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SMALL-BUSINESS GUIDE

The New Rules of Angel Investing

By KERMIT PATTISON

Angels still have wings, but they aren't flying quite so high.

The rules of the game of angel investing have changed in the post-crisis world. The average deal size shrank by 31 percent in the first half of this year, according to a recent study by the [Center for Venture Research](#) at the [University of New Hampshire](#). The [study](#) shows that total angel investments fell to \$9.1 billion in the first half of 2009, a 27 percent decline from the same period last year, but the number of companies getting venture investments actually increased by 6 percent, to 24,500.

Quick Tips:

- Bootstrap as long as you can. Finding early ways to get revenue.
- Get to break even quickly and remember that VC financing has gotten harder to obtain.
- Be realistic about valuations. Be coachable.
- Practice pitching and be prepared to make your case to dozens or hundreds of angels.
- Look for angels who complement your strengths and can help you with more than money.

Suggested Readings and Resources:

- An [overview of angel investing and a list of resources](#) from Angel Capital Education Foundation.
- [What Entrepreneurs Should Know About Angels](#) from the Angel Capital Education Foundation. (pdf)
- A [directory](#) of angel investors from the Angel Capital Education Association.

Angels are still financing deals, but at lower valuations and with more specific milestones. They have grown more picky and less tolerant of risk. “What you’re seeing now is a real flight to quality,” said David S. Rose, chairman of [New York Angels](#). “If you are the real deal, you can get funded.”

What’s the real deal? Angels are looking for companies with more modest capital requirements. They seek companies that bootstrap, beat quicker paths to profitability and have proven management teams. “The most striking change is angel investors are way more discerning about where they deploy their capital,” said Bruce Cerullo, a Boston-based angel investor who specializes in health care. “Now groups like ours are looking for more fully baked ideas that are much closer to revenue generation.”

Do It Yourself

There has been a sea change in risk sensitivity; the more self-sufficiency a company demonstrates, the less risky it appears. “Bootstrap it as long as you possibly can to validate your business model and to get some traction,” Mr. Cerullo said. “The more traction you have, the more leverage you are going to have in a valuation negotiation with an angel or [private equity](#) investor.”

Entrepreneurs should find ways to finance their own growth: working without salary, moonlighting, seeking grants, running lean operations and focusing on an aspect of the business that can generate revenue.

Bear in mind that the worst of times for the economy can be the best of times for starting a company. Labor is cheap and plentiful. The costs of starting an Internet-based company have fallen sharply thanks to cheaper technology, including open-source software. “Work hard to figure out if there’s a business plan you can pursue where your capital requirements are zero,” said Ian Sobieski, founder and managing director of the Silicon Valley-based [Band of Angels Fund](#). “The easiest way to raise money is to not absolutely have to raise money.”

Angels are looking for companies that can get to break even on the angel investment. In return, they are willing to be more patient, Mr. Rose said. In the old days, angels invested with the idea that they would finance the company at an early stage, then venture capitalists would step in with a large injection of cash that allowed it to blast off on a hockey-stick growth trajectory.

“Now we’re prepared to give up the immediate hockey stick in exchange for you being able to reliably get to break even on our cash while building value for the company,” Mr. Rose said. “The minute the market comes back, we can inject V.C. cash — and then you have the hockey stick.”

Be Realistic About Valuations

Valuations have fallen sharply — as much as 40 percent, Mr. Rose estimates. The upside is that the costs of starting a company have fallen, too.

Yet some entrepreneurs still cling to over-inflated valuations. They get hung up on achieving the highest valuation without regard to how it may undermine their long-term prospects.

“The biggest error they make, in my experience, is they focus solely on this round and take money based solely on whether they can fill out the round at the absolute highest valuation,” said John Huston, who invests with [Ohio TechAngels](#) and is chairman of the [Angel Capital Association](#). “They do not select investors who know the market and are willing to write follow-on checks.”

Unrealistic valuations will make serious investors roll their eyes. Even if entrepreneurs can get above-market valuations, they run the risk of getting a lower valuation on a subsequent round, a phenomenon known as the “deadly down round.” Mr. Huston said inflated valuations are a sign that the company picked the wrong investor and “took money from neophytes who were only attuned to this round and the promises of grandiose success.”

Lay Out Milestones

Mr. Huston warns that entrepreneurs should beware of “one-check Willy” — the angel who finances just one round. Instead, entrepreneurs should look for angels who are willing to discuss long-term plans with milestones and follow-on investments that guide the company “from here to liquidity.”

The exit market has changed drastically because of a decline in mergers, acquisitions and initial public offerings. As a result, [venture capital](#) firms increasingly are concentrating on their existing portfolios and forcing angels to support start-ups for longer.

Many angels now expect to write checks for follow-on rounds because they can no longer count on V.C. money being available down the road. John Morris, chairman emeritus of [Tech Coast Angels](#) in Southern California, said that angels were now keeping reserves of 200 to 300 percent — up from zero a few years ago.

“That’s probably the single biggest difference in angel land,” said Mr. Morris. “Angels are learning about reserves and the need to parse out the money in a series of tranches, keeping some dry powder for the next round.”

Practice Your Pitch

Get good at pitching the same way major leaguers do: practice, practice, practice. Entrepreneurs should be ready to present a full business plan, a 20-minute PowerPoint, an executive summary and a two-minute elevator pitch (which is what gets you in the door in the first place). Rehearse with anybody who can offer good advice. Go to industry events. Many angel groups hold quick-pitch events where entrepreneurs are invited to make brief presentations.

Susan Preston, general partner of [CalCEF](#), a clean-energy angel fund in San Francisco and author of two books on angel investing, said entrepreneurs might have to pitch to 50 or 100 investors before they got venture funds: “In tight times, only the absolute stars rise to the top to receive funding. If they want to have a chance, they’ve got to be well prepared.”

Know Where to Look

Angels often don’t advertise themselves because they don’t want to be deluged by suitors. And lists or directories have their limits (although this [one](#) from the Angel Capital Education Association can help you get started). “Look farther, network a little harder,” said Jeff Sohl, director of the Center for Venture Research. “Turn over those rocks like you should have been doing all along, rather than taking the easy route of Googling and looking at the first 10 hits. That might have worked in the go-go times of 2000, but it doesn’t even get you close now.”

Consider both lone-wolf angels and organized groups. Angels tend to focus on regional companies but increasingly are specializing in niches like medical devices, technology and clean energy.

One classic mistake is to look at angels solely as sources of cash. Ms. Preston considers money to be an angel’s third most important contribution after expertise and networking. She urges entrepreneurs to scrutinize potential investors: What expertise can they provide? How do their strengths complement your weaknesses? Who can they introduce you to?

Coached by an Angel

Murat Ozsü weathered the recent sea change in angel investing — and survived to tell about it.

Mr. Ozsü had spent more than two years bootstrapping his Long Island-based start-up, innRoad, an online platform that helps independent hotels manage guest bookings. He had moved to a smaller house, borrowed from family and friends, worked out of his son’s bedroom and spent many nights laboring into the wee hours so he could coordinate with his software development team in

India. He pitched to hundreds of angels before he attracted the interest of a few investors who began coaching him. Just when he had built up a base of customers and was poised to get financing, his plans hit a major snag: the financial collapse of 2008.

Mr. Ozsu took his plan and ripped it apart. On the advice of his angels, he recalibrated for leaner times and cut his capital requirements in half. “These are all guys who have run their own companies,” he said, “and they’ve all been through this before. I’d much rather learn from other people’s mistakes. I’m going to make my own mistakes, so why make theirs?”

Ultimately, innRoad won the backing of 15 angels and a New York State investment program and raised \$1.2 million — twice its goal and, surprisingly, the same amount it had planned to seek before the crisis. InnRoad recently did a second investment round of \$300,000, which Mr. Ozsu said would sustain the company until it reached breakeven next summer.

Along the way, he said he learned to think like an investor — often a difficult step for entrepreneurs who have poured their souls into their companies. “Trying to raise money is not the goal,” Mr. Ozsu said. “The goal is a business plan that makes sense on its own merits. Money is just one of the tools that you need.”

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