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The Risks of Angel Investing: More Knowledge About the Downside Is Crucial To Successful Investing

By John C. Yates, Special To LTW

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ATLANTA - In the late 1990s, angel investing was akin to printing money – or so it seemed. Early-stage technology companies were raising huge amounts of venture capital. Angel investors were reaping the benefits when these companies went public or were sold at substantial valuations.

In the 21st century, the rules of angel investing had changed. As a result, many angel investors have suffered significant losses. Consequently, the number of angel investors has shrunk.

Today, the angel investor needs to be more knowledgeable about the downside consequences. Unfortunately, many early-stage investors have learned these lessons the hard way.

Lesson 1 – Pay to Play – Many companies have been forced to raise additional capital from existing investors to stay in business. As a result, investors have passed the hat to collect funds for another round of financing.

What happens if an angel investor can't come up with his pro rata share of the net financing round? The consequences can be costly for the angel. For example, the angel may lose valuable protections of a preferred stockholder. As a result, the angel may be substantially diluted and be disadvantaged if the company is later sold.

What's the lesson? An angel investor must be prepared to pony up additional monies in later rounds in order to protect the angel's initial investment. If you're not so prepared, then suffer the consequences – or don't play the angel investing game.

Lesson 2 - Expect the Down Round (and don't whine about it) – You're an angel investor. You invest in a hot start-up company. The first round of institutional venture money raises the valuation substantially. You're feeling great!

As time goes on, the company fails to meet its revenue forecasts. Expenses are cut, the company downsizes and cash becomes scarce. The venture investors agree to put additional money in – but at a substantial discount from the original valuation.

As an angel investor, your investment may dwindle in value. The Board of the company may determine there's no alternative but to raise capital at the substantially reduced valuation. As a result, common stockholders are significantly diluted – and most angels are common holders.

Lesson 3 – Learn to live with limited information – By definition, an angel investor is an early-seed investor and receives common stock – just like the founders. In the early stage of the company, angels may serve on the company's Board of Directors. They're often privy to a broad range of financial and business information on the company. Also, one phone call to the founder may result in easy access to company records.

With the entrance of outside investors, the flow of information may change. As experienced management takes over, the amount of time needed to communicate with angel investors will increase – and the interest of management will subside. Institutional investors want their management team focusing on running the business – not investor relations. Angels may be deprived of their easy access to company data. They may be forced to make formal requests for this information or await the formality of the shareholders meeting.

Lesson 4 – If you restrict future investors, expect negative consequences – Some angel investors prefer a big piece of a small pie rather than a smaller piece of a large one. As a result, they restrict the company's ability to raise additional capital without permission of the angels. At first glance, this may appear beneficial to the angel investors. In reality, the restriction may hamstring the company's ability to implement its business plan.

Angel investors may insist on anti-dilution protection from a pure percentage perspective. In other words, the investors may refuse to be diluted below a percentage ownership level. By definition, this means that the addition of even one outside investor could violate the anti-dilution protection. Without angel investor approval, a company may be unable to raise additional capital unless the angels pitch in with additional financing. As noted above, this may be problematic.

Lesson 5 – If you want better terms, negotiate for them! – Too often, the angel investor complains about being abused or disadvantaged by later round institutional investors. Some angels feel an entitlement to protection because they were early investors in the company. Never mind that the management team is in the same situation, with common stock that may be impacted by down round financings.

The solution for the angel investor is simple – if you want additional protections, negotiate for them up front. If you're going to play the game, then stop complaining and do your homework. Common provisions that you may want to consider are:

- Information rights to receive unaudited financial statements, company budgets and sales pipelines.

- Observer rights to attend Board meetings.

- Notice provisions informing the angel investor about certain major changes in the company.

Angel investors are critical to the growth of technology companies. At the same time, an angel is like any other investor – they put up their money and rely on the company and its Board to make decisions in the best interest of growing the business. Just like the institutional shareholders, an angel must take steps to protect its rights and live with the consequences of its decisions.

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