Angel Investing by the Numbers: Valuation, Capitalization and Startup Economics

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This article is the first in an ongoing series on valuation and capitalization. To learn more about the financial mechanics of early stage investing, download this free eBook today Angel Investing by the Numbers: Valuation, Capitalization, Portfolio Construction and Startup Economics or purchase our books at Amazon.com.

In the sport of Major League Baseball, the greatest hitters are those who get a hit just one out of every three times at bat and a home run 5 or 6 times out of 100 at bats. In the world of startup company investing, the best-known investors are those who invest in the tiny percentage of companies that make it big. Think Facebook, Google or Amazon. If you invest in one of those enormously successful companies you will find your name in the equivalent of the Baseball Hall of Fame… it's called the Forbes Midas List.

To continue the analogy, the most famous investors don't worry about getting on base. In fact, their batting average might be quite low. They are so successful because they swing for the fences every time they get up to bat, and they are able to connect for the rare grand slam.

It is tempting to think that is the only way to succeed. And maybe if you are trying to build a reputation as the best home run hitter in baseball it is. But if you are trying to field a winning team over the course of a long season, it is not the only way.

The principles popularized by Michael Lewis' book *MoneyBall* illustrate a different and less dramatic way. An approach of chipping away at the problem, making every position and every at bat count for as much as it can. Efficiency and economy in playing style rather than flamboyance.

Angel Investing Approaches to Long Term Returns

So which is the right method for an angel looking for long term returns? Should a typical angel investor apply the "swing for the fences" approach to their personal investing? Afterall, if you make just one hugely successful investment in your portfolio, you will make up for dozens of failed investments. But, the likelihood of investing in the biggest winners is quite low - too low to bank on. Further, some of the biggest winners come in the consumer space where there is a global market, but a lot of consumer fickleness. Those deals have an element of risk it is almost impossible to be compensated for taking on.

Therefore, our personal strategy for angel investing isn't 100% focused on the hunt for the biggest winners. We always love when we find such investments, but we are realists and understand that, on a day-to-day, year-to-year basis we need to take a different approach to building our angel investment portfolios. Our strategy is more akin to the MoneyBall "efficiency and economy" approach to investing. We don't try to wait for the perfect pitch and rely on grand slams, we try to accumulate lots of doubles, triples and the occasional home runs. If the bases happen to be loaded when we get one, great, but we don't bet the portfolio on it.

So how does this actually work in real life? From reading some of our other articles, you know we love to invest in great teams, going after big markets with great new solutions to the customer's problem. But it goes beyond those basics. Here, we will discuss what investors should know about the financial mechanics of angel investing. Just like the baseball team manager using a MoneyBall approach needs to really understand the statistics of the game, the successful investor employing our approach needs to understand the financial mechanics of investing.

In the following series of articles we will cover important topics such as:

- How do you read and understand a Capitalization Table?
- How do you place a value on an early stage company with a limited track record?
- What are some of the financial paths that lead to a successful exit for angel investors?
- How do you construct your portfolio to improve the likelihood of successful returns?
- What does the underlying financial math look like in a top tier angel portfolio?
- What approaches do you use to exercise options and buy restricted stock that minimize taxes and optimize your financial outcome?

Having a solid understanding of valuations, exit paths and portfolio construction might not sound like as much fun as baseball for many of our readers. But trust us, after investing in startups for a combined 25+ years and 100+ companies, Christopher and I have learned the hard way and fully embrace the importance of mastering these important topics. Just because finance wasn't an interest in your career doesn't mean you can ignore the financial mechanics of angel investing…. unless, of course, you get lucky and invest in the next Amazon!

Read on for an in-depth discussion of understanding cap tables.

Want to learn more about the financial mechanics of early stage investing? Download *this free eBook today [Angel Investing by the Numbers: Valuation, Capitalization, Portfolio Construction and Startup Economics] or [purchase our books at Amazon.com].*