HOW THE INVESTMENT PROCESS WORKS

INVESTMENT EVALUATION AND PROCESS

The investment process can take many forms. These range from members making their own investment decisions to investment of group funds based on committee. The investment structure can vary from individual investments to creation of a limited liability company for each investment.

DEAL SOURCING

The success of any angel organization is ultimately based on the quality of investment opportunities available for its *members*. Generally, members are the best source of business plans. If members are active investors in the community, they will usually have a known reputation and have their own deal sources.

These sources include many of the following:

- *Service providers*, such as lawyers, accountants, and investment bankers, are good sources of deal flow. Many conduct their own analysis of early-stage companies before agreeing to accept them as clients. If sponsorship is one of your group funding sources, providing an opportunity for sponsors to submit clients for possible presentation can be a defined benefit.
- Another source of deal flow is *venture capital funds*. Venture funds often receive business plans from entrepreneurs too early-stage for VC investment needs and interests. Inviting regional venture capital funds to be associate members or establishing an ongoing relationship with these venture funds can provide an early look at companies for VCs and encourage them to send interesting business plans for your group's investment consideration. Additionally, VCs may offer the angel group limited opportunities to participate in first-round venture financings because of the positive aspects of this relationship.

- *Investment forums* and similar events can be a good source of presenting companies, as these businesses have generally already gone through some form of screening to qualify for presentation at the forum.
- Some groups have also found good potential deals through local *universities* that have a strong technology-transfer program and enterprise centers, which support development of entrepreneurial companies and community entrepreneurship.
- Direct application through a group *Website* can generate possible investment companies, although most angel investors generally prefer a referral from a member or trusted service professional.

Even with companies sourced through members, professional service organizations, VCs, and other methods, the best angel groups use one uniform mechanism for company applications, typically the angel group Web site. This provides an opportunity to inform applicants of your rules of presentation as well as the screening and selection process.

DEAL SCREENING

As with nearly any aspect of an angel organization, the screening process can vary from informal, with selection conducted by volunteer members, to a formal process in which the manager coordinates and conducts much of the screening. The screening process provides a mechanism for selecting companies that the entire angel group will review, typically through presentations at member meetings. Regardless of the level of formality, some type of screening process should be established to avoid taking up the members' limited time at periodic meetings with business plans not worthy of investment review and consideration.

If the group is Manager-managed usually the selection process is very organized. When a new project is received the first valuation step is a Pre-Screening phase and consists of a preliminary analysis of the business plan, to assess the essential requirements for a potential investment, strong IP, defensible technology, pertinence with group investment focus and financials.

Some groups have MBA interns serve on the screening committee alongside members, often completing initial screening of all applications against a list of group criteria. Duties may also include interviewing the entrepreneur to obtain needed additional information as part of the evaluation process. The MBA students then create a report for the screening committee.

For purposes of maintaining uniformity and controlling the number of hours each screening committee member must commit, it is recommended that organizations accept only executive summaries from applicant companies. Screening should be done using a well-developed and uniform evaluation form or matrix. Such forms help to ensure that evaluations are thorough, fair, and objective.

This phase is highly time consuming and it is fundamental to identify the key elements to valuate a business plan. Only the most serious proposals that fit with the investment focus are communicated to the members. Most of the opportunities do not pass this phase and are not admitted to the screening process.

When a business opportunity passes the pre-screening, it goes through the second phase that is Screening. At this stage, a small group of members, with expertise in the industrial sector, is composed and analyses the business plan and the documents sent by the entrepreneur.

If there is a positive answer from the group, then a meeting with the entrepreneurial team is scheduled to know personally the people behind the project. This is one of the most important step of the screening process since entrepreneurs and team is one of the relevant variable in the investment decision of angels.

After the meeting, if there is a positive impression of the screening group, the project is submitted to the Screening Committee. Depending on the number of applications, an organization may wish to consider a tiered review approach, with initial selection of several companies for presentation to the screening committee. From these presentations, a smaller number (say two to four companies) can be selected to complete the coaching process and eventually to make presentations to the members at a group meeting.

The opportunities selected by the Screening Committee are consequently presented to the Company Presentation Session. When a project is selected by the Screening Committee, the entrepreneurs are invited to present to members during meetings. The in-house staff, after the Screening Committee selection, sends a presentation format to those one who are going to present and, following the sending, there is a review of the presentation prepared by the entrepreneurs.

Some groups require presenting companies to have a member sponsor them, with at least one member agreeing to invest or having already invested in the company. Such requirement for a “guardian angel” has decreased in popularity with recent reductions in investment activity and the fact that this process does not necessarily guarantee better deal flow. Some groups do have a member assigned to a presenting company for purposes of shepherding or mentoring them through the coaching and presenting process. For manager-led groups, the manager often takes on this role.

COMPANY PRESENTATIONS

Many groups have company presentations at regular group meetings. Typically, two to four companies present for a limited time frame (ten to fifteen minutes), followed by a short question-and-answer session (five to ten minutes).

The first 15 minutes are for the entrepreneurs to present his company with the support of a power point presentation. No questions are allowed during this session but only when the entrepreneurs have finished to present. In fact, after the first session many groups ask the companies to step out of the room for a Q&A session and group discussion of investment interest.

This group-only discussion time serves a greater purpose than just a determination of “go” or “no-go” for presenting companies. Members have the opportunity to share additional information they may possess about the market, product innovation, and management, and to develop an effective message to communicate to the entrepreneur, particularly if that business is not selected for continued funding consideration. These discussions also provide an excellent learning experience for new members.

Within few days, the manager gathers the members’ liking for the presenting companies in terms of “soft commitment” that is an indicative expression of investment, non-binding and subject to Due Diligence.

DUE DILIGENCE

After the Company Presentation, if a project has received sufficient commitment by the members, the Sponsor (from this moment on, he become: Deal Champion) formally starts the Due Diligence.

This phase normally takes a few months (unlike the venture capitalists due diligence that are more formal and last approximately 6 months). During this time the Champion is in charge to check every aspect of the business plan, to carry out due diligence of the technology, of the business and of the legal aspects (also with the support of professionals).

Due diligence can be the most complicated and time-consuming part of angel investing. Many publications have been devoted to the due diligence process. This discussion is limited to suggestions for structure, rather than the steps and topics for due diligence.

In a manager-led organization, the manager will typically lead the investment-evaluation process. The manager will also often negotiate the structure of an investment or participate in the negotiation process with the lead investor. In member-led groups, whether an informal group with individual investment decisions or one in which members invest collectively, the due diligence process must ensure coverage of relevant topics and should be conducted by those with experience and expertise in particular areas. Some groups retain MBA students to support due diligence through an internship program with the local business school. Other groups retain outside experts to evaluate a company or give a briefing on cutting-edge technology related to the potential investment.

One angel group with a sidecar fund has the fund complete all due diligence on companies presented to the related angel group. Based on this due diligence, the fund members vote on whether or not to fund at the meeting. If the sidecar fund decides to fund a company, it then shares the results of due diligence with interested members of the angel group to round out the investment offering.

INVESTMENT VEHICLES

Needless to say, there are a variety of investment mechanisms and nearly countless number of investment terms. Angels invest locally for many reasons, including an interest in staying connected to the portfolio company, familiarity with the local market, and desire to give back to the community.

A few exceptions are organizations with an investment focus that requires a broad geographic review of potential deals, such as sustainable technology, energy efficiency, environmentally friendly products, or companies with a social-venture aspect. Therefore, throughout the process, from deal sourcing to signing the investment check, local investments prevail.

INVESTMENT TERMS AND NEGOTIATIONS

Angel investors, often being the first outside money in a company, need to be cognizant of follow-on funding needs and the possible sources for this additional company capital. Do not make the terms so complicated or onerous to effectively prevent attracting follow-on financing, which is undesirable for the company and angel investor.

Your angel investment training should include a fairly lengthy session on terms, which can seem complicated and hopelessly confusing to the new investor. Local professional service providers, such as lawyers and accountants, often have extensive hands-on experience with investment terms and negotiation techniques.

From an operational perspective, in manager-led groups, the manager often plays an integral and key role in determining and negotiating investment terms. A manager’s (and, for that matter, a member’s) ability to negotiate investment terms will depend on a few key factors:

- Is your group the lead investor? If not, you probably have little influence over the terms and must rely on the sophistication of the lead investor to negotiate investor-favorable terms. If a VC fund is leading the round, you will most likely receive favorable terms.
- Does your manager (or do your members) have the requisite experience? With the first few investments, and even thereafter as a safety factor, professional advice should be sought and used.
- Has the company already established terms, and does it have multiple potential sources of funding? Entrepreneurs usually know if they are a “hot” deal. If this is the case and you want to play, both your ability to get in on the deal and your negotiation leverage may be limited.