

# Angel Investing – Structuring for Success

Alberta Deal Generator  
Investor Briefing

March 26, 2008

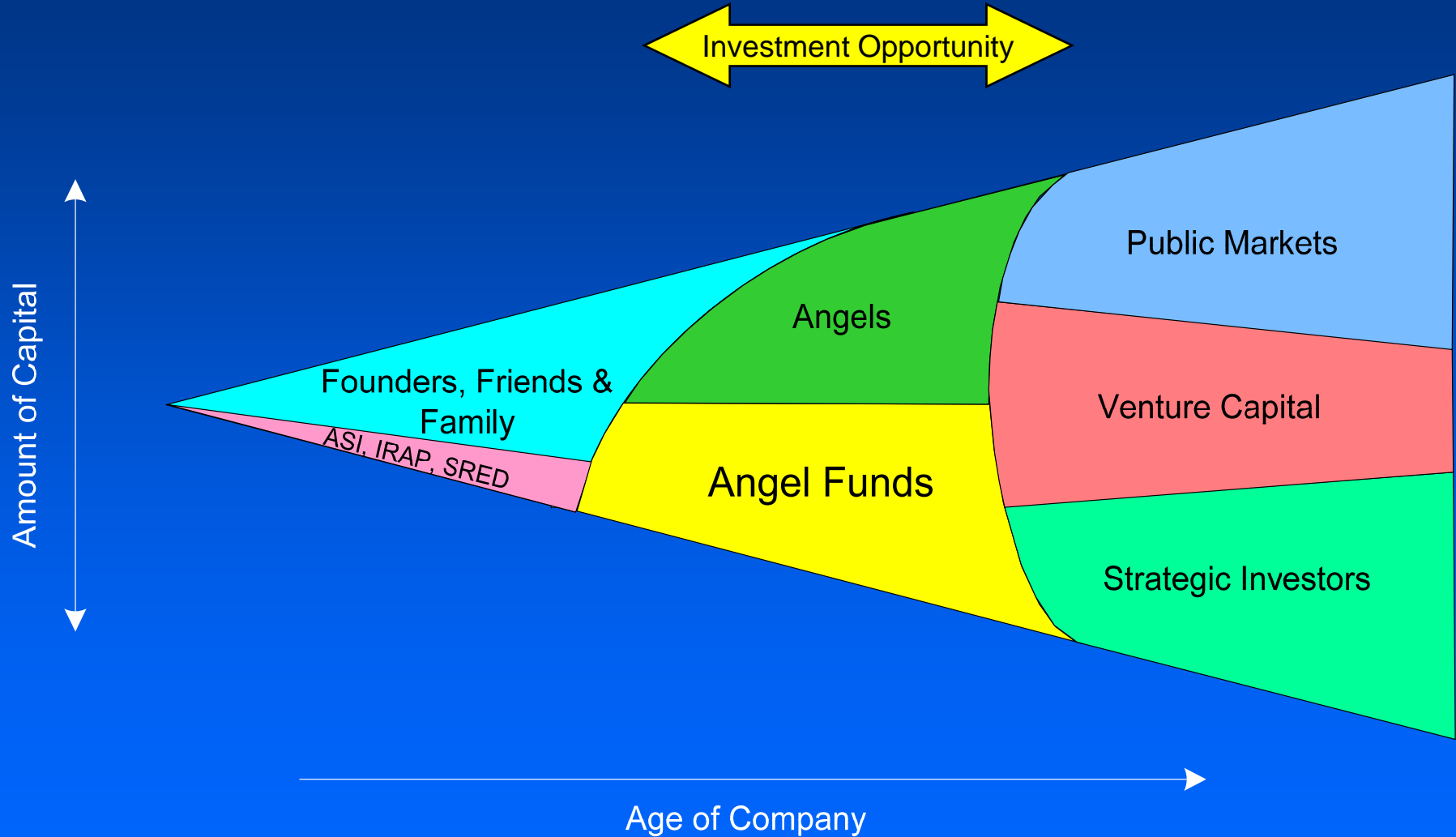
By Basil Peters

# Angel Investment in Canada

- Angel investors are a critically important part of Canada's economy and our future.
- Canadian angels invest about \$3.5 billion per year.
- About twice as much as all venture capital funds.
- Angels invest in 30,000 companies per year.
- On average, receive an 27% internal rate of return.

Source: National Angel Organization 2007 Fact Sheet.

# Investment Opportunity



# Angel Case Study - Brightside



# The University Spin Out

- Spin out company from the University of British Columbia Physics Department.
- University paid for the research and patents.
- UBC took shares not a royalty.
- I invested three times.
- Invested the first time when there was only two people on the payroll.
- At a pre-money valuation of \$3.2 million.

# The Entrepreneur - Helge Seetzen

- Helge came to Canada in 1998 when he was 19.
- He completed high school in Germany, and spent an obligatory year in the military.
- When he arrived, his first priority was to learn to speak English.
- Helge had an idea for a student project (a common theme among University Millionaires).
- That project got him introduced to Professor Lorne Whitehead in the Physics department at UBC.

# The Professor - Lorne Whitehead

- Professor Whitehead has over 100 patents.
- Lorne offered Helge a job in his lab as a junior research assistant.
- Helge's job included labeling storage boxes, maintaining the computer network and helping to build prototypes.
- Helge got excited about Dr. Whitehead's experiment to increase the brightness and dynamic range of liquid crystal displays (LCD's).

# The First Angel Investor

- In 2001, they started a company called Sunnybrook.
- Lorne and Helge introduced Don Graham to their idea.
- Don is a classic angel investor and capable mentor.
- Made his money with Canadian Tire franchises.
- Don and Lorne's "Friends and Family" provided the first 'couple hundred thousand dollars'.

# The Angel Rounds

- Sunnybrook presented at the local Angel Investor forums and several angels invested.
- My fund invested along with the angels.
- I also invested in the next two rounds,
- And helped design the financing strategy.
- Sunnybrook also completed an unusual brokered private round with Raymond James.
- Raising almost \$7 million in total.

# The Almost VC Rounds and Exit

- The company was renamed Brightside in 2004.
- Brightside tried for two years to raise money from traditional VCs, but never did.
- In part due to the ‘Preferred Share Issue.’
- This was even written up in the Globe and Mail.
- Dolby Labs acquired Brightside in February 2007.
- For \$28 million in cash.

# Everyone Made Money

- Helge is still in charge of research -but now he is a multi-millionaire. (He is still only 29 years old.)
- Professor Whitehead made a lot of money.
- The university made millions.
- All of the angels made good returns.
- My fund made a 300% return in about 3 years.
- VCs almost certainly would have blocked the sale.

# Common Elements

- All of the capital in Brightside came from angels and two angel funds.
- All structured as simple common shares.
- The university also had shares, not a royalty.
- No VC investors.
- Board was angel investors and one from the university.
- Early exit at very good returns.

# More on Brightside

- This is a classic angel case study.
- There is much more to the Brightside story.
- A more detailed description is online at:
- [www.University-Millionaires.com](http://www.University-Millionaires.com)

# Best Practices for Angel Investing

- Angel investing is still relatively new.
- Venture capitalists who have been around for several decades longer,
- Developed most of their common structures and methodologies in the mid 1980s to mid 1990's.
- The difference is analogous to parenting, what works well for your toddler does not work for your teenager, and vice versa.
- Angel best practices are just now being developed.

# Angel Investing Is Different

- The total capital invested might only be a few hundred thousand dollars in the first round.
- The legal fees should only be a few thousand dollars.
- This necessitates clean, simple documentation that is much shorter than standard VC investment agreements.
- KISS and focus on what's really important for success.

# Structuring - KISS

- In the 1990's traditional venture capitalists developed ever more complicated preferred shares and definitive agreements.
- Created complex corporate structures and fundamentally flawed relationships between the entrepreneurs and investors.
- Today, there is an encouraging move back to common shares.
- And keeping it simple.
- And fair.

# Structuring Objectives

- Fairness
- Alignment
- Governance
- All built into the structure of the company,
- From the first investment agreement.

# Structure Affects Success

- Corporate structures are like foundations in buildings.
- When angels invest, company structures and boards are often not well developed.
- Most angels see this as an opportunity.
- At these stages in a company's development, it is easy to improve the corporate structure.
- This can significantly improve the probability of a successful investment.

# It's A Little Different in the US

- Most of what is written about angel investing comes from America.
- I speak most often to groups of US investors.
- There are differences in style and legal structure.
- Most US angel investors use preferred shares.
- Some of the reasons are built into their tax system.
- A lot is just legal familiarity.

# Pref Shares and Convertibles

- Most VCs still require pref shares.
- This can make sense for later stage companies and larger financings.
- Recently, angels have been using convertible notes.
- As protection against VC terms and structures.
- In my opinion, almost never fair to the angels.
- The 'discounts' would have to be much higher and time based and therefore unpalatable.

# Exchangeable Shares

- Combines the best ideas in the convertible notes,
- With a more fair, and intuitive, pricing mechanism.
- The idea is simple:
  - Angels invest in commons shares (like we have always done)
  - At the price per share that makes sense at the time.
  - But if a VC comes along later and gets a better kind of shares, like prefs, we can convert into those shares to get the same benefits.
  - The pricing on the angels' shares does not change, just the terms and conditions.

# Fairness

- Successful early-stage investing is always win-win.
- If the agreement is not actually fair, and seen to be fair,
- today, and in the future,
- the lack of fairness itself can be sufficient to cause an embryonic company to die.

# Alignment

- Means that everyone is working toward the same objective.
- The starting place is everyone having the same type of financial interest.
- Misalignment builds failure modes into the corporate structure and company DNA that may not be apparent for years.
- Angels and entrepreneurs are holding onto common share structures to maintain alignment.
- Just say “No” to prefs, royalties and convertibles.

# Valuation

- Always challenging to do for start ups.
- There are literally only a few papers written.
- Impossible to do quantitatively.
- The Kauffman Foundation is building consensus.
- More based on 'gut' and 'instinct.'
- As much psychology as technology.
- Most important consideration is to be fair.

# Valuation Guidelines

- A few simple guidelines:
- For pre-revenue companies without extensive patent portfolios,
- Friends and Family round valuations are usually in the range of \$0.5 to 1 million.
- The Angels, should be investing at valuations in the range of \$1 to 3 million.

# Governance Instead of Legals

- VC investment agreements grew to 100+ pages because the investors did not trust the board to make the right decisions.
- This is the root cause of the misalignment.
- A solution is:
  - Make a good board a pre-requisite to investing, and
  - Build good governance into the corporate structure.

# Boards

- Boards are more important than CEOs.
- Even very young companies need engaged, capable boards.
- All directors, except the CEO, must be fully independent of management.
- All directors must have made a meaningful (to them) investment in the company.
- All nominees should be acceptable to the CEO and investors.

# Director Time Commitment

- The minimum time required is directly related to how fast the company is changing.
- A board for a single property real estate company might be able to do a good job in one half a day per quarter.
- A lead director for an early-stage, high-growth technology company might need a day per week, or even more.

# Harder To Attract Good Directors

Business in Vancouver February 18-24, 2003

## Insurance hikes force lawyers off boards

Clark, Wilson discourages appointments; partner off DataWave board

Tracy Tjaden

**U**.S. corporate governance scandals have pushed insurance rates sky-high, forcing one Vancouver law firm to discourage its lawyers from sitting as directors of public companies.

Bernard Pinsky, a partner of corporate law firm Clark, Wilson, resigned from Vancouver-based DataWave Systems Inc.'s board of directors February 7.

In total, Clark, Wilson lawyers have resigned from half a dozen boards in recent months.

Two years ago, its lawyers sat on about 25 boards of public companies, Pinsky said. The firm's lawyers are in the process of resigning from all public company boards.

The firm's insurance costs for directors' and officers' liability insurance shot up 150 per cent this year over last year. That's after a 75-per-cent increase last year over the year before.

"It's the big corporate governance failures in the U.S. that have driven rates up because [the insurance companies] are paying out billions," said Pinsky.



Resigned: Lawyer Bernard Pinsky left DataWave board due to insurance costs

# Director Compensation

- Good boards dramatically increase chances for success.
- Directors will have to make a significant time commitment.
- And accept very real personal risk.
- The company has to compensate them fairly.
- Rule of thumb: the total compensation for all of the outside directors should equal the CEO's.

# Being Fair to Directors

- There are usually two components to the director financial agreement at angel stages:
  1. Directors make a meaningful investment
  2. Directors earn a fair amount of equity
- Essential ingredients for an engaged board.
- At the Angel stage, the board should have at around 10% of the total equity.
- Vesting on the same terms as the entrepreneurs.

# Vesting

- After the board, and equity allocation, vesting is the most important structural element.
- Vesting is responsible for many more failures than is commonly appreciated,
- But is impossible to isolate from other personal and group factors.
- Is fundamental to fairness, alignment and motivation.
- The most fair vesting arrangement matches the intention of the entrepreneurs and investors.

# The Fundamental Agreement

Today, many believe that the fundamental agreement between investors and entrepreneurs is:

1. The investors invest their money as equity
2. The entrepreneurs all work together to increase the value of the equity, and
3. Provide the investors, and themselves, liquidity.

# Building Shareholder Value

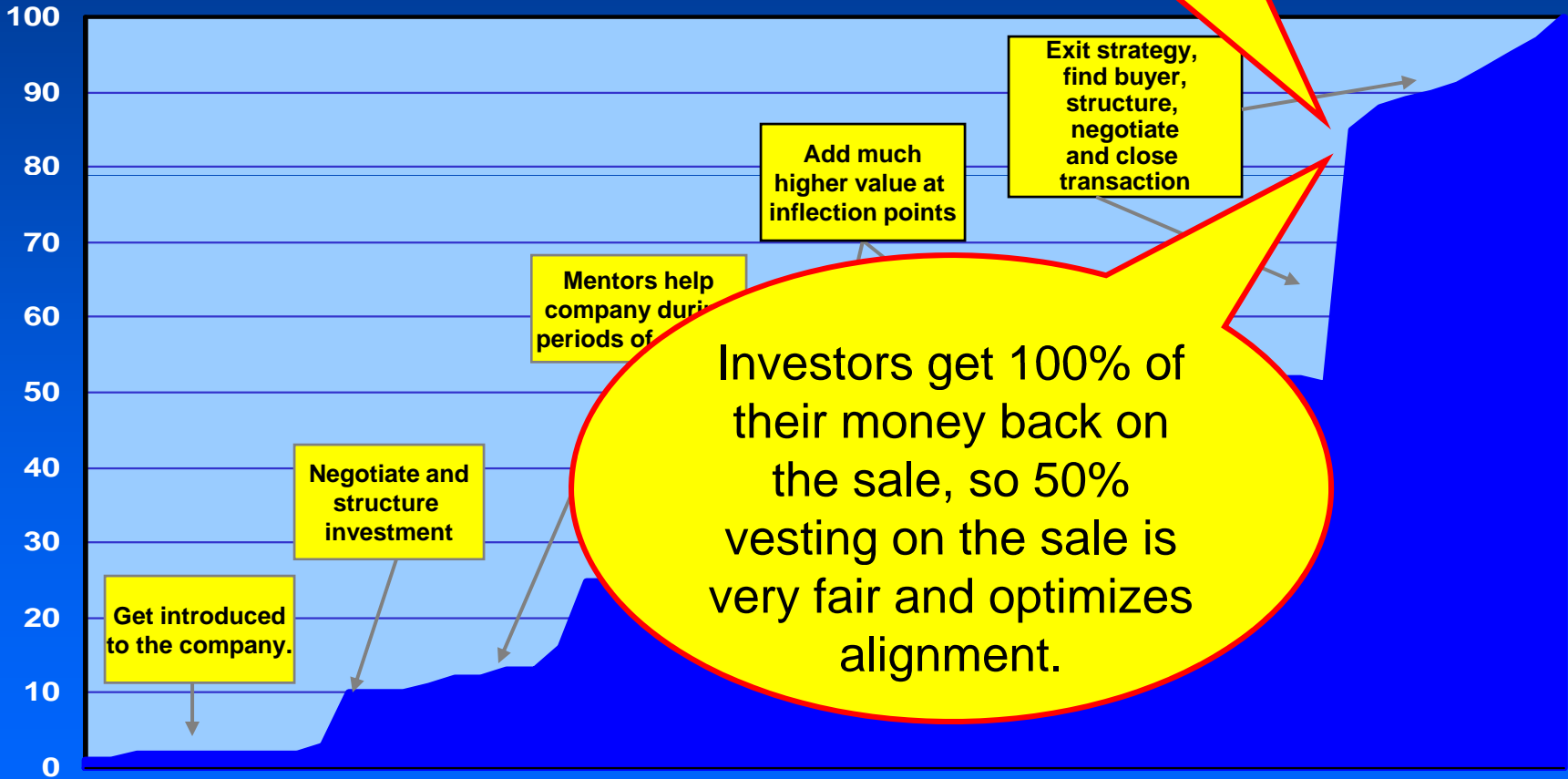
Investment = 10%

Mentoring & Growth

Completing the sale creates as much value as all of the other work.

& Sale = 50%

Shareholder Value



# Most Fair Vesting Formula

- Assuming that was the fundamental agreement,
- and that 50% of the value is typically created at the exit,
- Then vest:
  - 50% of the shares daily over a three year period, and
  - The other 50% when there is a 'sale' of the company.
  - All vesting for senior employees accelerates on a sale of the company.

# Other Standard Terms

- Clear and well understood share allocation
- Employment agreements
- Protection of corporate interest agreements
- IP 'cleanly' owned by the company.
- 51% shareholder vote required to sell the company
- Monthly CEO Update to Shareholders

# Putting It All Together

- Require a good board that you can count on to make the right decisions.
- Structure the equity ownership fairly.
- With fair vesting applied to everyone.
- Invest in common shares – keep it simple.
- With the right to exchange into prefs later, if someone else negotiates them.
- Along with the other standard provisions...

# The One Page Term Sheet

- All of this can be done on one page (two sided with a cap table and signature blocks).
- Many successful angel investments have now been structured this way.
- This is posted on AngelBlog for everyone to use:
- [www.AngelBlog.net](http://www.AngelBlog.net)

**Good Luck With  
Your Angel Investments!**