BUSINESS ANGELS’ MODUS OPERANDI

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The paper is focused on the theoretical and practical aspects of business angels’ phenomenon and different forms of early investors’ activities — in different countries at different stages of business life cycle. Theoretical part is dedicated to terms definition, capsule review of the initial stages of business life cycle and components of business angels modus operandi. Practical part is directed at the exposure of pitfalls that can complicate cooperation between business angels and novices in business in Ukraine. Special emphasis is placed on the review of the term sheet - a non-binding offer of business angel to invest in a company with terms and conditions attached. Analysis of these terms and conditions, categorized into three buckets, can equip Ukrainian novice entrepreneurs with the skill required to protect their economic interests, retain control rights and not to overdo investors’ protective clauses.

Key words: seed financing, start-up, business angels, modus operandi, term sheet.

Problem statement. It is a common knowledge that the driving force of any market economy is entrepreneur. Less known, especially in our country, is the full range of funding sources, available for novices in business — as a rule they are cut down to bootstrapping and 4Fs (Founder, Family, Friends and Fools) vs venture capital. Meanwhile in western countries the most rapidly growing group of investors is business angels’ community, providing start-ups with required funds, knowledge and experience, counsel and connections. For our country one can find a list of 2916 angel investors, interested in Ukraine, registered only on one US website for startups and angel investors [1].

The aim of this article is twofold: (i) to examine theoretical aspects of business angels’ modus operandi and (ii) to reveal issues of concern in Ukrainian entrepreneurs’ cooperation with business angels.

Recent literature review. There are no fundamental research published in Ukraine regarding theoretical and practical aspects of business angels’ funding.

In foreign scientific literature the first definition of business angels was proposed by William Wetzel in 1983 [2] and since then this kind of investors became the subject...
matter of numerous research works. The most quoted authors are Colin Mason [3], A. Wong, M. Batie and Z. Freeman [4], D. Stokes and N. Wilson [5], T. Lahti [6], Hans Landstrum [7], J.J. Madill [8], C. Mitteness, R. Sudek and M. Cardon [9]. For example, J.J. Madill et al. [8], following the findings of Harrison and Mason [10], identified aspects that differentiate business angels as early stage investors from other investors. The magnitude of their investments is smaller and earlier in time, when the so-called «equity gap» is most significant. By way of illustration, venture capitalists (VCs) invest only 1% of the value of their investments in the seed stage (5% of the deals), 18% in the start-up stage and the rest is provided to expand the company [11]. According to Sohl [12], business angels do not only look for more opportunities but also invest 16 times as often as typical VCs do. Of other opinion are Mason and Harrison [13], who showed that generally business angels invest in fewer deals than VCs. In contrast to VCs, who look for investments which may produce higher returns, business angels do not have the monetary capacity to diversify their investments, so instead adopt a less risky strategy, which leads to fewer «home runs» but also to fewer deals with a complete loss [14].

None of them has investigated Modus Operandi of business angels in Ukraine.

Presenting study records. To avoid pitfalls of misunderstanding it is advisable to start with definitions.

1. Contemporary definition: Business angels (also known as angel investors, informal investor, angel funder, private investor, or seed investor) are high net worth individuals (accredited investor with a net worth exceeding $1 million) who invest their own money, along with their time and expertise, in high-risk, high-return entrepreneurial ventures, typically in the seed and/or start-up stage, in which there is no family connection, in the hope of financial gain.

Business angel investment activities are actually not a newfangled phenomenon. The phenomenon of «business angels» has been known for ages: some researchers cite as an example the decision by Queen Isabella of Spain to finance the voyage of Christopher Columbus, which can be regarded as a highly profitable investment for Spain venture capital investment [7]. Other scientists argue that it was the investment made by the private individuals that affected the industrial revolution during the 19th and early 20th centuries. In their opinion such industries as railroads, steel, petroleum and glass would not be developed without private risky investments.

The term itself was coined by Broadway theatre insiders in the early 1900s to describe wealthy theatre-goers who provided money for theatrical productions that would otherwise have had to shut down. They invested their money primarily for the privilege of rubbing shoulders with the theatre personalities that they admired [3].

Modern interpretation of business angels was developed by the pioneer of business angel research William Wetzel. Since then the term is used in relation to wealthy individuals providing seed capital [15] or, more exactly, «a high net worth individual, acting alone or in a formal or informal syndicate, who invests his or her own money directly in an unquoted business in which there is no family connection and who, after making the investment, generally takes an active involvement in the business» [16].

According to definition, angel investors are typically a diverse group of individuals who gained their wealth through a variety of sources. However, the majority are usually entrepreneurs themselves, or executives who retired early from previous ventures that
developed into successful empires [17]. In the previous century typical business angel was a successful male over the age of 50 investing his capital and know-how into start-ups. Nowadays business angels are a lot younger. As an examples of the most famous successful business angels one should mention Armas Clifford "Mike" Markkula Jr. — an American entrepreneur who was an angel investor and second CEO of Apple Computer, Inc.

As a rule business angels prefer to invest in a business at «seed» and/or «start-up» stage of development, that employs a unique competitive advantage (such as proprietary technology or well-protected intellectual property) to capture a large new primary market, lead by a successful, experienced management team and priced at a reasonable valuation.

2. Terms «pre-seed», «seed», or «start-up» stage originate from the corporate life cycle model, suggesting that firms, like the organic body, tend to progress in a linear fashion (provided they don’t fail at birth) through predictable stages of development sequentially from birth to decline and that their strategies, structures and ways of funding correspond to their stages of development.

There are several multi-stage life cycle models, which differ in terms of the number of stages involved and specific features that correspond to each stage. Minimum number is 3 (idea, development and commercialization), maximum — 10 (courtship, infancy, go-go, adolescence, prime, the fall, aristocracy, recrimination, bureaucracy and death). In this article we will analyze only seed and start-up stages alongside with peculiarities of investment needs at each stage.

A pre-seed stage ends with the development of a minimum viable product (MVP). Funding of a business at this level is focused on maximization of future fundraising opportunities through testing and building (sometimes) a prototype; it comes usually from the 4F’s (Founder, Friends, Family and Fools). As a rule business angels do not participate in funding at this stage.

Seed stage is the beginning of the business lifecycle. This is the very conception or birth of a new business, early development of a new product or service, including market research, creation of a management team and business plan design. This is when it is being determined whether the business idea is worth pursuing. A genuine seed-stage company usually has not yet established commercial operations; thus external funding for continued research and product development is essential.

The start-up is completely different from seed. In this case, an entrepreneur has a business idea, has a project, has a business plan, identifying future profit margin; he has already certain monthly revenue which is consistent, constant and the business is growing month on month. Business is born and now exists legally. Now it is time to assess when it will start to become profitable; also the product or service has to be refined according to market demands, and business model adjusted to meet customers’ expectations.

Seed and start-up companies are most attractive for business angels and institutional venture capitalists. The difference between the two is most obvious in the investment stage: they differ in source and amount of their funds, responsibility, investment experience and capacity, operational engagement and exit strategy.

Contrary to popular belief, venture capitalists seldom provide seed and start-up funding to entrepreneurial ventures. Angel investors, on the other hand, exist to provide
seed financing. They are willing to take on the risk of a brand new firm, usually investing limited sums — up to $50 000.

Unlike venture capitalists, angel investors typically use their own money to fund an entrepreneurial venture they find interesting. That is why they are less rigorous in their due diligence, not being obliged to justify the investment to other general and limited partners. As a rule, they don’t demand board positions in the companies they invest in.

Generally, angel investors enter into a project because it appeals to them personally. That doesn’t mean they don’t want a nice rate of return. They certainly do and will not invest if their own financial analysis does not lead them to believe that is exactly what they will get [18].

In the report of MIT Entrepreneurship Center Venture Support Systems Project: Angel Investors Lucinda Linde and Alok Prasad stated, that «not all angels are alike» [19] and proposed categorization of business angels based on relevant industry experience and entrepreneurial experience. According to these researches one must differ Guardian angels, Operational expertise angels, Professional entrepreneur angels and Financial return angels.

David Beisel singles out Super Angel, Domain Angel, Previous-Colleague Angel, Friends & Family Angel, Fellow-Entrepreneur Angel, «True Believer» Angel, Financial Angel, «Sport Fisherman» Angel, Foolish Angel and Grouped Angels [20].

Gerald A. Benjamin and Joel B. Marquilis [21] differ such types of private investors: Value-added investor, Deep-pocket investor, Consortium of individual investors, Partner investor, Family of investors, Barter investor, Socially responsible private investor, Unaccredited investor and the newest breed of angels - the manager investor - investors looking for a job.

Irrespective of specific group affiliation all business angels perform similar procedures. As a rule their modus operandi consists of the following steps:

- Deal search
- Deal Screening and Due Diligence
- Term Negotiations
- Post-Investment Involvement
- Exit strategy design

Deal search in the context of legions of funds needy start-ups is governed by the scan for business that fits investor’s background, ROI requirements and personal motivations. Other sources include attorneys, accountants, consultants and investment bankers.

Angel investment is done either through individual investment or through networks. Experienced angels are more open to taking on deals directly from entrepreneurs if they have a well-defined deal screening process with established criteria. Otherwise they can make use of special networks.

There are three types of Angel Networks:

1. Non-profit Business Angel Associations, aimed to facilitate Angel’s investments in local Companies;
2. Incubators-Group of Angel, hosting companies;
3. For Profit Angel Networks, enabling entrepreneurs to meet business angels.

The first types usually work for a stake in the company looking for investment or support while the third one collects entrance and/or success fee. For example, the
biggest for profit network Angels Den, «that makes it simple to own shares in early-stage companies that could potentially become the next big thing» provides services to more than 4 500 angels, charge Online listing fee, Event pitching fee, Completion fee and Success fee.

One of Ukrainian business angels network — UAngel — facilitates the introduction of entrepreneurs to potential investors through pitching events, presentations, investors coffee mornings and other tools. Members are provided with selected deal-flow, high profile networking, syndicating possibilities, cross-boarder investments, educational help and much more. For these services they are charged membership fee.

The European confederation for Angel investing emphasize the two modern key trends (beside development of matching platforms) in business angels’ modus operations [22]:

1. Syndication, providing the following advantages: angels are able to pool risk, to do larger deals and to share due diligence on investment opportunities. Syndication also enables the angels to better participate in follow-on financing and being a bigger player in negotiations with VC’s. Unsurprisingly, most market reports claim that syndication is of high significance to the angels;

2. Co-investment facilities, supporting in increasing financial capability and diversifying risks.

Next step on the path to investment is deal screening and due diligence.

Angels are ready to invest in a company that employs a unique competitive advantage (such as proprietary technology or well-protected intellectual property) to capture a large new primary market, lead by a successful, experienced management team and priced at a reasonable valuation.

Each business angel has his/her own selection criteria. But it is possible to single out five sets of things business angel look for in a newborn enterprise (in order of importance):

- a large, rapidly expanding market
- people / management that can get the job done
- a brilliant idea of technology that can be commercialized
- a strategy that has a strong sustainable competitive advantage
- expected high returns/reasonable price per share.

The least popular for business angels’ funds are start-ups with poor assessment of entrepreneur, lack of sustainable competitive advantage, and limited markets. But it is evident that different angel types use different screening and investment criteria.

Next step is term negotiations, which if the most intricate phase of funding negotiation. 

**Term sheet** is a non-binding (but for two binding clause: (i) no shopping* and (ii) confidentiality) offer to invest in a company with terms and conditions attached.

Every term sheet, irrespective of its specific nature, has three buckets, consisting of:

1. terms that impact company valuation and split of profits and/or proceeds upon a liquidity event;
2. terms that impact control over decision-making;
3. investors’ protection terms.

*A no-shop clause is a clause in an agreement between a seller and a potential buyer that bars the seller from soliciting a purchase proposal from any other party.
(1) Main component of the economic bucket is definition of the securities, being issued by start-up in exchange for the funds of business angels.

Equity securities are rarely used at seed stage, as it is extremely difficult to calculate valuation of the company at the earliest stages. In case of their issuance business angels would prefer to receive preferred stock.

Most frequently are used convertible note/bond — a flexible financing option, a type of debt security that can be converted into a predetermined amount of the underlying company’s equity at certain times during the note’s life. Due to their specific features they are particularly useful for companies with high risk/reward profiles.

The main reason for issuing convertible bonds: investors demand a security that optimally protects their principal on the downside simultaneously allowing them to participate in the upside — should the underlying company succeed. This provision has direct relation to new companies that are risky projects with a potential to lose a great deal of money on the one hand, but may lead the company into profitability and outsize growth — on the other hand. A convertible bond investor can get back some principal upon failure of the company but can benefit from capital appreciation by converting the bonds into equity on preferential terms if the company is successful. That is why convertible bond is a useful financing option for both investors and companies when the company’s success resembles a binary outcome.

If preferred securities are involved, the term sheet should indicate the rights, preferences, restrictions, conversion rights, conversion ratio, timetable and conditions as well as other special or relative rights of such a security.

Other financial instruments used in start-up funding are SAFEs and KISSs. SAFE is abbreviation for «Simple Agreement for Future Equity» — alternative to convertible debt, introduced in 2013 by startup accelerator Y Combinator; KISS is abbreviation for Keep It Simple Security, introduced in 2014 by start-up accelerator 500 Startups. Note-alternatives are contractual rights to purchase the company’s equity at a future date, similar to warrants, but the conversion price remains undetermined until a later date. Like convertible debt, note-alternatives are a quick and simple way of providing companies with cash in exchange for the promise of future equity. A major difference is that note-alternatives generally do not accrue interest and do not have stated maturity dates. Until the note-alternative converts into stock, note-alternative holders typically have no management rights and do not share in any dividends that are paid; they are not treated as debt on the company’s balance sheet.

Economic bucket negotiations are always extremely vexed and complex. In brief other provisions of the term sheet can be presented the following way:

- amount to raise (each extra dollar invested resulting in additional investor’s claim);
- pre-money / post-money valuation (needed for ownership partition when equity securities are issued);
- employee pool (consisting of stock options or shares, reserved for employees as a way of compensation for their current underpaid job);
- liquidation preference (conditions, making provisions for investors to be paid before anyone at a startup when the company either sells or goes out of business; they can be participating or non-participating);
- anti-dilution adjustment (protecting an investor from equity dilution resulting from later issues of stock at a lower price than the investor originally paid; the clauses in the term sheet may initiate full ratchet or weighted average);
- dividend provision (provisions affording the preferred stockholders either cumulative accruing dividends** or non-cumulative ewhen, as and if declared; dividends in start-ups, usually unfit to generate substantial amount of cash);
- others.

(2) Second bucket consolidates terms that impact control over decision-making. This bucket as a rule is not submitted in full in term sheets with business angels, as they usually do not demand a position in the board of directors, but require some formal representation on a startup’s board of directors (as an «observer»). Some require certain reporting procedures as well (such as monthly sales or product development updates).

Standard methods of implementing control rights in start-ups typically show up in two forms and at two levels:
- blocking rights (i.e., the right to veto or stop an action from being taken) and approval rights (i.e., the right to force an action to occur); and
- rights inherent in the board of directors, allocation of control on shareholders’ level or combination of both.

Inter alia, Board of Director Controls can be implemented in two ways:

The first is the ability or right to appoint directors to a company’s board.

The second method is of allocating control at the board level is associated with increasing the approval threshold required for specified actions in order to provide certain parties with «blocking» rights. It can be requirement of the agreement of a super-majority of the board members or a unanimous agreement or any other provisions, agreed by the parties.

(3) Third bucket consisting of investor protection terms, usually is presented in term sheets with business angels in full. The most frequently used terms determine:
- founder’s treatment
- founder’s dismissal
- privileged rights to buy /sell shares
- control rights.

For example, terms related to founder’s treatment, usually include vesting provisions (providing for (i) vesting of unvested shares each month over a period of a number of years with a 1 year vesting cliff and (ii) triggers for accelerated vesting). Provisions for founder’s dismissal usually include list of clauses (if any) or possibility of constructive termination. An anti-dilution provisions («full ratchet» or «weighted averages») protect an investor from equity dilution resulting from later issues of stock at a lower price than the investor originally paid.

Each business has its own unique issues, and every particular term sheet should focus on those unique issues. But all term sheets in one form or another include mentioned provisions.

** Cumulative accruing dividend provisions as a rule state that at issuance each share of preferred stock begins to accrue either a set dollar amount or a percentage of the share’s original purchase price, whether or not the company has the cash on hand to pay the dividends and whether or not approved by the company’s board of directors.
Post-Investment Involvement of Business Angels may include:

Recruiting and Coaching Management/Board: Helping in recruiting management is the most widely performed role by active angel investors. They are good in assessing candidates and checking on their track records; They also enjoy coaching the management team.

Recruiting Venture Capitalists: Some of the angels feel that their primary post-investment role is to help prepare it for subsequent venture capital funding: having strong venture capital contacts angel investors often help start-ups find the right venture capital partners on the next round of financing.

Assistance with Financial Structuring: Angels can help with structuring the option and incentive plans. They can also help craft the company’s financial strategy, including in raising capital. Many angels have deep experience in financial structuring for mergers, acquisitions, and strategic partner investing.

Angels also provide support in organizational structuring; defining and establishing the marketing, sales and distribution strategies and providing general coaching and guidance. Some angels were willing to act as interim CEO or interim member of the senior management team [23].

Angel investors like both IPOs and acquisitions as exit strategies. Also in the following rounds in many cases business angels choose not to sell their securities to a bigger company, but to convert their notes into shares and enjoy their growth in value coupled with dividends.

Conclusion. In 2015–2016 members of business angels network UAngel invested in Ukraine $7 million in 87 deals [24]. Even the brief review of abovementioned aspects of business angels’ and entrepreneurs’ cooperation reveals numerous underlying potential problems threatening their fruitful partnership. It should be useful for first time entrepreneurs, business angels, regulators and other members of the venture community to understand the fundamentals of angel investing.