How to Recoup Difficult Angel Investments

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By Marianne Hudson, Angel Capital Association Executive Director

Angel investing is about a lot of things: supporting startups, building companies, and, of course, creating a return for investors when they exit the investment. There are three basic types of exits of angel-backed companies. The positive exit results from a startup acquisition or IPO; the negative exit happens when a company goes out of business; and then there's the dreaded "stall," where your money is stuck in limbo for the foreseeable future. In this case, the company has been in business for a while and has reached cash flow break-even, but isn't growing or moving toward a positive exit. After several years it's apparent that something needs to be done if investors want liquidity, but what?

Parker MacDonell, managing director, and Michael Kindrat-Pratt, director, of the Ohio TechAngel Funds (OTAF) have experienced all three types of exits. About a third of their portfolio companies have been in the "stall" situation. OTAF calls these companies "unexitables." MacDonell and Kindrat-Pratt shared some tips with me recently and will discuss their experiences in more depth at the Angel Capital Association Summit in Philadelphia.

Before diving into the tips, it's important to address some smart questions most angels might ask: Why is it better for angels to find a way to exit these companies versus leaving your money there? Or, aren't angels just going to lose their money anyway in their unexitables?

Getting out of these companies may result in a return that is less than the investment, but there may be some potential upside to the scenario. At least you can take advantage of tax losses and there won't be a requirement to invest in future rounds of the company or being further diluted. Also, in some cases it is possible to make a positive return.

So if your investment is mired in an unexitable startup and you believe it's time to find a way to exit, what is the best approach? MacDonell says, "Angel investors don't talk much about this topic. It is hard work. It's just as hard as finding promising deals and doing due diligence."

That's why he and Kindrat-Pratt developed a playbook for what to do when these "stalled" companies need to be removed from your angel portfolio.

The Playbook

The playbook offers six practical plays worth considering, all of which begin with an important decision for investors. “All plays in the playbook start with developing the minimum price or return you’re willing to accept,” Kindrat-Pratt said. “This amount depends on many company and deal variables, so the range can be wide.”

1. Sell shares back to company. This may be the easiest and most desirable option. However, it doesn’t happen that often because most startups don’t have enough money to buy back their stock or there are other deal provisions that get in the way. For instance, if the company has debt, the debt-holders will usually be first in line for money from the company.

2. Sell shares to another shareholder. This option offers the best chance for a good multiple return. The key is finding one or more shareholders who are more bullish on the company than you are and have a longer time horizon for investing. Maybe they are on the Board or they own a larger percent of the company. These shareholders may have an emotional stake – or they see an opportunity to build their returns eventually. “In our experience,” says Kindrat-Pratt, “selling to an investor is the most lucrative approach. We got a 2X exit this way.”

3. Hold an auction. Angels can run an auction with all existing investors, with care of good information and fairness for everyone. Most often, an auction will result in returns being a percentage of money invested. OTAF successfully held an auction with the price settled at 30 percent higher than the starting basement price. At the ACA Summit, MacDonell and Kindrat-Pratt will discuss a series of practical steps to conduct effective auctions.

4. Distribute the shares to all individual investors. In this scenario, investors receive their pro-rata share in the capitalization table. This option is typically less desirable for everyone – investors and companies alike – because it means that the number of investors on the company’s cap table will increase if individual angels invested via a fund or single purpose LLC. Most companies don’t want to have another 98 investors on their cap table.

5. Create a “Lost Causes Fund.” Tech Coast Angels has created a non-profit fund to which investors can donate shares they no longer want. In return for the donation they can take a tax loss on the investment. The fund then owns the shares, and if there is a financial return on the donated stock, the proceeds go to a designated charity.

6. Sell shares in secondary markets. In the evolving world of angel investing, angels can now use online platforms or exchanges to sell stock to other individual investors. Although these platforms are most often used to buy and sell shares of high performing companies, they could be an option for angels looking to unload a floundering investment. As the saying goes, one person’s trash is another’s treasure, so if you’re willing to sell at garage sale prices, this approach is viable.

In the end, moving towards an exit is the angel’s ultimate goal. How to get to an end that is best for everyone takes research, planning, and patience. In the case of unexitable companies, there may be exit options, but they will likely take a little more work and creativity.