IESE Business School University of Navarra

# Seven steps to heaven

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## If you need to grow, but you're not yet big enough to attract venture capital, then it's time to petition the angels.

There comes a point in any start-up when you need someone else's money, but if you're still a small fish the venture capitalists won't be interested. What you need is a business angel, those investors who typically invest between 25,000 and 500,000 euros in new concerns, often with the aim of taking them on to the stage where they can attract venture capital.

In their technical notes, "Best Practices of Angel Investing: Tactics and Strategies of the Winners," Heinrich Liechtenstein and Istvan M. Fulop look at the different types of angels and find out what it takes to make a winner. They present four categories of angels:

*The Player*. These are "serial entrepreneurs" who have already started and sold one or more of their own enterprises. They are opportunistic investors and spend less time on portfolio enterprises than other angels.

*The Silent Investor*. While they are as opportunistic as players, they take less of an active role in the businesses in which they invest and tend to sit back and hope for profits.

*The Hands-on Investor*. As the name suggests, these investors take an active role and there is sometimes risk of friction between them and the entrepreneur if they have a significant stake.

*The Professional Angel*. These are both serial entrepreneurs and investors who tend to support portfolio enterprises by leveraging their networks to maximize the value of the venture.

## Seven steps to success

Each of these four varieties can become a winning angel if they follow the seven fundamentals of early-stage investing.

*Sourcing.* Winning angels have a very clear idea of what they are interested in and have well-defined investment criteria that help them filter out deals they don't want to get involved in.

*Evaluating*. Includes assessing whether there is a market for the service or products, the competitive advantage, whether the time and the scale are right, the exit strategy and, above all, whether the entrepreneur and the team inspire confidence.

*Valuing*. Some go on a $3 million ceiling as a rule of thumb; others give $1 million each for a sound idea, a prototype, a quality board and existing sale and then up to $2 million more for a good team. But none of these is a hard rule.

*Structuring*. Although some argue that if you focus on having a positive relationship with the founding team, structure loses its importance. Yet there remain questions of the legal relationship (private investor or partner), the choice of investment instrument and the corporate structure of the firm and how that affects its flexibility.

*Negotiating*. As with structure, not all angels agree on the fifth fundamental, negotiation. Many winners don't negotiate, or they leave it to someone else, while others do, principally over price, structure and the amount of capital invested.

*Supporting*. Working with management is the supporting role most widely performed by angels. The six supporting roles are:

- *Silent*: financial investment with no involvement
- *Reserve Force*: ready to help if called upon
- *Team Leader*: very active
- *Lead*: the most active investor
- *Coach*: Investor who acts as a mentor to the entrepreneur
- *Controlling Investor*: takes control of the deal

Many winning angels feel that, once they have made their investment, their primary role is to prepare the company for the next round of venture capital funding.

*Harvesting*. This is the financial score by which success will be measured. The positive harvests are:

- *Strategic Sale*: the most common form of exit, in which the company is sold to an industry player.
- *Financial Sale*: the company is sold to financial buyers, who p
urchase it for its future cash flows.
- *IPO*: the company sells a percentage of shares, which are listed on the public stock exchange, creating a market for the investors? shares.
- *Partial Sales*: the investor's stake is sold to the management or an outsider.
- *Walking Harvest*: the company distributes cash to investors on a regular basis.

There are also negative exits, of course, such as when a company runs out of fund (known as Chapter 11 bankruptcy in the United States) or when it is liquidated, in which case the investor may get little or nothing back.

Winning angels understand that the extent to which they can follow these seven fundamental steps has a direct impact on their performance. They have learned to focus on the entrepreneur, knowing that when it comes to success, it?s the people who really count. They plan their exit from day one and make sure that the entrepreneur is also exit focused.

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