July 16, 2019

Angel Investing Lessons: The First Mover Disadvantage Part 1

Despite the explosive growth of institutional venture capital in recent years, independent Angel investors remain vital components of the high risk/reward entrepreneurship ecosystem. Good Angels fill a role – hands on, value added capital in small amounts at the earliest, riskiest stage of the entrepreneurship cycle – that most of today's larger venture funds, focused as so many of them are on deals (and entrepreneurs) that are ready for bigger chunks of capital sooner rather than later, just don't have time for.

Just as Angels remain important players, so they remain vulnerable to the bane of the Angel investing business model: taking an investment bath when the VCs come to the table for the Series A round and beyond.

That isn't to suggest that there aren't plenty of examples of Angels reaping their just rewards for first mover investing jobs well done. But, there are as well many examples of Angels finding their early stakes washed out by later-arriving venture investors. VCs who go on to pocket handsome profits while the Angels lick their wounds and wonder how they ended up holding the short end of the investment stick.

The washed out Angel role is one I've experienced myself, and when it happens the insult is almost as bad as the injury (I'm a pretty small Angel investor, so the injury is seldom serious). Seeing the entrepreneur (that you thought was your friend) and the venture investors (after you set the table for them), harvest the investment crop while you get the stubble is more than a little frustrating.

And yet, it happens. A lot.

Today, we'll look at the post-Angel round negotiating dynamics that often conspire against Angel investors. In Part II of this series, we'll look at how smart Angels plan ahead to mitigate those dynamics.

Most of the time, the groundwork for an Angel washout is laid with a surfeit of good intentions and a shortage of venture

Related Practices

Fund
Grow
Sell
Start
Venture Capital & Private Equity

capital realpolitik. Ultimately, it's rooted in a common Angel assumption: that being right about their investment in terms of size, timing and milestones is the *sine qua non* of a good Angel investment. Unfortunately, while being right about those things is important, it is frequently not enough.

The reason getting the investment basics doesn't by itself make a good investment has to do with the dynamics of the post-Angel financing game. Truth be told, VCs don't care about what anyone, including Angel investors, might have done for them lately; they only care about what folks can do for them going forward. Thus, when they arrive on the scene of an Angel-financed startup, they don't ask themselves "how can we reward the folks who created this opportunity for us," but rather "who are we counting on to make this deal work for us going forward?"

Let's look at a hypothetical, with the usual caveat that the hypothetical is illustrative of a certain paradigm. It's simplified without being simplistic.

For purposes of our illustration let's assume that Newco was founded by Cain and Abel with 50/50 ownership. Along comes Angel who pays $200k for a 20% interest in Newco – 200,000 shares at $1.00/share. An equity incentive pool of 100,000 shares is also set up, and Cain and Abel each own 350,000 shares. If you work through these numbers, you'll find that the pre-money valuation for the Angel round was $800k and the post-money valuation was $1 million.

Some months later, the Angel round milestones have been met. For whatever reason, at this point Abel is now critical to Newco's next steps; while Cain's mission critical contributions are in the past. At this point, VC Black Hat shows up and figures to invest $1 million in Newco in an A Round in exchange for 1/3 ownership of Newco. Angel, having allocated all of the capital it has available for Newco, will sit on the sidelines for the A Round. Secure (and correct) in the knowledge that Angel got the size, timing, and milestones of the Angel Round just right and so having understandable expectations of doing well by the A Round.

On these numbers, the "obvious" deal (at least to Angel, if not to you) is done at a $2 million pre-money valuation, with Black Hat paying $1 million for 500,000 shares, or $2.00/share. Post A Round, Angel can then point to a nice 2x step-up on its $1.00/share investment in the Angel Round, while Black Hat gets its 1/3 stake in Newco for it's $1 million investment at $2.00 per share.

Post $200k Angel Round @ $1/Share; $800k Pre			Post $1 Million A Round @ $2/Share; $2m Pre	
Abel	350,000	35%	350,000	23.3%
Cain	350,000	35%	350,000	23.3%
Pool	100,000	10%	100,000	6.7%
Angel	200,000	20%	200,000	13.3%
Black	-	-	500,000	33.3%
Total	1,000,000	-	1,500,000	

Life is good, it seems. Black Hat bought 1/3 of the company for $1 million, and while everyone got diluted by 1/3, they also get to point to a nice 2x step-up on the share price in the transaction.

Or maybe life is not so good after all. Black Hat, as it turns out, has a more … nuanced … view of the post-Angel/pre-A Round landscape.

When Black Hat looks at the pending Newco A Round, it sees more than numbers. It sees a mix of folks variously interested in and valuable to Newco's future prospects. Four players, actually, each with its own interests and value proposition. There is Black Hat (the guys with the gold, and thus the enforcers of the golden rule); Abel (the founder who remains critical to success); Cain (the founder who, not to point to fine a point on it, could be hit by a bus on the way home from the A Round closing without any real hit to Newco's prospects); and Angel (who, sad it say, is if anything even less important to Newco's future prospects than Cain). Black Hat also concludes that the 100,000 shares in the Pool post-A Round, looks light next to Newco's future team building needs.

With this more … sophisticated … appreciation of how much future value the various folks on the Newco bus have to contribute, Black Hat has another idea for the A Round. An idea that (of course) gets Black Hat its 1/3 interest for its $1 million investment, but as well maximizes the incentives for future value contributors. Unfortunately (for Angel and Cain), though, this A Round scenario is at a $1 million pre-money (the post-money on the Angel Round) at $0.50/share (a 50% markdown from the Angel share price).

	Post $200k Angel Round @ $1/Share; $800k Pre		Post $1 Million A Round @ $0.50/Share; $1.5m Pre	
Abel	350,000	35%	1,000,000	33.3%
Cain	350,000	35%	350,000	11.7%
Pool	100,000	10%	450,000	15.0%
Angel	200,000	20%	200,000	6.7%
Black	-	-	1,000,000	33.3%
Total	1,000,000	-	3,000,000	

This more … sophisticated … A Round structure has some important advantages for Newco, providing extra incentives, as it does, for critical extant players (Abel), and critical new players going forward (more shares in the Pool). All without requiring any sacrifice on Black Hat's part. (Indeed, Black Hat's path towards an up B Round is easier with a lower A Round post-money valuation.)

All those benefits, of course, come from somewhere. In this case, from Cain and Angel, both of whom experience 2x the dilution they would have experienced under the “obvious” A Round deal at $1/share and $2 million pre-money. That hardly seems fair. And I suppose it isn’t. But it’s realpolitik. Yet, don’t look for Black Hat to lose any sleep over it. As for Abel, well, he may lose a little but, in my experience, not much, and not for more than a night or two.

As noted, our example is just that, an example. It is illustrative, however, of the general dynamics of a post-Angel financing VC-led A Round of financing (and, indeed, of subsequent VC Round dynamics). The point is that there are multiple players at each round; players that often have divergent interests and leverage to massage the specifics of the A Round to their respective advantages. It is critical to recognize this – and in many cases to recognize it well before the A Round negotiation begins.

Next time, how Angels can minimize their risk of being downsized by the Black Hats of the world.

Related People

Paul Jones
Of Counsel
pajones@michaelbest.com
T 608.283.0125

Paul Jones
Of Counsel
pajones@michaelbest.com
T 608.283.0125