notes come in many forms, but when properly structured, provide all of the advantages of both debt and equity. Such notes generally are issued for either a fixed rate or variable rate of conversion. Fixed notes carry the same rate for their duration, normally 1 to 2 years; convertible notes usually carry a set rate for some period, typically 6 to 9 months, and then increase the rate monthly or quarterly until the due date. For example, such a note might carry a 20% rate for the first 9 months, and then increase 5% per quarter up to a 30% maximum.

Conversion rates can range from 15% to 50% and can be structured as “discount” to the following priced equity round or as a “premium” with warrants to purchase a additional shares. For example, a note can carry a discount of 30% (i.e., the holder gets to purchase 130 shares for the price of 100), or a separately exercisable warrant to purchase an additional 30% of shares (typically, at a nominal price per share). There are advantages and disadvantages to both methods, but in practice, the discount method is generally preferred since several years of post investment activity often presents significant logistical or administrative issues for exercising warrants.

NOTE: If the conversion rates are on the high end, venture capital or later investors might be dissuaded from accepting such a premium. This can become problematic as it makes the company less attractive on the next round of finance. The optimal rate is one which provides a reasonable premium for the risk taken, but which is not so onerous as to discourage follow-on investors.

Alan May of Life Science Angels in Menlo Park, CA states the following: *“The principal advantages of convertible debt to the entrepreneur and startup are (1) the avoidance of setting a pre-money value by angel investors and, (2) the raising of money via an initially non-dilutive instrumentthe Note is carried as debt on the balance sheet. Many venture and professional investors feel that angels are not sufficiently experienced to price early stage rounds and do not want to be in a position of investing at a “down round” to the angel set value. As such, they prefer maintaining the right to set the initial price and allow the earlier investors to convert into that price with their premium, so long as the premium is considered reasonable and proportionate to the risk taken. For the investor, a properly structured convertible note can carry all of the downside protections of debt and all of the upside protections of equity. The*

Note can be secured by the intellectual property of the company, which often is the only asset a startup company possesses besides management.”

Corporate Structures

Common corporate structures include S-Corporation (“S-Corp”), C-Corporation (“C-Corp”), and Limited Liability Corporation (“LLC”). An S-Corp cannot have more than 100 shareholders (and generally has 35 or fewer shareholders) and pays no corporate income taxes on its profits. There is only one class of stock in an S-Corp. Note: Sub S Corps cannot have LLCs as investors, so angel funds that are LLCs cannot invest in a Sub S Corp. Similar to a partnership, the shareholders in the S-Corp pay income taxes on their respective shares of the S-Corp’s profits. In contrast to an S-corp, a C-Corp does not have any restrictions on the number of shareholders or class of stocks. Furthermore, the income of a C-Corp is taxed under Federal income tax laws.

A LLC is a business company offering limited liability to its owners. This means that the owners of the LLC are protected from liability for acts and debts of the LLC. It is similar to a C-Corp in that an LLC is often a more flexible form of ownership, and typically appropriate for smaller companies with a limited number of owners. A LLC with multiple owners is typically treated as a partnership for tax purposes, whereby the profits and deductions proportionate to each member’s ownership are reported on that owner’s tax return. An advantage for an LLC is that there is no loss of power to a board of managers. Furthermore, in the event that there is an illness or even death of the owner(s), similar to any corporation an LLC will carry on and avoid complicated business termination of sole proprietor death.

Negotiating the Deal

“Angel group deals have become more structured. What angel groups are doing now is very similar to what VCs were doing five years ago. Angel group deals are just as airtight and professional as VC deals.” – Paul Sciabica of New York Angels

The key aspects that underpin negotiating the deal include reduction of risk, amount of control, and provisions for liquidity.

“When structuring the term sheet in a deal negotiation, various terms and conditions have different priority. What’s always important to remember is that percent ownership does not mean percent control.” – Stephanie Hanbury-Brown of Golden Seeds

“As a group of investors, there is enough power to negotiate good terms. A balanced term sheet is best – some things for the investor and some things for the entrepreneur. And take care of your friends. If venture capitalists think they will invest with angel investors, they won’t upset them. An angel group can be a steady source of good deals to the venture capitalists, so the venture capitalists know he/she must be nice.” – John May of New Vantage Group

It is important to consult an attorney during the negotiation process, but one must try to be cognizant of all the options and risks before you start accumulating legal fees.

“Some angel groups prefer to get the terms of the deal fully negotiated with the entrepreneur before they bring in the attorney... Many times a fixed amount for the attorney fees is agreed upon with the attorney before the attorney steps in – this is usually in the ballpark of \$20,000.” – Stephanie Hanbury-Brown of Golden Seeds.

The terms and conditions commonly considered in an angel investors group’s term sheet:

Liquidity

Dividend:	Dividend rate at an agreed %, cumulative
Registration Rights:	Two demand, unlimited piggyback, one S-3 per year. All rights terminate 5 years after IPO.
Co-sale agreements:	Provision to include investor shares on a <i>pro rata</i> bases in a private sale of founder shares. All rights terminate upon an IPO.

Risk

Liquidation Preference:	In sale or liquidation of the company, founders have first risk of loss while investors recapture their investment and minimum return ahead of founders. Non-participating Preferred (Return capital to Series A, then remaining proceeds to Common); provided that if the Company grants participating rights to next round of investors, then Series A will be revised to include similar rights; participating preference (“double dip”).
Conversion:	Autoconversion on IPO at 5x purchase price with offering size of at least \$10,000,000; permissive Conversion at any time.
Anti-dilution:	In a down round, founders have disproportionate share of dilution and conversion ratio of preferred adjusted or issue more shares to preferred. Stock splits and price based anti-dilution on a weighted average basis. “Ratchet” to adjust price of old investors to new round, however less common.
Right of First Refusal:	Major investors get right to maintain ownership percentage on future financing.
Drag-along rights:	If holders of 50% of the Preferred approve a proposed sale of the Company, then other involved parties will agree to approve the proposed sale. All rights terminate upon an IPO.
Key person life insurance:	The Company will obtain and maintain a “key person” life insurance policy on essential Company person in case of incapacitation of that person.

Control

Voting Rights:	Preferred vote with Common, except as required by Law. Other protective provisions may be included.
Directors:	Series A elects one director, Common elects one director, all others elected by Common and Preferred voting together.
Information Rights:	Monthly or Quarterly Internal Statements– and annual reviewed or audited statements
Vesting of founders shares:	Shares and options of founders subject to 4-year vesting with 25% vesting on first anniversary and remaining vested over scheduled vesting rate thereafter.
Vesting of employee shares:	Usually same as founder, plus the company will have right, upon termination of services, to repurchase any unvested shares.

Capitalization

“Numbers are numbers. No such thing as accurate numbers in a capitalization table. The table is a reflection of the legal structure of the company, options granting, warrants, fundraising, etc.” – David S. Rose of New York Angels.

An integral part of deal negotiation involves examining the capitalization table for the company. Capitalization is the total amount of a company’s outstanding securities such as common stock, preferred stock, stock options and restricted stock, warrants, convertible securities and shares reserved for issuance under company option plans. For purposes of display in a registration statement, the capitalization table presents the capital structure of the company, both prior to the offering and assuming that all securities offered are sold. The components of the capitalization table typically reflect:

- Number of shares
- Ownership percentage
- Security structure type
 - Common vs. Preferred
 - Warrant/Options (e.g. convertibles)
 - Dividends
- Debt Financing

It is important for the entrepreneur and angel investors to understand the anticipated capitalization and pricing. It is also useful to provide pro-forma capitalization information. For later financing rounds this information should also take into account the effect of any anti-dilution provisions of prior stock issuances.

Typical Securities Distribution of Early Stage Companies

Lenders get ...	Warrants
Angels/Venture/strategic investors get ...	Preferred Stock
Key hires/employees get ...	Restricted stock/options
Founders get ...	Common Stock

“A management team carve out is important to negotiate the employee options pool in advance to ensure that there is equity compensation for future hiring. Also, option pools and vesting are important ways to keep the management team motivated.” – Carol Sands of The Angels’ Forum

Warning Bells

There are some red flags that investors should watch out for. Are there any unknown investors? Is the term sheet too complicated or inappropriate for the nature, context and stage of the company? Is the company raising enough money? What’s the possibility of dilution?

Red Flags in Deal Negotiation

Entrepreneur

- Under financing
- Impossible milestones
- Limitations of syndication
- Corporate strategic investor?

Investor

- Lack of downside protection
- Non-willingness to report
- Weak board composition & poor approval requirements for board membership
- Corporate strategic investor?

With regard to ensure that there are no unknown investors: *“The SEC requires investors to be listed, accredited investors. The investors are sent a questionnaire in which they self certify.”* – David S. Rose of New York Angels

It is critical that the size of each financing round will enable achieving significant milestones in order to justify selling the next round at a heightened valuation (i.e. an “up round.”)

“What’s the burn rate and is the company raising enough money to make it to the milestones for the next round? Where will this round of financing get the company to? Will it be something measurable to justify a higher valuation in the next round?” – Bill Moore of LORE Associates

Angel investors worry about dilution when the company is low on cash and may have to raise additional financing in a “down round”, or reduced valuation round of financing. Dilution is a reduction in a shareholder's relative ownership percentage of a company as a result of the company’s issuance of more shares, which will generally occur in the VC round. The entrepreneur, early investors and angel investors are invited to participate, but they may not have

the money to invest since it is already tied up in the company. Thus, the entrepreneur and angel investors are subject to being “crammed down” and diluted through the subsequent purchase of stock at valuations that are close to or less than the initial purchase price, which can cause their percentage interest in the company can be reduced significantly. John Huston of Ohio Tech Angels Fund states, “Of course, the angels’ best protection against a “down round” is to have adequate dry powder to preclude the need to seek new outside investors”.

“Ultimately investors care more about whether the value of the stock has changed more than whether or not their percent ownership has changed.” – Stephanie Hanbury-Brown of Golden Seeds

These circumstances can put an angel investors’ equity stake at risk. In order to avoid these situations, it helps to get to know the Company’s advisors. A company needs good advisors who are experienced and can help navigate these pitfalls.

Exit Strategies

“Typically look for an exit through a sale of the company, a merger or to take it public.”
– Stephanie Hanbury-Brown of Golden Seeds.

Context and Reality of Exits

- Distributions and calls on capital
- Control of company passes:
 - To buyer in a merger
 - To management in IPOs
- When to sell out and get out:
 - Waiting to see further growth in company
 - Fixing IRRs

Exits for investors can occur when there is still further growth to occur in the company or the investors are ready to realize a return on their investment. Exiting an investment can result in the transfer of control to another party. In the instance of a merger or a sale, the buyer assumes control. When a company is exited through an IPO, the management takes control. The reality is that roughly 85 percent of exits are through mergers and acquisitions. IPOs are glamorous and receive much media coverage, but mergers and acquisitions generate the bulk of angels’ returns.

Finally, it is important to be aware that potential exit strategies affect the way a deal is structured. For example, if an entrepreneur does not pay enough attention to the possibility of a low exit valuation and concedes many participating preferred terms in the deal terms, then the entrepreneur may get little return upon exit. Therefore, this underscores the point that the best negotiated deals are the deals in which the terms between each party are balanced, the investors and the entrepreneurs understand one another, and each party made concessions.

Take-Home Lessons

*“Angel investing is a learned profession. It takes 18-24 months for an investor to simply experience a normal cycle of angel investing. At that point, investors start to see their losses. In their enthusiasm, they may have over invested. Then they suddenly say, ‘Why am I doing this?’ They are **now** ready to make investments but they usually get out, unfortunately.*

Some simple advice is to start off with really small [investment] amounts. Always be a follower if you are new. If you can’t find someone to lead a deal, pay attention to that. Furthermore, group wisdom is the best. But also remember that investors need to make their own decisions and can’t always follow someone else’s lead.” – Carol Sands of The Angels’ Forum

References:

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Leaders interviewed for the guidance document:

- Catherine Mott of BlueTree AlliedAngels (Pittsburgh, PA)
- Tom Jones of BlueTree Allied Angels (Pittsburgh, PA)
- Stephanie Hanbury-Brown of Golden Seeds (New York, Connecticut)
- Carol Sands of The Angels' Forum (Palo Alto, CA)
- David S. Rose of New York Angels (New York, NY)
- Paul Sciabica of New York Angels (New York, NY)
- James Geshwiler of CommonAngels (Boston, MA)
- John May of New Vantage Group (Washington, DC)
- Bill Moore of LORE Associates (Philadelphia, PA)
- John Huston, Ohio Tech Angels Fund (Columbus, OH)
- Alan May, Life Science Angels (Menlo Park, CA)