Right-Sizing the First Angel Round

The most common cause of my losing ventures' failure has been the inadequate size of their first angel round. Too often I was overly sensitive to the founder's fear of excess dilution, so I participated in round sizes with a precision that is hilarious in hindsight. For instance, some of my earliest checks bought a piece of $545K, $630K, and $780K rounds. All three ventures burnt through their cash, could not raise their second round and died. *("Those who cannot raise their second round have already had their 15 minutes of* ***flame."****)* Unsurprisingly, this was because they had so egregiously missed their promised milestones that most angels ducked round two. Here are my thoughts about round sizing, based solely on my personal loss experiences.

First: Pre-revenue ventures rarely miss their initial revenue forecasts by less than 50%. They are not only wrong in the amount, but the much lower amount also occurs much later. Over half of my lucrative exits only achieved 50% of their initial revenue forecasts two years later……and each of them had some paying customers at the time of my first check. Ventures with zero paying customers have zero data points about the length of their sales cycle, and what pricing strategy will work. And, this presumes their product or service works 100% as well as they assume. This means the amount of "added runway" that should be baked into the first angel round is rarely knowable. Based on my experience, what is knowable is that some amount underperformance is a certainty. *("Dilution is painful, but running out of cash is fatal.")*

Second: Having hot deals in our hopper is one of the true joys of angel investing. My portfolio company follow-on rounds are always competing against deals my CEOs do not see. Many angels limit the amount of their liquid capital we will devote to our arcane asset class. Some employ a template to decide when to continue supporting a venture. Entrepreneurs should be aware of the competition they face when asking for that second check. For active angels, the decision is between investing further in a company that has already missed its forecasts, or backing the NSO (New Shiny Object) that has yet to disappoint. Speaking solely for myself, when I write my first check, I am largely buying hope. *("The result of my due diligence is that this is a fantasy I have chosen to believe.")* Of course, I know that all forecasts are too good to be true, but every NSO's promised fantasy of performance is more tantalizing than the underperformance my portfolio company has provided so far. *("By the time I'm asked for my second check, too often the results are too true to be good.")* NSO's have a "hope advantage" over most second rounds.

Third: It is wise to establish the Definition of Success (DOS) for both this and the next round. A common DOS for this round is being oversubscribed at the initially offered valuation, terms and conditions. However, whether this round's size was optimal can only be determined when the next round is raised. Here's my generic DOS for the second round: It is oversubscribed by 25% with some new, smart, impressive investors joining the cap table and the closing occurs in six weeks at a valuation uptick of at least 20%. Each second round is unique, but regardless of the precise DOS, agreeing upon it as a goal is essential to right-sizing the first round.

Fourth: Once the DOS for the second round is established draft the story that both inside and outside (i.e. new) investors will need to hear so the CEO can achieve it. This narrative will be grounded on a few specific achievements so compelling that the elevated valuation will appear reasonable. Selecting these milestones enables estimating the amount of cash that will be consumed en route to achieving them. Said differently, knowing the stipulated accomplishments allows estimating how many dollars it will take to buy the amount of runway needed to achieve them.

Fifth: Armed with this dollar amount discussing the optimal flavors of this capital is the next step. Of course, the Board of Directors (BOD) and the Founder(s) will want to control dilution to the greatest extent possible so will explore all types of capital other than equity. A critical issue is the amount of time needed to attract each funding flavor. For instance, winning grants requires a much longer lead time than selling notes. *("After considering the lead time, paperwork, constraints, and requisite reporting, grants can be very expensive free money.")* Additionally, the time needed to gain approval of the second round by all those with voting clout must be estimated.

Sixth: Knowing the estimated total amount and composition of the funding needed to achieve the second round milestones, address the timeline. For instance, if the BOD is confident that the milestones will be hit and the narrative will be so compelling that the second round can be oversubscribed in the desired six weeks, then just two factors remain. The first is how many weeks prior to the closing date should the fund raising commence. The second is how much "headroom" for underperformance would be prudent. In other words, we're providing a margin of error for both the timing of the close and the amount of cash that will be consumed prior to launching the funding effort.

SUMMARY: So, when an entrepreneur invites you to join the initial angel round, ask her/him to:

- Agree on the DOS for this and the second round
- Make the pitch that will be needed to oversubscribe the second round, mentioning a few specific accomplishments this first round enabled.
- Explain why the amount of this first round provides enough runway to reach these milestones, assuming some reasonable headwind.
- Remember that woeful underperformance evaporates hope, making any NSO much more alluring by comparison.