Angel Investing

Lucinda Linde
Walnut Venture Associates

ENET October 2012
# Walnut Venture Associates: Where We Focus, How We Operate

<table>
<thead>
<tr>
<th>Objective:</th>
<th>To help talented entrepreneurs build lasting businesses of significant value and to participate as active investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Focus</td>
<td></td>
</tr>
<tr>
<td>Geography: New England</td>
<td></td>
</tr>
<tr>
<td>Industries: Information Technology, Software, Internet in Rapidly Growing Markets</td>
<td></td>
</tr>
<tr>
<td>Stage: Seed, First Round, Expansions</td>
<td></td>
</tr>
<tr>
<td>Typical Round: $50,000-300,000</td>
<td></td>
</tr>
<tr>
<td>Leverage the Strength of our Members</td>
<td></td>
</tr>
<tr>
<td>Each Walnut member brings in a unique and valuable blend of operating experience, deal flow, industry expertise, financing capability and contact base to help make Walnut investments successful.</td>
<td></td>
</tr>
</tbody>
</table>

**Walnut Venture Associates looks for exceptional people with exceptional ideas.**

| Integrity: | We will handle all constituents in our dealings with integrity |
| Commitment: | Members should actively participate in the investing operations of Walnut. For example, each member is encouraged to participate in two or more due diligence teams, lead one or more team each year and bring one or more companies in for Tuesday presentations. |
| Speed: | Walnut will crisply and professionally move forward the due diligence process. |
An HBS/MIT Study Captured Best Practices of Established Angels

Professor Howard Stevenson at HBS and Ken Morse of the MIT Entrepreneurship Center provided visionary direction for an in-depth study on angel investors, VSS Project: Report on Angel Investors. Lucinda Linde and Alok Prasad co-authored the study. The Project was generously funded by the Kurtz Fund For Venture Support Systems.

Total Number of Interviews Conducted
- Established Angel Investors: 26
- Angel Groups: 12
- Complementary Interviews with Lawyers, Accountants, I-Bankers, Entrepreneurs & VCs: 15
Angel Investors

Agenda

1. How do angels fit in the funding life of a company?

2. Who are these angels and what do they want?

3. How do angels operate?
1. How do angels fit in the funding life of a company?
# How Do Angels Fit in the Funding Life of a Company?

<table>
<thead>
<tr>
<th>Financing Round</th>
<th>Definition</th>
<th>Typical Amounts</th>
<th>Who Typically Plays</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seed</td>
<td>Prove a concept/qualify for start-up capital</td>
<td>$25,000–500,000</td>
<td>Individual Angels, Angel Groups, Recently: VCs in Internet</td>
</tr>
<tr>
<td>Start-up</td>
<td>Complete product development and initial marketing</td>
<td>$500,000–3,000,000</td>
<td>Select Individual Angels, Angel Groups, Early-stage Venture Capitalists</td>
</tr>
<tr>
<td>First</td>
<td>Initiate full-scale manufacturing and sales</td>
<td>$1,500,000–5,000,000</td>
<td>Venture Capitalists</td>
</tr>
<tr>
<td>Second</td>
<td>Working capital for initial business expansion</td>
<td>$3,000,000–10,000,000</td>
<td>Venture Capitalists, Private Placement Firms</td>
</tr>
<tr>
<td>Third</td>
<td>Expansion capital to achieve break-even</td>
<td>$5,000,000–30,000,000</td>
<td>Venture Capitalists, Private Placement Firms</td>
</tr>
<tr>
<td>Bridge</td>
<td>Financing to allow company to go public in 6–12 months</td>
<td>$3,000,000–20,000,000</td>
<td>Mezzanine Financing Firms, Private Placement Firms, Investment Bankers</td>
</tr>
</tbody>
</table>

Source: VSS Project Angel Investors: a joint HBS/MIT study on Angel Investors; definitions taken from Pratt’s Venture Capital Guide ©1999 MIT Entrepreneurship Center
Angels Invest in the Majority of Startup & Early Stage Deals

Number of Deals in 2009: Angel Investment and Venture Capital

Source: “Jeffrey E. Sohl, Center for Venture Research” and 2010 NVCA Yearbook
Mostly Complementary Funding Sources

2011 Angel Investment
source: UNH CVR

$22.5B
66,230 deals
Average Round
$340k
Earlier stages

2011 VC Investment
source: NVCA/PWC/VE

Later stages
$41B
3752 deals

1449 Early Stage
412 Seed

source: James Geshwiler
updated to 2011
2. Who are these angels and what do they want?
Angel Groups are Small - *but Important* - Subset of All American Angels

<table>
<thead>
<tr>
<th>U.S. Millionaires</th>
<th>Informal Investors</th>
</tr>
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<tbody>
<tr>
<td>4,200,000</td>
<td>3 study estimates</td>
</tr>
<tr>
<td></td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Active Angels Center for Venture Research</th>
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<tbody>
<tr>
<td>225,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investors in Angel Groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>12,000</td>
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</table>

2009 Report from Spectrem: $1 millionaires down in 2008 27%, those with $5 million down 28%

World Wealth Report (Capgemini): 19% drop in HNWI and 22.8% drop in wealth in 2008
Growth in Number of American Angel Groups

Sources: Center for Venture Research (pre 03 data) and Kauffman Foundation/ACEF (04-09 data)
Profile of Angels - Median

- Years investing: 9
- Number of investments: 10
- Total exits/ closures: 2
- Years as entrepreneur: 14.5
- Number ventures founded: 2.7
- Age: 57
- Percent of wealth in angel investing: 10%
- Education: Masters degree

Source: *Returns of Angels in Groups*, Robert Wiltbank and Warren Boeker (funded by Kauffman Foundation)
Investors seek 3-10x returns over 3-7 yrs.

Can we get a great exit valuation?
  - Revenue ramp, Hot space, Best in class
  - Number of acquirers, Prices paid, Channel leverage

Window of opportunity or lots of chances

Amount of capital required over life: dilution and cram down risks
While Angels Do Seek High Financial Returns, They Also Seek Psychic Returns

- Desire to "Give Back"
- Involvement
- Networking
- Other
- Up-to-Date
- Intellectual Challenge

Number of Mentions

<table>
<thead>
<tr>
<th>Motivation</th>
<th>Number</th>
</tr>
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<tbody>
<tr>
<td>Desire to &quot;Give Back&quot;</td>
<td>15</td>
</tr>
<tr>
<td>Involvement</td>
<td>14</td>
</tr>
<tr>
<td>Networking</td>
<td>7</td>
</tr>
<tr>
<td>Other</td>
<td>11</td>
</tr>
<tr>
<td>Up-to-Date</td>
<td>6</td>
</tr>
<tr>
<td>Intellectual Challenge</td>
<td>6</td>
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</table>

Multiple Responses Allowed

Number of Angels Responding to Question: 25
3. How do angels operate?

"I'm sorry, but you don't get frequent flyer miles for regularly investing in high risk securities."
Angels Operate With a Rich Diversity of Styles and Motivations—To Simplify, We Defined Four Categories of Angels

<table>
<thead>
<tr>
<th>Operational Expertise Angels</th>
<th>Guardian Angels</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Execs from Large Industry Players</td>
<td></td>
</tr>
<tr>
<td>• Active or Passive</td>
<td></td>
</tr>
<tr>
<td>• Provide Industry Knowledge and Contacts</td>
<td></td>
</tr>
<tr>
<td>• Valued by VCs</td>
<td></td>
</tr>
<tr>
<td>Financial Return Angels</td>
<td>Professional Entrepreneur Angels</td>
</tr>
<tr>
<td>• Investing wealth from family or occupation (doctor, lawyer etc.)</td>
<td></td>
</tr>
<tr>
<td>• Passive</td>
<td></td>
</tr>
<tr>
<td>• Cannot offer industry or entrepreneurial support</td>
<td></td>
</tr>
<tr>
<td>• Created a company before in this industry</td>
<td></td>
</tr>
<tr>
<td>• Active in one or two per year, take board seat</td>
<td></td>
</tr>
<tr>
<td>• Can Provide Industry Contacts and Company Building Support</td>
<td></td>
</tr>
<tr>
<td>• Highly valued by VCs</td>
<td></td>
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</tbody>
</table>

©2000 MIT Entrepreneurship Center
## Angels Operate Differently Than Venture Capitalists

<table>
<thead>
<tr>
<th>Aspect</th>
<th>Experienced Angel</th>
<th>Venture Capitalist</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stage</td>
<td>Seed, Start-up</td>
<td>Early Stage VC- Seed to Exit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Mainstream VC- First Round to Exit</td>
</tr>
<tr>
<td>Investment</td>
<td>Individuals $25,000-$750,000 Groups $500,000-$1,500,000</td>
<td>Early Stage VC- $3,000,000 +</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Mainstream VC- $5,000,000 +</td>
</tr>
<tr>
<td>Speed</td>
<td>Rounds can close in few months</td>
<td>Rounds often take 6+ months</td>
</tr>
<tr>
<td>Due Diligence</td>
<td>Varies, can be extensive. Based on judgement of individual or group.</td>
<td>More exhaustive, with help of junior associates</td>
</tr>
<tr>
<td>Entrepreneur</td>
<td>Willing to Invest in First Time Entrepreneurs</td>
<td>One VC invested &gt;70% of their funds in repeat entrepreneurs</td>
</tr>
<tr>
<td>Valuations</td>
<td>Individuals- Varies Groups- Approaches VC norms</td>
<td>Stick to VC Norms (+/-15%)</td>
</tr>
<tr>
<td>Level of Involvement</td>
<td>Passive- Minimal involvement Active- Company building advice, industry contacts, VC introductions, financing strategy, recruiting assistance</td>
<td>Active, especially in Financial Strategy and Recruiting Top Management</td>
</tr>
</tbody>
</table>

Source: VSS Project Angel Investors: a joint HBS/MIT study on Angel Investors ©1999 MIT Entrepreneurship Center
Deal Sourcing: Experienced Angels Rely on Their Network of Trust to Supply Pre-Screened Deals

Deal Sources of Established Angels

<table>
<thead>
<tr>
<th>Source</th>
<th>% of Deals from Various Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>From Entrep.</td>
<td>18</td>
</tr>
<tr>
<td>Business Assoc.</td>
<td>37</td>
</tr>
<tr>
<td>Angel Group</td>
<td>24</td>
</tr>
<tr>
<td>Attorney</td>
<td>5</td>
</tr>
<tr>
<td>Acct &amp; Consult.</td>
<td>2</td>
</tr>
<tr>
<td>I-Bankers</td>
<td>1</td>
</tr>
<tr>
<td>VC</td>
<td>12</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
</tr>
</tbody>
</table>

No. of Angels Responding to the Question: 23

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A Typical Angel Investing Process

**Pre-Screening**
- Geography
- Industry
- Potential For High Returns
- Initial Assessment of Business Idea/Model
- Initial Assessment of Entrepreneur
- Initial Assessment of Management Team

**Initial Presentation**
- 30-60 Minute Presentation
  - 50% Presentation
  - 50% Q&A
- Problem Solved
- Market Size/Growth
- Solution
- Initial Markets and/or Customers
- Team Track Record
- Business Model
- Capital Needs and Milestones
  - Now
  - Next Rounds

**Due Diligence**
- Follow-up Meeting: Meet with Key Management at Company Office
- Thorough Due Diligence
  - Personal References
  - Customer References
  - Competitive Assessment
  - Financial Review
- Negotiate Term Sheet

**Investment and Support**
- Board Seat
- Refine your business plan
- Help Recruit Key Management
- Introduce Company to Sources of Follow-on Financing
- Guidance on Financial Strategy
- Make key contacts for strategic partnerships
- Configure the company for an IPO or being acquired
# Deal Screening: Seek to Determine the Key Drivers of the Company’s Success

## Introduction and Concept
- **Pre-screening**: Is the company within the geography, valuation, and industry focus of the angel?
- **Elevator Pitch**: Briefly state what important problem is solved and how the company will make money.
- **Concept**: Describe the product or service offered and how it solves an important problem.

## Markets and Customers
- Demonstrate there is a rapidly growing market and briefly describe one or two driving forces.
- **Customers**: Who will buy this and what is it worth to them?
- How will the company reach/sell to the customers?

## Management Team
- Tell us why this team can execute and win
  - Relevant industry experience
  - Customer knowledge/contacts
  - Technology expertise
  - Company/organization building skills
  - Other experience or skills needed

## Competition
- What are the alternative ways of solving the problem?
  - Who are the competitors?
- How does this offering differ from the others?
- Tell us why and how the company can win

## Finances and Capital Needs
- Show high level revenues and costs, and include the major driving assumptions of your business model.
- State the total capital needed to achieve cash flow breakeven and profitability; and the anticipated financing rounds over time.
- How much capital is needed for this financing and what is the valuation of the company?
- How will investors exit?
  - IPO—why is this a good company for an IPO?
  - Being acquired—who would buy and why?

## Other
- Are there any crucial alliances required to execute the business model such as distribution or technology?

Source: Walnut Venture Associates Investing Process
**Due Diligence: Assess the Key Elements of the Business to Decide Whether to Invest and on What Terms**

### 1. Market, Customers, Sales

**Documents**
- Business plan
- Sales Pipeline Documents - Prospects, revenue projections, probability

**Interviews**
- Customer references: validate need, willingness to pay, comments on competition, impression of the team
- Current, prospective and rejected channel partners references
- Industry experts

**Assessment**
- Growth and size of market
- Initial customers
- Sales cycle: revenue velocity
- Distribution channel: motivated

### 2. Produce/Service Offering

**Documents**
- Business plan, marketing literature

**Interviews**
- Alliance partners
- Customers: functionality

**Assessment**
- Technical Assessment & Demo

### 3. Management Team

**Documents**
- Full resumes

**Interviews**
- Reference checks on top management

**Assessment**
- Work with them to see leadership, coachability, commitment
- Weaknesses or gaps in the team
- Are they financeable by VCs?

### 4. Competition

**Documents**
- Business plan

**Interviews**
- Customer & Alliance references and industry experts; discuss competition

**Assessment**
- Assess threats of players to company; positioning, strength, focus, lead-time, financing, management team

### 5. Financials

**Documents**
- Revenue and costs going forward with driving assumptions
- Cash flow - past and future
- Capitalization Table
- Options plan
- Funding plan with milestones
- Financing history with valuations

**Interviews**
- Discuss business model assumptions, costs, hiring with management

**Assessment**
- Valuation for this round
- Follow-on capital needs and likely sources
  - Milestones and valuations
- Robustness of business model; sensitivity to driving assumptions
- Straightforward capital structure
- Previous investors
- Realistic path to exit

Source: Walnut Venture Associates Investing Process
Angel Investors

• **Address the Risks**
  - Management Risk: Experienced Teams
  - Market Risk: Revenues and Customers
  - Financing Risk: Deep Pockets, in Early if Possible
  - Operating Risk: Drive to Cash Flow Break Even
  - Technology Risk: Top Notch Talent; Patents

• **Walk Away from Optimistic Valuations**
  - Lower Exit Valuations in the Public or M&A Markets
  - Mean Lower Valuations at Each Stage

• **Maintain Your Pro-Rata**
  - Set Aside Capital to Play In Follow-On Rounds
2. Companies in Promising Markets; with Customer Traction

- Marquee customers paying cash for your product because they receive compelling benefits
- Customers that validate the business model assumptions
- Customers that validate the size and expandability of the opportunity

- Promising Markets:
  - Software/Internet
  - Biotech
  - Medical Devices/Equipment
  - Medical Software/ Info Services
  - Consumer and Business Services
  - CleanTech
  - Semiconductors

1. Great Teams

- Repeat Entrepreneurs
- Proven Functional Heads
- Industry Veterans

3. Protectable Technology

- Proprietary Technology
- Patentable Technology
- Compelling Benefits

4. Credible Operating Models

- Verifiable revenue model
- Credible distribution strategy
  - Credible operating plan
- Capital required to break even
- Milestones achieved for slices of capital
After Investing: Active Angels Can Help Build Valuable, Lasting Companies

Post-Investment Involvement: Perceived Strong Contribution by Active Angel Investors

Number of Mentions

<table>
<thead>
<tr>
<th>Category</th>
<th>Number of Angels Responding to Question: 25</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recruiting Board</td>
<td>16</td>
</tr>
<tr>
<td>Recruiting Mgmt</td>
<td>21</td>
</tr>
<tr>
<td>Cust./Rel. Bldg</td>
<td>9</td>
</tr>
<tr>
<td>Fin. Strat.</td>
<td>21</td>
</tr>
<tr>
<td>Recruiting VCs</td>
<td>20</td>
</tr>
<tr>
<td>Other</td>
<td>10</td>
</tr>
</tbody>
</table>

Note: Multiple category mentions allowed
VCs: Annual Round Allocation

Deal Flow Allocation by Round Class (1995-2011)

*Seed and First Rounds Combined

Source: NVCA/PWC MoneyTree
Recent VC Surge in Seed Investments

Source: CB Insights
Special Case: VC Seed Surge in Internet

Source: CB Insights