ANGEL INVESTORS: STRUCTURING DEALS THAT WORK

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Canadian small business people are turning to private investors more than ever. However, many opportunities fail to proceed as well as they should because some independent investors need a level of participation and control that their target investments are unwilling to give up. Balancing this conflict can be the key to making a deal with angel investors that actually works.

The need for private investors in Canadian small business has never been greater. Real estate assets cannot be levered to provide funding as they could in the 1980s, bank support for small business is extremely risk adverse, government support programs are being cut back, and most venture capitalists will not look at deals less than $5,000,000.00.

At the same time, the supply of potential investors has never been higher. The parents of baby boomers, many of them successful business people, are retiring in larger numbers with money to invest. The baby boomers themselves are aging and are having difficulty finding places to put their money which offers some fun, some security and some good return on investment.

The opportunity for doing deals with "angel investors", namely individual men and women with surplus capital to invest and an interest in helping people with small or new businesses, has never been greater.

The U.S. market seems to be taking advantage of this opportunity. One recent presentation quoted Venture Economics statistics that U.S. angel investors provide five times the capital of U.S. venture capitalists, namely 10 billion dollars per year in average investments of $200,000.00 to $500,000.00 each.[1]

However, completing a successful "angel" investment can be difficult if the different types and needs of angel investors are not taken into account.

The Two Kinds of Angel Investors: Celestial Angels and Guardian Angels

All angels are motivated by the desire to "help" the entrepreneur. However, there are in fact two main kinds of kinds of angel investors: "celestial" angels and "guardian" angels.

[1] ***How to Find Angel Investors***, by Mark Borkowski, President, Mercantile Mergers & Acquisitions Corporation; ~~presented at *New Money for New Busin*~~*ess: A Critical Guide for Owners and Investors*, a conference presented by Insight Information Inc. on January 29th, 1997 in Toronto, Ontario.

Celestial angels are mere passive investors. They provide money and little else. They are content to be “silent” partners. Their main concern is getting their money back in a relatively short time frame. Structuring deals for them is not too difficult. Once they decide to help and take the risk they are generally content with some blend of debt and equity. They take a “good Samaritan” view of investing and are either oblivious to the risks, have special reasons for investing (e.g., family members), or are content to make a “gamble”.

Guardian angels, on the other hand, want to provide more than just money and want to take less of a “gamble”. They also want a piece of the long term success that will be generated by their investment. Failing to recognize that guardian angels do not want to be passive investors and want a long term investment, and failing to take into account the unique needs and contributions of potential guardian angels, is resulting in many missed opportunities and poorly structured deals.

Selecting an Angel Investor

In selecting an angel investor, or trying to decide if you should be one, consider the following criteria for an angel investor:

- at least one important intangible reason for making the investment; for example: a personal connection with the entrepreneur; a belief in the company, product or service; the desire to help deserving companies and management teams to find the financing that many small businesses can not find from institutional or government sources
- enough financial resources to lose their investment without suffering a strong, personal, financial hardship

Special Issues With Guardian Angels

Guardian angels require two things bankers, venture capitalists and celestial angels do not -- active participation and real control. This is because they are often experienced business people themselves, want to contribute more to the deal than just money, want more assurances that the business will succeed, want to directly improve the chances of getting their money back, and want a good chance at a reasonable long term investment.

The problem is this: while these special qualities are often what attracts the guardian angel and the entrepreneur to each other, the entrepreneur may end up resenting or misinterpreting how these qualities manifest themselves. What are basic “needs” to the guardian angel can be perceived as unwarranted intrusions into the affairs of the business, or worse, mistrust and paternalism..

If dealing with a guardian angel, or if you are a guardian angel, the following additional criteria are also important:

- the financial resources to provide 100% of the investor financing required for the company
- the ability to provide business mentoring, management expertise or valuable industry connections to the management team
- a relationship between the guardian angel and the entrepreneur based upon mutual respect and trust.

“Participation” and the Angel Investor

There are two ways an angel investor can be “participate” in the business: by providing management expertise and by taking an equity position. Both can be contentious.

Both guardian and celestial angels invest in people. They do not “need” to make an investment. They are financially secure, are not in the business of making private investments, and will not lose sleep at night if they do not invest. They invest because they want to help the people involved.

Celestial angels do not look to have much say in management of the business. Guardian angels, however, want to help with more than just money, and do not want to invest if the entrepreneur only wants their money, or if they cannot add any other value to the business. These investors know that they will not be happy investors unless they have a long term role in the success of the business, and will be valued and appreciated for that role.

When it comes to equity, both celestial and guardian angels want a significant equity position in the business. However, guardian angels tend to value their money more than celestial angels. While they appreciate the sweat and financial capital that has gone into the business already, guardian angels know that their money is usually more important than the entrepreneur’s vision and hard work, know how much the entrepreneur needs the money, know the risks involved, know the potential returns, and want to be compensated accordingly. An equity participation in the business, both before and after the original investment is repaid, is what a guardian angel is usually looking for. While many celestials are content to get their money back with some kind of bonus, guardians typically want a long term stake in the business.

These two elements (management say, residual equity) clearly present higher risk to the entrepreneur dealing with a guardian angel, as well as a significant long term cost. However, these “needs” simply reflect the unusual role played by the guardian angel, who should be both a financial and non-financial benefactor of the business.

Therefore, while a celestial angel is probably content with a passive role and an opportunity to get their money back with a reasonable return on investment over a short period of time, a successful guardian angel deal should include:

- a guardian angel who really can contribute more to the business than just money
- e.g., business savvy, industry experience, connections
- mutual respect between the investor and the entrepreneur, including the honestly held belief by the entrepreneur that he or she can and should listen to the advice the angel has to offer
- the right, obligation and need of the angel to have some say in the management of the business, either as a formal board member or as a key member of an informal operating board
- an arbitration or mediation clause to prevent the deal from blowing up over anything but significant items and to allow quick and cheap resolution to most issues
- a reasonable mechanism to exit the angel out of the deal if a working relationship with management falls apart over substantial issues, which could include a conversion of the investment to a high interest/participating/secured debt type instrument and could be triggered by either the investor or the entrepreneur
- immediate and long term (“residual”) equity for the guardian angel.

"Control" and the Angel Investor

Celestial angels are not typically looking for much control over the business. They will frequently invest pure equity or participating equity (preferred shares with interest or royalty components), but rarely even look for a secured position.

Guardian angels are more demanding. Because their experience and wisdom are a big part of the package, because they know their capital represents the highest category of risk capital, and because they want greater assurances they will get their money back, guardian angels look for significantly more "control" of the business. This can be manifest itself in many ways, including a say in management (as mentioned above), voting control of the company until such time as their investment has been repaid, and secured creditor status for all or part of their investment.

Again, as with the participation issues discussed above, this level of control often conflicts with the entrepreneur's sense of fairness and need for independence. However, if the entrepreneur truly trusts and respects what the angel has to offer in terms of support, guidance and risk capital, and truly believes they can together achieve what the business plan says they can achieve, then many of these elements can be balanced in a well-crafted contract that balances the needs of both parties.

Therefore, with respect to "control" issues, a successful guardian angel deal might typically contain elements of the following:

- a significant say in management, as mentioned above, especially with respect to expenditures, contracts or investments with a significant value or liability attached
- regular and detailed reporting, especially accounting and financial matters, with rights of access to source documents
- some signing limitations on bank account activity without angel approval, usually expressed as dollar limits
- a fixed compensation structure for the entrepreneur to be kept in place until the angel gets their investment money back, which can include performance incentives
- significant voting rights in favour of the angel until certain pay back levels have been achieved
- a secured position for the investment by way of a general security agreement or debenture, so that the angel can take absolute control of the business as a secured creditor if the business fails or if the original investment amount is not repaid within certain time limits.

Balancing Deals made with Guardian Angels

At this point it looks like a deal with a guardian angel is all one way, but there are several things that an entrepreneur can and should get in return:

- the angel should be willing to "go it alone"; the deal should require the investor to put up <u>all</u> the money required to implement the business plan so that the entrepreneur has all the money he or she needs and only has one person to deal with
- the angel should agree to make his or her time available at not additional cost, as well as other intangibles which could be useful such as industry connections or introductions

- the deal should contain certain “patience” provisions, which prevent the investor from jumping ship at the first sign that unanticipated bumps in the road will be encountered
- the investor should be required to take his or her money back over a reasonable period of time (two to five years), with a corresponding and mandatory reduction in participation (equity and management) and control once that occurs, so that the entrepreneur can get their business back
- an opportunity for the entrepreneur to purchase all or part of the angel’s residual equity for an agreed price or formula within an agreed window of time after the original investment has been returned, giving the angel good value for his or her long term contribution while giving the entrepreneur the opportunity to obtain total control.

Other Issues to be Considered after Return of the Initial Investment

As mentioned, most deals involving celestial angels end after their investment is returned because most of those deals involve interest, royalty and return on investment components that satisfy the angel’s basic needs to “help” the business while getting their money back with some modestly decent returns over a short period of time.

Guardian angels, however, are different. They generally try to arrange their deals so they have a long term investment as well as their money back with a return on investment. Therefore, issues related to the operation of the business after the return of the guardian angel’s investment and final determination of the guardian angel’s residual equity should be addressed, including:

- the “security” held by the angel should be discharged
- the angel should have less rights and say in management, and less control over the entrepreneur and the business
- assuming the guardian angel retains residual equity, but on a minority basis and with lessened participation and control rights, the angel should be in a position to force the company to payout the angel’s share of company profits on an annual basis, so that the angel can continue getting his or her return on investment
- the angel’s rights as a minority shareholder and significant historical contributor to the success of the business should be protected in the usual way by a shareholders’ agreement that suits the circumstances.

Some Final Thoughts

At first impression, an angel investor, especially a guardian angel, might appear to be more trouble than they are worth. However, it must be remembered that we would not be looking at angel investment if other kinds of capital were available. Also, failing to structure a deal around the intangible contributions of a guardian angel is an opportunity lost. After all, a successful guardian angel will bring much more to the table than money, and should be the only thing the business requires to succeed other than the entrepreneur’s good planning and implementation.

Like any business relationship, the key to successful angel investing for both the angel and the entrepreneur is in selecting the right person to do business with, and for the right reasons. After all, the only thing more important than getting into the right business is getting into business with the right people.