# EXIT GOAL CONGRUENCE (EGC) BETWEEN ANGELS AND VCS

***Overview:*** The initial financial goal of most angels is to reap returns that exceed their total portfolio investments so they are "playing with house money." Even if this is not their stated goal, many say that once they needed no more exits in order to have a profitable portfolio, they started enjoying angel investing even more. Ventures that cannot have a positive exit unless they raise VC funding are adding two layers of risk on top of the many that their investors always face. The first is whether they can attract the capital they need from VCs. The second is whether it will be provided on a basis that does not degrade the returns of the prior investors.

***Are VCs essential for a lucrative exit?*** One due diligence question that can significantly inform angel's potential returns is whether financing by VCs is essential to reaching a liquidity event, or whether an "angels only to the exit" outcome is believable. This is not to suggest ventures that cannot exit without VC funding are necessarily less attractive. My point is that before investing angels should have assessed whether VCs are a "necessity, or a nicety." This can readily be determined by asking four basic questions:

- What does this company have to achieve in order to attract multiple cash bidders? (Marquee customers, revenues, installed base, team, IP, etc.)
- How much capital will it need to achieve these goals?
- How much of that capital can be non-dilutive (i.e. grants, customer prepayments, debt)?
- How much of the required equity (dilutive) capital can angels & "strategics" provide?

If the venture manages to hit its numbers and its angels continue to invest, but they cannot provide all the dilutive capital needed to achieve an exit, then the Board of Directors (BOD) knows its most pressing goal is not to build a great company that will provide a great return. Instead, the BOD must first build a company that can attract VCs……..and hopefully on terms that will not incinerate angels' returns.

***To VC or not to VC?*** Many angels (including me) prefer deals with a plausible non-VC exit pathway. This is because we would rather settle for earlier and smaller exits, in lieu of relying on how VCs we have yet to meet will treat us. But, I am not suggesting that ventures should eschew VC funding at all costs.

When a venture's BOD has the opportunity to exit before taking venture capital it might decide that shareholders' returns will be significantly enriched if non-angel professionals are added to the cap table even though a lucrative exit is possible without them. This is a pleasing option to have. Such a decision can be made after much analysis and without the urgency of needing VC funding.

Many angels' experiences suggest that VC funding is an extremely beneficial source of capital if the BOD from the outset guided the venture to be attractive to such sources. Conversely, when ventures needed an unplanned VC round to survive, angels should have expected the worst, and they often received it! This is due to the lack of Exit Goal Congruence (EGC) between the VC and angel communities. The latter constituents are investing their own capital, but VCs' primary fiduciary responsibility is obviously to their LPs. They cannot serve their LPs while being overly concerned about angels' returns.

***Variations of being "crushed:"*** Whenever angels congregate a frequent topic is how they have been "crushed" by VCs. Over my last 18 years of start-up investing I have my own stories of being "crushed" by VCs, and list below some of the tactics that destroyed my returns:

1) When VCs joined the cap table initially and wanted to retain current management, they refreshed the option pool, diluting angels before the VC round closed.

2) They inflicted a huge down round valuation while demanding that the angels relinquish their anti-dilution protection.

3) Asked angels to waive their pre-emptive rights, thereby canceling the reason we invested in the earlier rounds (to maintain an option to invest further to protect against dilution).

4) Used a pay to play scheme precluding most (if not all) angels from participating in the VCs' initial round (usually by setting the minimum so high). This is especially painful for angel funds that may have inadequate dry powder at the end of their fund's life. ***(n.b.:** Angel funds should petition to have their members be able to take the angel fund's pro rata in its stead.)*

5) Converted angels' outstanding preferred shares into common shares, thereby rescinding all accrued dividends, protective provisions, liquidation preferences, anti-dilution protection, registration right, and pre-emptive rights.

6) Removed the angel directors, ceasing their option vesting schedule.

7) Retained an angel director, but refused to approve any compensation going forward, whether via options or fees.

8) Limited future information dissemination to those who qualify under the VCs' new "Majority Investor" definition. The qualifying amount of investment is often set at the level high enough to exclude most, if not all, angels. Therefore, the early investors will subsequently have no knowledge of the venture's performance and the details of follow-on rounds. The result is that the angels cannot even guess at the prospects of any future return since they are ignorant about the thickness of the preference stack.

9) A few quarters after establishing an asymmetry of information, the VCs then offered to buy out angels' shares at a modest return, obviously without divulging their progress in orchestrating an imminent exit.

10) Seeing an exit on the horizon, VCs orchestrated a Pay to Play investment round with the sole purpose of crushing the angels into common prior to the exit (to obliterate our liquidation preference).

In retrospect, I deserved each of these "crushings." I made numerous blunders, but my major ones were:

- Before writing my first check neglecting to admit that VCs were essential for an exit. Therefore the BOD did not address the fact that the CEO was unlikely to be viewed as fundable by VCs, and had to be replaced at a most inopportune juncture.
- The BOD did not focus on the crucial intermediate goal of positioning the venture to be attractive to VCs. Therefore no effort was made in building relationships well before we needed VC funding to survive.
- I used "motivated reasoning," meaning that if all went as planned we would have adequate dry powder around the cap table to achieve an "angels only" exit. I chose to disregard my past experiences that showed much headroom is needed for likely underperformance. Being behind plan and needing to raise more capital to survive is a prescription for financial pain.
- I did not realize that the preference stack arising from multiple financing rounds means VCs could reap a positive return at an exit price that hands the angels a big loss. Some experienced angels contend that their lowest yielding positive exits were those driven by the VCs.

***The Maximization Myth:*** But, even putting aside these tactics, angels should realize that VCs do not always seek to maximize their returns from each and every portfolio company. Their overarching goal is to raise their next fund to keep their management fees flowing.

VCs' management fee structure ensures they benefit from raising larger and larger funds, regardless of the amount of carried interest they might receive from future exits. Therefore, VCs' overarching loyalty is to those LPs who will hopefully invest in their next fund. Providing LPs cash distributions when getting ready to launch a new fund is the most frequent reason that a VC might intentionally sub-optimize its return from a given portfolio company. **This is both completely ethical and fully understandable behavior.**

However, there are other reasons why VCs "exit early" that are more subtle. I gathered the list below by asking candid VC friends to give examples of when they pushed for an exit (positive or negative) while knowing that doing so might not maximize their fund's yield from that particular investee.

1) We wanted to remove a gross underperformer from our reports especially if it was likely to need much more investment from us, so we shuttered the company to make it vanish.
2) We were perfecting our PowerPoints to raise our next fund and we wanted to cull all those that dragged down our returns or were known as losers. Therefore we exited.
3) The company was a zombie; our opportunity costs vastly exceeded any possible return. We, therefore, preferred to close the company or disengage by seeking a buyer for our shares.
4) The venture was on a path to potentially "return the fund" so we delayed the exit to push our return to the absolute maximum Return on Investment (despite hurting our IRR).
5) The venture had the potential to become a unicorn (>$1 Billion in valuation) which we thought would bring vastly elevated visibility/fame/fortune so we kept funding and delaying the exit.
6) We thought the venture might be able to IPO, so we hung on and hoped to orchestrate a high visibility IPO event.
7) Our firm was disbanding so we needed to minimize the cost of managing our legacy portfolio.
8) The fund which invested in the venture was nearing the end of its life (including extensions) and we thought exiting the ventures would provide better results than selling the fund's positions on the secondary market.
9) We felt there was insufferable dis-harmony among the VCs on the BOD so we pushed for a premature sale of the venture (or sold our holdings in the secondary market).
10) Although we had not planned to sell yet, an unsolicited offer arrived and we estimated that taking it would improve that fund's returns more than the alternative of investing more and hoping for a better return later.
11) The venture was located remotely from my office and we reached the point where we believed the venture displayed insufficient potential to justify time attending distant BOD meetings and staying engaged.
12) I thought I would be able to find other attractive portfolio companies in the area to increase the productivity of my trips, but that never occurred so I was making trips for one Board meeting.
13) The venture became an "orphan" in our firm because the lead partner left/retired/died and no one wanted to add the venture to their portfolio (especially if lots of travel was required).

***<u>VCs can vastly improve angel's returns:</u>*** It would be short-sighted for angels to overlook the many skills VCs can provide our portfolio companies that few angels can provide. In my experience, the most prevalent are:

- They are excellent at vetting IP, often having IP counsel on retainer. As an investor, I have always felt more confident about the freedom to operate and the allure of my investee's IP portfolio after VCs have joined the cap table.
- Often the VCs can provide BOD members domain expertise that exceeds that of the angel BOD members.
- Industry specialists can excel at making introductions to suppliers, customers, and potential acquirers.
- While most angels have great local networks to assist in building the team, VCs have a much larger and geographically broad Rolodex
- Too often angels struggle to replace an under-performing CEO because few talented candidates will sign aboard unless there is at least a year's burn rate in the bank. Having less capital, angels are hesitant to provide the requisite war chest to attract an outstanding new CEO. VCs do not only have the dry powder but also generally more experience in replacing CEOs than most angels.
- Once they join the cap table, the primary responsibility for raising future rounds shifts from the angel to the VCs.
- VCs are more likely to be able to attract top tier confreres than an angel-only funded venture can. This is especially true regarding investees located in fly-over states who seek coastal VCs.
- The same goes for engaging top tier law firms, most notably those with vast M & A and IPO experience that may not seek start-up clients.
- Obviously, VCs are more experienced at IPOs than most angels. And, they have the appropriate investment banker contacts.
- Importantly, angel-only ventures cannot access venture debt. Having VCs on the cap table is a pre-requisite for accessing this flavor of capital that can boost angel's returns.

***<u>What can angels do when needing to work with VCs?</u>*** While each investee is a unique story, here are some general steps that might lessen the likelihood that VC's will damage our returns:

1) Ensure there is adequate dry powder around the cap table to bake out enough of the investee's risk factors that VCs will be interested.
2) Said differently, craft a Capital Access Plan that will lower the odds of being desperate for capital when approaching the VC community.
3) Being able to achieve Survival Cash Flow Break Even on angel funding is one way to avoid negotiating with VCs from a position of weakness.
4) Preclude the CEO from leading the VC selection process. Assign an angel director to do the initial spade work to identify targeted firms.
5) During the VC due diligence process take steps to enable the CEO to avoid becoming so totally immersed that the venture misses its plan (which can cause negative deal drift in the terms, conditions, and valuation between the signing of the term sheet and closing the round.

**<u>SUMMARY:</u>** The comments above are not meant to pillory the VC community. Angels who want to swing for the fences with each investment are unlikely to enjoy many bases loaded home runs if they limit themselves to angels-only opportunities. VCs can be invaluable. But, entrepreneurs and angels will benefit from:

- Assessing at the outset whether VC funding is necessary to achieve a lucrative exit
- Not presuming that Exit Goal Congruence exists among entrepreneurs, angels, and VCs
- Remembering the factors that might cause VCs to sub-optimize their return on any one investee
- Establishing cordial relationships with VCs prior to needing them
- When they are needed, encourage an angel director to identify candidate firms and not the CEO.