<u>Frequently Asked Angel Questions (FAAQs)</u>

Background: Having been writing angel checks since 2000, I am often asked questions by those how are just entering our unique asset class. Below are some of the most frequent questions posed to me.

<u>What is an Angel Backed Company (ABC)?</u>

Let's start with its antonym which is a PTC: Publicly Traded Company, which refers to all entities whose shared trade on a stock exchange. All other companies are privately held, and those who have angels on their cap tables qualify to be called ABCs, even if they also have Venture Capitalists (VCs) among their investors.

<u>Why should I invest in ABCs instead of PTCs?</u>

Getting the same price as every earthling who buys or sells at the instant you do is but one aspect of Publicly Traded Company (PTC) shares. For some, the big benefit is being able to blame a well credentialed Wall Street analyst when money is lost. (Recall the comfort that provided in September of 2008.) While holding a position in a PTC you cannot take any action to boost its stock price, but over cocktails, you can mention your paper profits.

Conversely, 1) Purchase and sale transactions of ABC shares are privately negotiated; 2) They are confidential; 3) During the holding period your wisdom can actually elevate the exit price; and 4) The potential exit multiples vastly exceed those ever recorded among PTCs, more than offsetting the illiquidity. But, when you suffer a loss you can only attribute it to an ID Ten T error (write it out, idiot).

<u>Should I become a director an Angel Backed Company?</u>

<u>Absolutely</u>........or.........<u>Never!</u> <u>Never,</u> if you lack *any* of the following: 1) Full grasp of your fiduciary responsibilities (i.e. how to avoid being named in litigation); 2) The liquidity to invest in future rounds; 3) The stomach to replace the founder CEO; 3) The courage to add a failure to your list of engagements (since at least 1 of 5 start-ups croak); or, 5) The willingness to deal with funding and other emergencies while being under-compensated for the effort. Conversely......

<u>Absolutely</u>, if you savor the thrill of helping bring a unique idea to market and making a bunch of new friends at the exit (happy investors)!

<u>What is the best method for calculating the valuation of a young venture?</u>

It depends on whether you think "best method" as one that: 1) Displays your superior mathematical skills and knowledge of market comps; 2) Doesn't insult the CEO; or 3) Enables a swiftly and slightly over-subscribed round with market terms & conditions. The right answer is #3. But, remember the old adage....."I will agree to your valuation if you will agree to my T & Cs." For instance, I can compensate for a higher valuation by a larger liquidation preference and BOD control. The worst approach to negotiating valuation is to decouple it from the T & Cs.

<u>For pre-revenue ventures, on what should I be basing my decision to invest?</u>

Having not sold anything to anyone, there is no evidence to enable the CEO to dimension market demand or know the efficacy of a pricing strategy. This means for angels that the only value of assessing pro forma financials is to know that the founder is facile with Excel or Google Sheets. The basic question we must answer is this: Why do I think this founder can assemble a team that will figure out how to make money with their idea before they cannot raise additional funding to stay alive?

<u>What is the #1 reason start-ups fail?</u>

Who knows? Most available data sets span so many years that they disregard how the market changes over time. And, who would allege that the un-surmounted challenges Ohio ventures face mirror those of coastal firms? However, I do know that the #1 reason for most of my losers going dark: We short funded the first angel round. When I first started I was too sympathetic to founders' dilution concerns. In fact, in 2000 I participated in a first angel round that was $540,000, the precision of which now convulses me in laughter. If our portfolio companies rarely come within 80% of their predicted first-year revenues, why should we think they are more adept at guessing at their cash needs? Remember the adage..........."Dilution is painful, but running out of cash is fatal."

What is the MOST important question to ask during due diligence?

I think every angel has a favorite, but mine reflects my desire to increase, via exit proceeds, the amount of my liquidity earmarked for my angel activities. Therefore, I want to know who will be driving the exit. Identifying the precise individual is impossible when we write our first check, but we can put the candidates into three categories: 1) The CEO; 2) One or more angel directors; or 3) One or more VC directors. In early angel rounds, it would be an outlier if the VC directors have been identified, but the critical point of asking my #1 question is to force the discussion regarding the essentiality of raising VC funding to provide angels with a positive return. Angels who think that the exit goals of angels and VCs are congruent might read up on fiduciary responsibility and preference stacks.

Should I invest in husband and wife teams?

Absolutely, if you think divorce is a non-event..........and the venture's operating landscape is too sparsely populated with other potential landmines to hold your attention.

Should I avoid ventures whose CEO has added multiple family members to the team?

The answer is a personal one and depends upon your assumptions. Let's presume you want to see your money again but think that will only occur via an M & A exit. If you are confident the yet-to-be identified acquirer will retain all the current employees, then overlook nepotism. But, for me, it is a reason for the CEO and team to be reticent about selling the company. My exit experience has forced me to believe that......."No matter how high we think our barriers to entry are, our barriers to exit are always much higher." Why would I want to raise them further?

If I am offered a seat on the BOD, why would I ever dial back to just being an observer?

After you have read a D & O insurance policy and fully understand the fiduciary responsibilities directors take on, just remember that attending BOD meetings as non-voter means that you cannot vote to replace the CEO. Knowing this, some CEOs wisely develop a beneficial relationship with observers that transcend their director relationships. This can be valuable when you value a friendship with a founder. It is for you to decide whether the value you place on this exceeds the possible future value of the options directors are routinely granted.

Should I take a director seat if D & O insurance is not obtained?

D & O insurance is only important if your assets exceed zero........but, wait......aren't you an Accredited Investor? The insurance will probably cost $10K per annum (+/- $5K). Personally, I don't like any of my BOD seats to preclude my being slumberous.

Should I invest in deals via crowdfunding?

If you like drinking downstream from the herd, crowdfunding is for you. Since they are so distant, meeting the CEO and team is unnecessary. The importance of management is exaggerated. Surely they and their BOD members are honest, hardworking folks who deserve to make millions with your financial help. And, by attracting investors from around the globe, the odds are high that many of them are not only more astute than you but have also done deeper due diligence. Conversely, if your deal flow from within your region and personal network is so paltry that you need more chances to write checks, become more sociable........or just buy PTCs (Publicly Traded Companies) your broker recommends.