

# HOW TO FUND OTHER STARTUPS (AND GET RICH)

Angel investors describe their paths  
from **entrepreneur to financier.**

BY JEANNE LEE GAINESVILLE, FLA.



IF YOU CASH OUT OF A FLOURISHING SMALL business, what's next? Another startup is likely to be all-consuming, yet retirement would probably bore you. For an increasing number of entrepreneurs, the middle ground is angel investing, in which wealthy individuals give financial backing to budding companies. Last year some 227,000 angels in the U.S. pumped \$23 billion into startups, up about 3% from 2004, according to the University of New Hampshire's Center for Venture Research. In 1996 there were only about ten angel groups in the U.S.; today there are more than 200. One reason for the growth: the void left by venture capitalists, who have started to favor larger, later-stage investments.

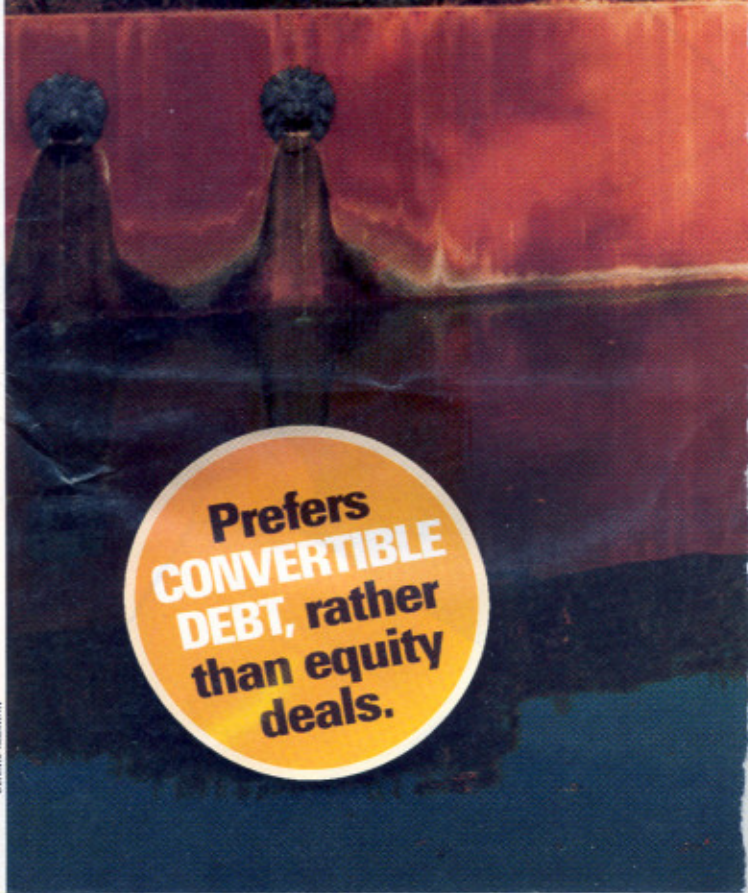
No school teaches angel investing, so newbies often earn their wings in typical entrepreneurial style—by the seat of their pants. We asked four veterans for advice they'd give to someone just getting started. One thing they all agree on: Devote only a small portion of your portfolio, say 3% to 10%, to such risky investments. Here's what else they said:

## DON'T GO IT ALONE

**B**Y AGE 53, TONY SHIPLEY HAD FOUNDED AND BUILT two companies and successfully sold the second one—a \$60-million-a-year maker of software for monitoring heavy equipment, with 380 employees—to Rockwell Automation in 2000. The sale left him set for life, but he soon

DEANIS KLEMAN

Real estate developer (and angel investor) Lee May, at her home in Gainesville, Fla.



**Prefers  
CONVERTIBLE  
DEBT, rather  
than equity  
deals.**



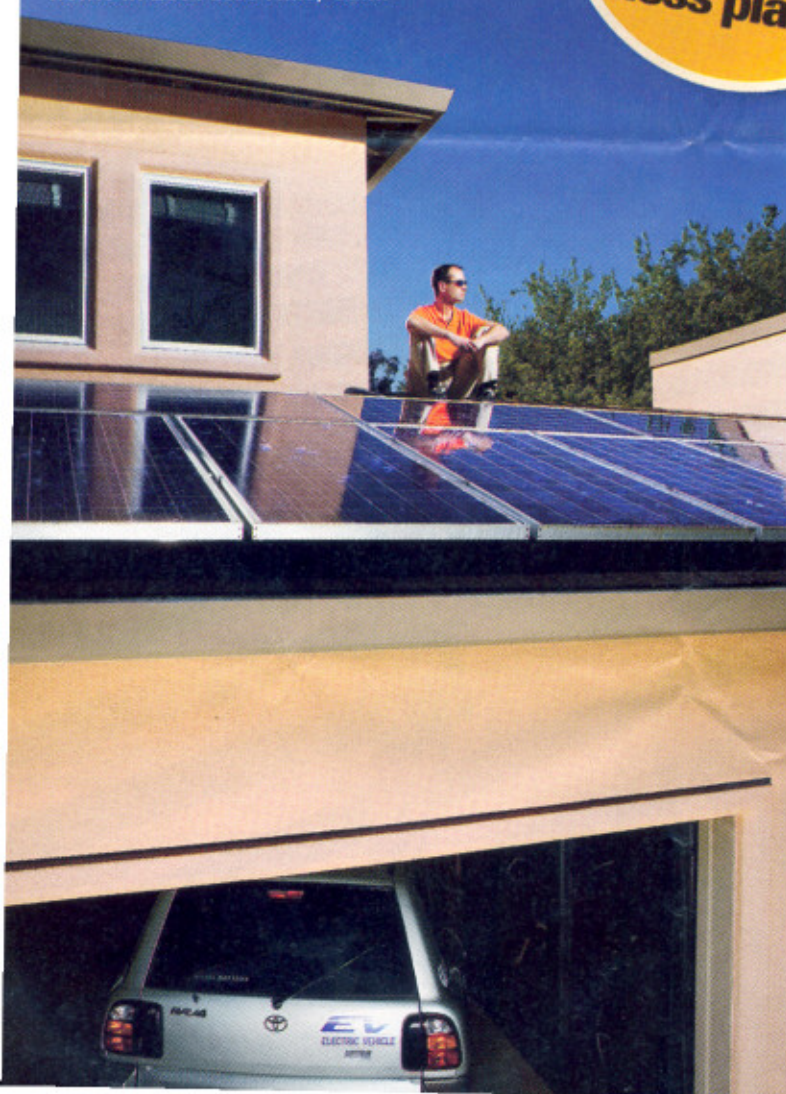


found that full-time golf and leisure weren't all he thought they'd be. He missed the intellectual challenge of solving business problems. Together with a few friends, he made an initial foray into early-stage investing.

"It was a typical angel story," says Shipley, now 59. "A software company that belonged to a friend of a friend. I wrote a check and probably did not do the proper due diligence." The result? A major bust, to the tune of about \$1 million, divided among several friends and a few outside investors. Watching the company's decline and eventual bankruptcy taught Shipley a valuable lesson. "We realized that a single investor or a small group of four or five can get too emotional about deals," he said.

Next time around, Shipley took a more structured approach. Together with a half-dozen friends who had known one another for 30 years, he formed a group in Cincinnati in 2001 called Queen City Angels.

Green-themed investor Chris Vargas atop his solar-powered home in Los Altos Hills, Calif.



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He studied other angel networks and started evaluating companies, pooling resources, and looking for members with the time, energy, and passion—as well as the dollars—to invest. "We structured our process to mimic what you'd do at the VC level, even though our checks are not as big," he says.

Members of Queen City Angels make a handshake (not a written) commitment to invest a total \$250,000 over three years, spread out over several deals—a fairly high bar as angel groups go—and must give of their time and experience too, by vetting business plans, writing term sheets, and serving as advisors to portfolio companies. The 22 members come from a variety of backgrounds, including tech and medical startups and large corporations. Shipley spends 20 to 30 hours a week running the network.

Several other members devote similar amounts of time, though most put in fewer hours. A full-time administrator takes care of paperwork and sets up meetings every three weeks, where members hear pitches from entrepreneurs for about three hours. Altogether Queens City Angels sees about 100 companies a year and has committed to 16 deals since 2001. The group has cashed out of two, earning back about 2.5 times their initial investment on each.

One current project is C.H. Mack of Cincinnati, a maker of health-care-management software. "The company was in a lot of trouble, but it did have a good product and a great market opportunity," says Shipley. Simply writing a check would have been of little use—the company needed serious help. So in 2001, along with their capital injection (\$3.8 million to date), Queen City Angels installed Shipley as chairman and another member as CEO. (The founders of the company retain a minority equity stake.) They nurtured their investment by ditching a less-promising product and focusing on two niches, managed-care organizations and hospitals. The company now makes "a couple of million" a year in annual sales, Shipley says, and the investors are likely to seek VC funding in the next year or two.

## FOLLOW YOUR PASSION

**C**HRIS VARGAS, 42, A VETERAN OF SEVERAL high-tech startups (including Cisco), has long nurtured an interest in environmental technology. Three years ago he installed 45 solar panels on the roof of his home in Los Altos Hills, Calif. The thrill of tapping into all that free, clean energy—while eliminating his \$175 monthly electric bill—led Vargas to buy a solar-powered electric car and an electric motorcycle. As his passion for the environment grew, he realized he could foster green causes through his investments.

"When you combine investing with your passion, you get a great sense of satisfaction," says Vargas. However,

Michael Geilhufe on his 46-foot sailboat, off the Pacific coast of Mexico

he tempers that with a dose of caution. "When I started, I promised myself I wouldn't do a single deal for a year. It's too easy to make the transition from entrepreneur to investor, because you meet exciting people with stars in their eyes." And entrepreneurial enthusiasm, he says, is contagious.

Vargas spends about 20 hours a week vetting business plans through a Palo Alto-based group called the Angels' Forum (TAF), one of some 19 such groups in California. Its 25 members commit at least one day a week to research, and they meet every Thursday to hear half-hour presentations from two or three entrepreneurs.

About 15 to 20 prospective companies each week are prescreened by at least two members familiar with the relevant industry. If the group decides to invest, it forms a limited-liability company through which members who choose to participate in the deal act as a single entity. (Names are not revealed to the entrepreneur or anyone else.) The whole process, from first contact to writing the term sheet and cutting the check, can be as quick as 30 days, Vargas says. He adds that the LLC structure is more typical of venture capitalists than of angel investors, who more often invest as individuals. "Sometimes working with angels can be like herding cats for the entrepreneur," he says, "because you have ten different checks, and ten opinions on the term sheet."

In the past six months Vargas has invested in four deals, including Seattle-based Organic-to-Go, a healthy takeout restaurant and corporate delivery service specializing in prepared meals made with all-organic ingredients. Vargas liked founder Jason Brown's experience—he had built and sold an online prescription-drug firm and quickly expanded his second business by buying a company out of bankruptcy for pennies on the dollar.

Another angel who follows his passion is Michael Geilhufe, 62. Geilhufe co-founded a tech company in 1988 called Information Storage Devices, which made voice-recognition chips. Seven years later the company went public, and three years after that, it was bought out by a Taiwanese firm. Since then he has spent his time—when he isn't sailing—as an investor in a Silicon Valley network called Band of Angels. He's had a few ups and downs: His first deal, a company that developed calendar software for wireless phones, went bankrupt, costing him his "modest five-figure" investment, but he has also invested in six startups that are still growing, and he hasn't cashed out of any yet. His latest is a venture called Civic Space, which uses an open-source approach to provide low-cost customer-relationship management soft-

ware for small nonprofits such as churches. (Full disclosure—his son is one of the principals.) "It's a for-profit venture but with a social conscience," he says.

## LOCATE THE EXIT

**S**OME ENTREPRENEURS THINK THAT ANGELS ARE BANKS, that the angel will give them the money, then wait around for years until the entrepreneur returns it to you with interest," says Bill Payne, 65. That's not what angels are about. When Payne makes an early-stage investment he stands ready to lose it all, but





if he wins, he's hoping for a big payday—returns on the order of 20 or 30 times his bet. He made his first angel investment in 1980 in Southern California, where he had founded a successful electronics-materials business, Los Angeles-based Solid State Diagnostics, which he later sold to DuPont for about \$10 million. Back then angels were few, and angel groups practically nonexistent. Today Payne has 31 deals under his belt and has about \$500,000 invested in seven ventures. "More than half of my companies have gone under," he says, "but four were home runs, returning more than 25 times my investment. The others gave me a small return, or at least part of my money back."

He invested in two informal deals on his own and started working with angel networks in 1998 as a founding member of the San Diego chapter of Tech Coast Angels. Three years ago, upon relocating to Las Vegas, he brought his experience to a budding network called Vegas Valley Angels. Since the spring of 2003, the group has heard presentations from about 50 entrepreneurs and invested in five deals, with two more in the works. In 2004 and 2005 the group put \$1.25 million—from 15 angels—into a company called SmartConnect, a Las Vegas-based maker of fraud-detection software that Payne thinks will become a "must have" for fast-food restaurants, convenience stores, and casinos, allowing owners to have digital video surveillance of cash drawers.

Payne's advice to newbies? It's all about the exit. "You have to understand that entrepreneurs have two hats: the founder/CEO hat and the shareholder hat," he explains. Angels usually invest with a rough time horizon of five to seven years (for VCs it's three to five), though obviously a deal can take longer to ripen. "I've been in some deals for 15 years before we harvest," says Payne. An angel investor's worst nightmare is a founder/CEO who is chugging along running the business, making a nice living, with no interest in selling or going public. That leaves the angel with no route by which to realize a return.

## BEFRIEND THE VULTURES

**I**N ANGEL CIRCLES, VCS ARE JOKINGLY KNOWN AS "VULTURE capitalists." When those deep-pocketed, later-stage investors put money into a company, they often dictate terms, even if that means shredding the carefully laid plans of angel and entrepreneur. For example, how a VC values a company at the time of her investment could potentially dilute the stake of earlier investors and owners.

Lee May, 48, a real estate entrepreneur who developed one of the first gated communities in Gainesville, Fla., is the chairman of two-year-old Emergent Growth fund, an angel group that partnered with the University of Florida to fund startup companies built around new technologies patented by the university's researchers. The group has invested in eight budding companies so far. May's advice: "Make sure the term sheet is user-friendly to the VCs who will come later," she says. "Otherwise, when they're negotiating they may restructure everything." For example, VCs might be turned off by a contract in which the angel has veto power over many decisions.

Jamie Grooms, 46, is CEO of AxoGen, a medical technology company in Gainesville that is working to commercialize peripheral nerve-grafting and -regeneration technology (in which Emergent has invested), and an angel investor himself. He founded Regeneration Technologies in 1996 and saw the company through an IPO in 2000. He says that angels frequently employ techniques to try to protect their investment, such as stipulating in the term sheet that there will be no "down rounds," meaning future financing deals in which the company's valuation is lowered. For example, if the owner and angel agree today that the company is worth \$100, a VC can't later say that it's worth only \$50. However, such provisions have limited power. If the VCs don't like them, they'll overrule them or take their money elsewhere.

A better strategy is to sidestep the valuation issue by making your investment through convertible debt rather than an equity stake. This strategy offers angels better protection on the downside—if the company goes bust, holders of convertible debt get paid before holders of common shares, out of any assets the company may have left. It also eases relations with future VCs because there is no need to predetermine the value of the company. Owner and entrepreneur simply agree on a percentage discount for the angel at the time the debt is converted to equity.

For example, say the company founder raises \$1 million from angel investors today and plans to raise \$5 million more from venture capitalists in 18 months. The angel issues the money as convertible debt, stipulating that it will convert to equity when the next round of financing comes in. Because of the higher risk associated with coming into the deal earlier, the angel will get equity at a discount—say 25% or 30%—relative to later investors. In other words, for every \$1 of equity that the VC gets, the angel gets \$1.25 or \$1.30 worth of shares. Skeptics say that this approach limits the potential upside. Investors get the same 25% to 30% on their money even if the startup hits it big. But May remains a believer. "Convertible debt is my favorite because I'm not in the valuation business," she says. □

For links to these angel groups and others (or for help in starting your own), go to [angelcapitalassociation.org](http://angelcapitalassociation.org).

**Puts about 10% of his investments into angel deals.**