After the Check - When Angels *Really* Make Money

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By Marianne Hudson, Angel Capital Association Executive Director

Angels love the thrill of the hunt. We like learning how entrepreneurs are going to change the world or which is the new Unicorn that will go public and bring a 100X return. Perhaps this is why many stories about early-stage investing focus on the first part of angel investing – finding good deals, negotiating good terms, and due diligence.

John Huston, Chairman Emeritus of the Ohio TechAngel Funds focuses even more on the second part of angel investing – what happens after the check is written. John is a deeply experienced and sophisticated angel investor with 18 years of success in the game and has found that when angels help entrepreneurs grow their companies and also protect their investments, they are much more successful.

John has a way of quickly simplifying complex issues. After showing me a photo of some really cute golden retriever puppies, he said, “My personal view is that it’s more fun to focus on picking puppies that you think will become winning show dogs, but it is nearly impossible to tell which puppy will grow up to be best in show. Like these puppies no startup is formed well enough at the outset that you can be certain that you a picking a lucrative investment. Instead, you can make sure your startup is nurtured to get to the best possible outcome.”

That makes sense to me. When you consider that all of our returns occur at the exit, maybe the better question is: Why do so many angels spend so much time before the check versus after we’ve invested?

It goes without saying that you need to do your diligence to make astute investment decisions. However, angels can have a significant hand in affecting the outcomes of the companies they invest in. The key is to know what to focus on so you can help build value during the holding period and drive a lucrative exit. John shared with me the tactics he uses to improve returns. For those that want to explore this topic even further, John will expand on these ideas in an upcoming Angel Capital Association webinar.

Six Tactics to Improve Returns--*After the Check*

- **Stay in touch with Angel Directors.** Most angels may not have direct voice with the companies they invest in, but we can stay in touch with angels who serve on their Boards. It's important to build rapport, create alignment and set expectations with those "Angel Directors." Remind them that you expect to get your money back through an exit and to be informed about how the company is doing in the interim. Have discussions about what the minimum acceptable exit is. Keep consistent pressure on this and what it will take to get there, in meetings reconfirm that this is still the company's focus.

- **Make sure the Board is controlling the CEO's total compensation.** This is about ensuring exit congruence. The key is to ensure that the CEO's payday is the exit so that this remains her focus. For example, a highly paid startup CEO heading toward the typical angel exit of $30-60M might prefer a high salary over exit returns. This creates less incentive to sell. The smart strategy is to keep CEO pay below market and ensure that they have enough ownership so that they are well compensated at the exit. When you connect with angels on the board, make sure they are keeping an eye on the Compensation Committee and ensure the non-management members of the committee can control the CEO's compensation.

- **Keep ample "dry powder."** Unless your strategy is "one and done," you need to be prepared for follow on rounds. To protect your investment from being crushed by later investors, ensure that you have ready funds for the successful companies in your portfolio. John's advice, "Establish your investment rules at the onset." For example, put in no more than half of the total you want to invest in the company at the start, and draw a hard line on your maximum exposure to any one portfolio company.

- **Use your follow on check template.** Figure out the decision making criteria you will use, or what factors will cause you to automatically write a second check or decline. For example, if you've lost confidence in the team or determine that the problems can't be fixed with money that's you signal not to invest any more. Or, conversely, if the company is repeatedly performing to plan, or the round is grossly over-subscribed the entrepreneur probably deserves your continued support. Making a bad decision in either case will hurt, but one of the most painful experiences is not doing a follow on in a successful company.

- **Minimize your loss.** Some startups don't fall, they stall. If you've lost all hope of an exit, you need to have a plan to minimize losses. With startups that evolve into zombies, or lifestyle businesses that aren't attractive enough for an exit, sometimes you can find ways to get some of your money back by "exiting the unexitables." Two other ideas to keep in mind: push your Director for a Lights Out Reserve to ensure there is enough money to pay for ceasing operations, and for C Corps, research IRC 1244 regarding the possibility of offsetting some of your loss against ordinary income.

- **Use Federal tax breaks.** Don't neglect to maximize returns from your winners through tax incentives. For instance, if a C Corp you invested in qualifies for Qualified Small Business Stock treatment, ask your tax advisor whether IRC 1202 might shelter some or all of your capital gains.

Angels are in a unique position to help startups succeed in ways that many other investors can't. Clearly, there is a strong correlation between angels returns and the time angels spend after the check. One might even say that angels who remain disengaged between writing the check and the exit are sub-

optimizing their returns because they provided no experiential capital to the entrepreneur. All money is fungible. The unique value angels can provide is our experience and connections.