An Explanation of Angel Investors (*Entrepreneur Magazine* – July 17, 2000)

Entrepreneurs who launch smaller-scale enterprises know that commercial banks generally don't lend funds to ventures with little or no assets, customer base or sales track record. And venture capitalists typically work with business concepts that are already up and running with the potential for multimillion dollar revenues. Many of the owners of smaller firms have heard that "angel investors" can provide funding and even some much-needed expertise and referrals for these in-between business deals. So who are these people and what kinds of investment terms can owners expect?

Angel investors got their name 100 years ago in New York City when struggling playwrights--with limited financial means--had theatrical productions funded by a wealthy and visionary individual (usually at the last minute). It was likened to an angel floating down from heaven with money so the show could go on. But these were also very astute investors with a keen eye for plays with great market potential for tremendous profitability. The bottom line is that these angels funded productions to get in on the ground floor of an extraordinary opportunity for financial gain. Plain and simple, they were in the deal to make money, and in today's business financing arena, that hasn't changed.

Many of the angel investors have made their relative fortunes in other businesses where they had an active role in managing and directing. They typically understand business risks, competition from others in the proposed venture's industry, and the kind of financial structure and performance results necessary to ensure operational success. They expect to see their stake significantly appreciate in value to the next stage when a bank, venture capital fund or acquiring company puts together a larger financial deal to support the continued growth of the firm.

Angel terms usually are structured in one of three ways:

1. They initiate funding with a promissory note, defer monthly or quarterly interest payments for a year or two, and then exercise successive options at various performance benchmarks, converting the debt into an equity position of 15 to 30 percent (depending on the venture scope). They begin as passive creditors during the formative launch phase, but they'll want to see detailed financial statements every few weeks or once each quarter. They'll also require a seat on the board of directors and will hold the entrepreneur to a strict set of sales targets for the first one to two years.
2. They initially take a cumulative convertible preferred stock position. They allow the firm to defer fixed cash dividends for four to eight fiscal quarters while holding a board seat and keeping the entrepreneur tied to the same performance measures as outlined in the first format.
3. They take a common voting equity position right up front, have their place on the board and such but are also actively involved in company management. They may want to bring in one or two associates for 12 to 18 months to assist with the operations, marketing and distribution launch. This can often be the best situation for the entrepreneur and the angel. The owner gets funding and one or more people with specific business experience to help the business get going, and the investor gets a voting equity stake as well as hands-on involvement in running the firm to decrease some of the perceived risks.

Overall, the deal hinges on the quality of the relationship between the angel and the entrepreneur. But remember, angels want to make a huge profit on their funds given the high risk of an early-stage venture. They'll require strict budgets and sales goals. But for the entrepreneur willing to give up some equity and perhaps share some decision-making, angel terms can provide an excellent funding source for new venture development.