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How to Attract Angels
Prime Source of Needed Expansion Capital

There comes a time in the life of almost all successful businesses when the owner's capital invested in the business—as well as capital provided by partners, banks or family members—is insufficient to fund the growth of the business.

Approaching venture capital firms is one option for seeking the money needed to grow. But what if the venture capital firms will look only at deals much bigger than yours? Or they insist on owning a larger portion of your business than you feel comfortable with—in exchange for their capital?

One increasingly viable alternative is getting investment capital from *angels*. They are usually wealthy individuals seeking growth-oriented investments with above-average returns.

Most angels seek companies with the potential of growing by at least 20% annually in revenues and even more in profits. Angels aim to take their profit from the investment in three to five years—usually by a sale or initial public offering.

GROWTH: HOW MUCH? HOW SOON?

While I spend much of my time assisting businesspeople who are motivated to achieve maximum growth in the shortest period of time, I am not necessarily an advocate of that approach. That's especially true for those who have the option of adapting a more conservative approach.

One of my efforts in the early stages of an advisory or investment banking relationship is to help the business owner carefully analyze why he/she wants or needs to maximize growth. Too often, there is little sound strategy, which usually means prospective investors will find the company too risky.

But—for now, let's assume the rationale for wanting to expand the business is sound. This usually means the company has attractive opportunities to enter new markets with profitable products or services, but lacks the capital to fuel that growth.

These companies are strong candidates for angel investments. So—how should they go about attracting the angels?

Different businesses must use different techniques. And—the use of the proceeds will often dictate the approaches to be used. That's because raising money for a business acquisition...equipment purchase...increased marketing...new product development...or buying out a partner or investor each have different preferred investment structures.

Rule of thumb: Expect angel investors to be interested in making

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as much money as possible—while assuming as little risk as possible.

The typical angel is not a friend or family member and is not motivated by any factor other than achieving maximum return.

To succeed, angel investment deals must fairly meet the needs of both the provider and the consumer of capital.

WHAT WORKS BEST...

Two approaches I frequently use in structuring angel financing for private companies...

- **Revenue Participation Certificates (RPCs).** An RPC is a royalty or entitlement to a percentage of revenues. I use RPCs as the inducement for Letter of Credit collateralized one- or two-year bank guarantees.

Example: If an angel is entitled to 3% of the company's revenues for 12 years he/she may provide the credit substitution or enhancement necessary for the business owner to obtain the desired funds from a bank—without the owner having to suffer dilution of ownership.

By using RPCs you can also avoid contentious valuation discussions. The primary areas for RPC negotiation are duration and early termination consideration. The terms surrounding an RPC can be as complex as the combined imagination of the parties...or as simple as, for example, "5% of all revenues over $2 million a year for 10 years."

- **Continental Puts.** They are options that are exercisable only at maturity for a prescribed period of time. They differ from standard American options which are exercisable at any time until maturity.

Example: The company can issue shares to the capital provider with a transferable or nontransferable Continental Put option requiring, on the demand of the holder, the purchase of the shares at the end of three years for three times the purchase price.

That's the equivalent of a 44% annual average compound return—if exercised. The company issuing the shares and undertaking the put purchase option carries the obligation as a contingent liability on its financial statement.

Of course, if the company's stock were to be worth more than the put exercise price at the end of the period the holder of the option might well decide not to put the shares and the contingent liability would be extinguished.

This works well for private companies anticipating going public—for it usually all but guarantees that the price of the stock will be at a higher price at the time of the public offering.

Other angel approaches to financing growth...

- **Sale of—or participation in—certain activities of the company,** such as the right to acquire exclusive sales in designated geographic or industrial areas...a percentage of European sales activity...distribution rights in one or more areas...sub-licensing intellectual property, etc.

- **Partial—or first loss—loan guarantees.** Here, the angel contracts with a bank or another credit provider to accept the portion of the initial loss on a loan or line of credit that the bank has extended to the company.

The angel collects a fee from the company—in the form of cash or equity or a combination—for making the guarantee. If the company being guaranteed is unable to meet its obligation to the lender, the angel steps in to do so, and the company owes the angel the amount the angel has paid to the lender on behalf of the company.

- **Purchase and lease of assets to the company,** such as real property, buildings and equipment.

- **Assignments of intellectual property, brand names, customer lists, etc., as collateral**—as is often done with accounts receivable and inventories.

BASIC QUALIFICATIONS

Before a company can even think seriously about attracting angel investment, it must make sure its business house is in perfect order.

The company must have financial statements—generally fully audited. It should also be prepared to make available all relevant information—tax returns, customer lists, supplier records, etc.

The typical angel wants it all, and is usually uncompromising about having...

- Untarnished belief in the integrity and competence of the business owner.
- Clear evidence that the business will grow and prosper.
- Strong indication that the company's asset value will increase enough to generate the high returns angels expect.

GETTING CONNECTED

Networking is the best way to find angels. Your accountant or lawyer might be helpful—or one of the larger accounting firms, law firms and brokerage firms.

There is a new angel network Web site called ACE-Net (https://ace-net.sr.unh.edu) established at various universities and supported by the Small Business Administration. It promises to link entrepreneurs and angels (see *Bottom Line/Business*, November 1997, p. 11). □□