

ANGEL WORKSHOP

SESSION 2: IS THIS ONE WORTH THE RISK?



**STARTUP
FUNDING**

+



**ONGOING
SUPPORT**

=



**PHX EV
ANGEL**



PRESENTED BY JAMES GOULKA
May 16, 2018

INTRODUCTION

- **Objective:** Add more Angel Investors in the PHX East Valley
- **Who:** Accredited Investors who live or work in the PHX East Valley
- **What:** 3 session primer on how to think about angel investing
- **When:** 5:30 – 7:30 pm
- **Where:** University Building, 92 W Vaughn Ave, Gilbert

WHY WE'RE HERE

More Local Angel Investors



More Local Capital for Local Startups



Easier to Raise Money



Spend Locally On:

Hiring, Buying Goods and Services, Occupying Space,
Creating Local Wealth for Local Investors

JIM GOULKA

- Leads Arizona Tech Investors



90 men and women

56 companies in 10 years

- Serial CEO in software & NASA tech transfer
- COO/CFO of \$650 million publisher
- Private Equity finance
- Corporate finance

PREVIOUSLY

- Defined angel investors
- Discussed potential for huge gains
- Showed how to analyze new businesses

PART 1

IS THIS ONE WORTH IT?



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You don't have to invest millions of dollars to be an angel investor. A typical investment is \$25,000 to \$100,000. Over time, you'll want to build a diverse portfolio of startups to mitigate risk and maximize your odds of a home run investment.

STARTUP SEEKING CAPITAL

- 1-2 year old business
- Management: Most are first time entrepreneurs
- Team: Incomplete
- Product: Prototype
May be a thing or may be electrons
- Disruptive: Requires customers to change behavior
- IP: Is there any?
- Capital: Limited to founder funding+friends+family

WHAT YOU KNOW

- Determined you like the company
 - Management
 - Market
 - Product
 - Growth prospects
- Lots of fish in this particular sea
- Your target return expectations

TARGET RETURN: PORTFOLIO

- Government bonds = 2% +inflation
- Public common stock = 8% +inflation
- Phoenix suburban RE = 8% cap rate
- Angel investments = >25% IRR

RISK

- Government bonds = basis points
- Public common stock = stop loss
- Phoenix suburban RE = reuse
- Angel investments = total loss

DE-RISK STRATEGY #1: PORTFOLIO OF INVESTMENTS

- Portfolio = 10 - 20 angel investments
- Typical Returns
 - 1 - 2 make 10x your money
 - 2 - 3 are total write-offs
 - 5 - 7 return 1- 3x your money

PORTFOLIO RETURNS

- Assume 10 equal investments
 - Made the same day
 - Sold 5 years later on the same day
- $1 \times 10x = 10$
- $1 \times 0x = 0$ = 24.475% IRR = 3x
- $7 \times 2.7x = 18.9$
- $1 \times 1x = 1$

SINGLE INVESTMENT TARGET RETURN

- Investment Return in 5 Years =
 - 58.5% IRR
 - 10 x your investment amount

OPPORTUNITY

- Interesting Company is an asset
- Investor buys a piece of an asset
- The piece is securities issued by the company
- Exact form of security is addressed in second part of this session

PRICE (f) VALUATION

- Price per share = derived from deal
- Value of business drives the deal
- Total enterprise value as measure
- Return @ disposition of business (IPO or sale)
- Your return = your share of disposition

VALUING THE ENTERPRISE

- **Pre**-Money Valuation =
Valuation before investment
- **Post**-Money Valuation =
Pre-money Valuation + New invested dollars

VALUATION FOUNDATION

- History.....Little or no enterprise history
- Trends.....Emerging
- Markets.....We always have these

COME AT VALUATION OBLIQUELY

- Art more than science
- Apply a set of 4 tools
- Ref's Call: Completed Pass or Not?
(aka Gut Check)

VENTURE CAPITAL METHOD

➤ Know Anticipated ROI: 58.5% IRR

		IRR								
Years		2	3	4	5	6	7	8	9	10
Multiple										
1	X	0%	0%	0%	0%	0%	0%	0%	0%	0%
2	X	41%	26%	19%	15%	12%	10%	9%	8%	7%
3	X	73%	44%	32%	25%	20%	17%	15%	13%	12%
4	X	100%	59%	41%	32%	26%	22%	19%	17%	15%
5	X	124%	71%	50%	38%	31%	26%	22%	20%	17%
6	X	145%	82%	57%	43%	35%	29%	25%	22%	20%
7	X	165%	91%	63%	48%	38%	32%	28%	24%	21%
8	X	183%	100%	68%	52%	41%	35%	30%	26%	23%
9	X	200%	108%	73%	55%	44%	37%	32%	28%	25%
10	X	216%	115%	78%	58%	47%	39%	33%	29%	26%
11	X	232%	122%	82%	62%	49%	41%	35%	31%	27%
12	X	246%	129%	86%	64%	51%	43%	36%	32%	28%

VENTURE CAPITAL METHOD

- Determine Terminal Value at Exit
 - Research for comparable companies
 - Research for comparables' valuation multiples

PUBLIC MARKET VALUATIONS

Current & Forward Market Multiples

	Median TEV/Revenue		Median TEV/EBITDA	
	LTM	NTM	LTM	NTM
Application Software				
Customer Relationship Management (CRM) & Customer Engagement	6.0x	5.0x	55.5x	31.2x
Accounting & Enterprise Resource Planning (ERP)	4.7x	4.5x	21.6x	15.4x
Supply Chain Management (SCM) & Logistics	4.5x	4.2x	24.0x	22.4x
HR & Workforce Management	5.8x	4.7x	21.5x	29.3x
Education Technology	2.0x	3.1x	13.1x	24.2x
Industrial & Automation Software	2.1x	1.9x	14.5x	11.4x
Business Intelligence & Data	5.1x	4.1x	15.8x	23.7x
Design & Engineering Software	5.3x	5.1x	21.7x	14.9x
EMS / Infrastructure Software				
Security Software	4.0x	3.8x	26.2x	18.0x
System and Network Management Software	3.7x	3.1x	12.8x	11.5x
Platform / OS	3.5x	4.2x	11.8x	11.5x
Financial Solutions				
Banking Solutions	5.7x	5.4x	17.2x	14.4x
Capital Market & Investment Solutions	5.9x	5.4x	17.1x	14.2x
Consumer Data & Analytics	5.3x	5.0x	16.4x	15.1x
Payment Processing	3.2x	3.2x	14.7x	13.1x
Insurance Solutions	6.6x	6.4x	17.9x	15.5x
Online & Digital Media				
Digital Advertising & Marketing	1.1x	3.0x	22.8x	9.4x
Digital Media & Video	2.7x	2.6x	14.1x	12.2x
Digital Advertising Agencies & Service Providers	1.5x	1.3x	9.6x	9.2x
Online Retail & Marketplaces	2.7x	2.4x	25.3x	15.7x
Digital Gaming	3.6x	3.4x	15.9x	10.2x
Social Media	6.1x	4.9x	28.9x	14.3x
Digital Commerce Solutions	1.3x	1.2x	16.2x	10.9x
Other Digital Companies	3.4x	3.3x	15.3x	11.7x
Tech Enabled Business Services				
IT Services, Integration & Consulting	1.6x	1.4x	11.6x	10.3x
Business Process Management (BPM)	2.6x	2.3x	15.1x	12.6x
Data Center Hosting & Services	6.3x	5.0x	23.1x	16.2x
Call Center	0.9x	0.9x	8.2x	8.6x

Medians				
Application Software	4.8x	4.2x	18.8x	16.2x
EMS / Infrastructure Software	3.9x	3.4x	16.5x	14.8x
Financial Solutions	5.2x	5.1x	16.5x	14.8x
Online & Digital Media	2.9x	2.6x	17.8x	11.9x
Tech Enabled Business Services	2.1x	1.9x	12.3x	10.5x

VC METHOD MATH

- Assume: SaaS Business Comps Valued at 5 x Revenue
- Projected Revenues of \$10 M in Year 5
- Terminal Value = $5 \times \$10 \text{ M} = \50 M
- Assume: Required IRR is 58.5%
- Assume: No dilution (no future funding)

VC METHOD MATH

- **Post**-money Valuation at investment =
- Terminal Value (in year 5) / ROI for 5 years =
- \$50 M / 58.5% (power of 5) =
- \$5 Million

VC METHOD CONCLUSION

- **Post**-money Valuation = \$5 Million
- **Pre**-money Valuation = **Post**-money **less** **New** Investment
- Assume New Investment = \$1 Million
- New Investment buys 20% of company

SCORE CARD METHOD

- Objective: Define Pre-money valuation
- Start: Identify median valuations for comparable companies in domain / region e.g. \$ 2 M
- Evaluate specific business in comparison to the median
 - 6 categories
 - Weigh categories
 - Score strength

SCORE CARD METHOD

Average Company Valuation	Weight	Factor	\$2,000,000
Team	30%	200%	0.60
Opportunity Size	25%	200%	0.50
Product/Technology	15%	150%	0.22.5
Competitive Environment	10%	100%	0.10
Marketing/Sales Partnerships	10%	200%	0.20
Need for additional investment	5%	100%	0.05
Other factors	5%	100%	0.05
Total Weight			1.7300
Medial Value x Total Weight			
Scorecard Adjusted Valuation			\$3,460,000

RISK FACTOR METHOD

- Objective: Define Pre-money valuation
- Start: Identify median valuations for comparable companies in domain / region e.g. \$ 2 M
- Evaluate specific risk types
 - Assign + or – Depending upon risk
 - Use increments of \$100,000
 - Range is + or - \$300,000 max

RISK FACTOR METHOD

Technology Risk		+2
Execution Risk		+2
Market Risk		+2
Competitive Risk		=2
Financial Risk		0
Political/Legal/Regulatory Risk		+1
Economic/funding Risk		+2
Social		+1
Partner/Supplier Risks		0
Management		+3
Aggregate Risk Factor		11
Risk Adjustment		\$1,100,000-
Comparable Value Assumption for your industry/stage		\$2,000,000
Current Risk Adjusted Value		\$3,100,000

MARKET FACTORS METHOD

- Local Pricing Market Factor: Addressed
- Comparable Funding's
 - Milestones in the domain / industry
 - Similar deals in domain
 - Local investor competition / enthusiasm
- Domain Expertise
- Additional Funding Round Calculations

SUMMARIZE

- Array the alternative methods
- Calculate Mean Valuation
- Determine
 - What you really want
 - How high a valuation you will accept
 - Impact of future rounds

NEGOTIATE

- “I’ve never seen a valuation that was too low”
 - Base Horner, Desert Angels
- “That’s way too low”
 - Every Entrepreneur
 - Lawyer advising entrepreneur

EXPERIENCE

- Every deal ATI liked but failed to fund was due to:
 - Entrepreneurs demanding a valuation that was too high
 - Governance (to be addressed next time)
- Overvalued companies
 - Never found funding
 - Found some, but slowly, which curtailed growth
 - Experienced down rounds subsequently

LESSONS LEARNED

- ATI has never regretted walking away from any opportunity due to an excessive valuation.
- ATI has regretted investing in opportunities at too high a valuation.

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SESSION BREAK

PART 2

DE-RISKING THROUGH DEAL TERMS



Most high-growth companies are not venture-capital backed. A Kauffman Foundation survey of 479 companies on the Inc. 5000 list revealed that only 6.5% raised money from venture capitalists while 7.7% raised money from angel investors.

RISK

- Government bonds = basis points
- Public common stock = stop loss
- Phoenix suburban RE = reuse
- Angel investments = total loss

“LIFE DIDN'T WORK OUT THE WAY I PLANNED”

- Company #1: Software /Hardware Combo
 - \$4 million of very savvy investors
 - 100% loss
- Company #2: Consumer Application
 - TV Celebrity lead investor
 - 100% loss
- Company #3: Disease Diagnostic
 - Superb management team
 - 100% loss

DE-RISK STRATEGY #1: PORTFOLIO OF INVESTMENTS

- Portfolio = 10 - 20 angel investments
- Typical Returns
 - 1 - 2 make 10x your money
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DE-RISK STRATEGY #2: STRUCTURE THE DEAL TERMS

- Money is safe before you hand it over
- Set conditions for life after investment
- Analogous to loan covenants
- More dynamic

PART A: ONGOING OPERATIONS

A SAY IN THE BUSINESS: GOVERNANCE BOARD SEAT

- Minority Shares but Majority Money
- Board = Real Business
- Not "yes people"
- Ideal is 5 members
 - 2 founders
 - 1 representing investors
 - 2 independent

FINANCIAL PROBITY: COMMITTEES

- Board Compensation Committee
 - Investor director
 - Independent members
 - No insiders
- Audit Committee

OTHER ADVISORY ROLES

- Board Observer
- Advisory Board Member
- Mentor / Advisor / Consultant have some de-risk value

INFORMATION RIGHTS

- Periodic (ie quarterly or monthly) Reports
 - Financial Statements
 - Management Report
 - Management Dashboard
- Annual Budget

PART B: ANTICIPATING FUTURE FINANCIAL TRANSACTIONS

ANTICIPATING FUTURE FINANCIAL TRANSACTIONS

- New Round of Financing
 - Higher price (“up round”)
 - Lower price (“down round”)
- Sale of Business
- IPO
- Failure

FOR ALL BUT FAILURE: CONVERSION TO C CORP

- LLCs have their place in very early companies
- Institutional investors and acquirers are not interested in figuring out how to deal with “membership interests,” “revenue interests,” or other special characteristics of LLCs.

GOOD NEWS: AN UP ROUND

- Maintain information rights
- Probably lose board seat; exchange for board observer
- Right of First Refusal (ROFR) to invest in new round
- Pro-rata Right to invest to keep % interest owned
- Buyout Option

BAD NEWS: A DOWN ROUND

- Anti-Dilution: An adjustment to the price paid at the earlier round
- Rarely fully equal to the new price / share
- “Broad-based weighted average” is the norm
- Right of First Refusal to invest at lower price

GREAT NEWS: SALE OF THE BUSINESS

- Vote by each class of securities holders to accept transaction on as-converted basis
- Automatic Conversion of securities at price offered
- Automatic trigger of warrants, if any
- Drag Along Right to prevent hold up by recalcitrant minor shareholders

INCREDIBLE NEWS: IPO

- All same as for Sale of Business
- Registration Rights
- Piggy-Back Registration Rights given to later investors

DISASTER: FAILURE

- Preference: The Term that is the meaning of "Preferred" Stock
- In a wind up, assets are distributed to the claim holders in accordance with US bankruptcy provisions:
 1. Taxes due
 2. Employee obligations
 3. Secured Creditors
 4. Unsecured Creditors
 5. Preferred Shareholders
 6. Common Shareholders

THE PREFERENCE BOMB

- Preference Element #1: How many times your money back?
 - 1x is perceived as fair
 - See deals at up to 4x for the preferred holders
- Preference Element #2: Participating or Non-Participating
 - Non-participating means investor gets his preference and that is all
 - Participating means investor gets his preference and then shares pro rata in the residual
 - The bomb explodes in multiple rounds of funding
 - EVEN IN A SUCCESSFUL EXIT

TERM SHEET

- The proposal from the Lead Investor incorporating these protections.
- IT IS NEGOTIATED
- Follow on investors accept these terms
- Investor documents conform to the Term Sheet

ATI STANDARD TERM SHEET

- ATI Standard Term Sheet is found by going to:

<https://arizonatechinvestors.com/Entrepreneurs/ApplicationProcess>

- And downloading it from the embedded link in 'Stage 5'

RECAP

- Opportunity to invest in a young tech company is a huge risk
- Demands a huge return = to that risk
- Can diminish actual risk by
 - Owning a diversified portfolio of angel investments
 - Diligence analysis
 - Deal Terms
 - Deep ongoing involvement

NEXT & FINAL GILBERT SESSION:

WEDNESDAY JUNE 13th

- Trends in Investing, with a Nod to Venture Capital:
 - Startups are emerging in Arizona in software, semiconductors, medical devices and other fields all the time. Arizona is not Silicon Valley and Silicon Valley is not the entire U.S. Some trends apply everywhere; others are localized, and all of them matter. Learn which comparisons are important and which are not. And learn how Angels and VCs are dependent upon each other... to a point.
- Angel Investing – Doing It:
 - Individuals invest as Angels in several ways: alone or together in groups sharing intelligence. They can be active or passive. They can have a little of each. Learn the differences and how to take action that suits you.

QUESTIONS?

Join the conversation online using

#PHXEVANGELS