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Angel Investing Lessons: The First Mover Disadvantage Part II

In Part I of this short series, we looked at how the dynamics of A Round financing negotiations can work against earlier Angel investors. As much as A Round VCs might appreciate an Angel setting the table for them, their real concern is maximizing their own return. To the extent that means transferring some of a deal's upside from earlier Angels (and other pre-A Round contributors) to themselves, well, c'est la guerre.

Today, we look at what Angel investors can do to reduce their exposure to being played by later venture investors. While there is no failsafe tool, there are a number of steps Angels can take that, in various deal scenarios, can at least mitigate their exposure in the A Round.

Probably the most conventional way to mitigate an Angel's risk of being washed out in the A Round is taken right out of the venture capital playbook: at the Angel Round itself (i) set aside some dry powder to invest in the A Round, and (ii) make sure to include a pro rata preemptive right in the Seed Round agreements. When venture investors get into a deal, they routinely earmark at least as much dry powder for future investments in the company as they invest in the entry investment. Angels should – but often don't – do the same thing.

Of course, participating in the A Round doesn't make the A Round VC any less likely to juice her deal at the expense of the Angels Seed Round shares. It does, however, at least direct a portion of that juice back at the Angel investor via his own A shares.

Another way to mitigate Angel exposure at the A Round is making sure the Pool for future incentives is big enough to withstand scrutiny at the A Round. For whatever reason (most likely because it juices the apparent valuation at the Seed Round, which appeals to the entrepreneur), most Seed Round deals undershoot the size of the Incentive Pool that will be needed going forward. In turn, that makes a boost of

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the Incentive Pool more likely at the A Round. That boost, typically, comes at the cost of additional dilution to the folks already at the party when the A Round comes around.

Closely related to making sure the Incentive Pool is sufficiently large at the Seed Round is making sure that founder equity split at the Seed Round reasonably reflects the contributions of the various founders, both in magnitude and vesting arrangements. The tendency for founders to split their equity equally may be understandable, but it is usually more emotionally-driven rather than the result of critical thinking. As hard as the discussion might be for the founders and the Seed Round Angel, passing by that conversation at the Seed Round basically invites the A Round VCs to fix the problem.

(These last two points are both rooted in a common Seed Round negotiation dodge, where the Angel and the Founders punt on serious valuation and value-add differences by fudging the Incentive Pool allocations in the first case and the Founder allocations (as between the founders) in the second. The Angel should not be surprised when that negotiation expediency comes back to bite them in the A Round.)

One of the most powerful ways to protect Angel investors from excessive dilution in the A Round and beyond – in theory, if not always in practice – is to include strong protective provisions in the Angel Round agreements. More particularly, include a protective provision (one that the A Round will almost certainly include) giving the Seed Round shares a veto right over any future issuance of shares with rights equal or superior to the Seed Round shares.

As noted, this approach works very well in theory (assuming you can get it done), but the real world has some limitations. In particular, the legal right to block a future sale of equity is nice, but in the actual event, there are limits to that leverage based on the company's (and the Angel's) financial realities. Saying "no" to a new investment is all well and good – if it is practical. Saying "no" when the alternative is running out of cash and tanking the business is usually not practical.

And so, therein lies another way for Seed Round Angels to mitigate their A Round exposure. Encourage the company to look far and wide for A Round investors. As pretty much everyone knows (or should know), by far the best way to maximize the valuation of any financing round is getting more potential investors interested in the deal. Boosting the A Round valuation does not eliminate Angel exposure to excessive dilution (it doesn't address any negotiated increases in incentive grants or the incentive pool) but, all other things equal, a higher valuation makes for less dilution.

Finally, one "soft" approach to limiting excessive Angel dilution can be very powerful: stay relevant to the deal, and on good terms with the key founder and any other key employees of the company. Just as the A Round investors will be keen on making sure key founders/employees are well-incented after the A Round, so they will want those folks feeling good about the A Round. To the extent key founders/employees consider their Angels useful and/or their friends, they will be less agreeable to letting the A Round VCs cast them aside. Or, at least not as far aside as they might absent that good will.

Again, Angels too often find themselves suffering substantial dilution at the A Round, even in situations where (as in the example in Part I) on paper the pre-money of the A Round exceeds the post-money of the Angel Round. Avoiding that fate is problematic: there is no practical tool that completely eliminates the potential realities of being taken to the cleaners by the A Round investors. There are a number of steps, though, that can give Angels some meaningful leverage at the A Round negotiating table; leverage that can mitigate first the risk and then the extent of suffering excessive dilution at the hands of the A Round investors.

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