



Angel Investing 202: The Mechanics of Investing



**This webinar will
start when the
first participant
joins zoom.
Please unmute
and announce
that you are in
the call.**

Agenda

- **The Big Picture**
- **Investment instruments**
- **Angel Investing Norms**
- **Valuations**
- **Post-investment activities**
- **Tax considerations**



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The Network

About

- First investment in 2016
- Primarily pre-seed investments
- 85 angel investors
- Chapters in Austin, Dallas and Houston
- We fund companies from across the US
- We also has a Philanthropic sidecar fund

Investments

- Have invested \$13M in 39 impact companies
- Per year
 - ~300 company apply
 - ~ 6 companies get initial funding
 - ~6 portfolio companies get follow-on funding

SWAN Evaluates Two Bottom Lines

Primary consideration

Financial return to shareholders

**Impact created by company's
primary business mission**

Secondary consideration

**ESG (Environmental, Social,
Governance), DEI & other socially
responsible internal operations**



The Big Picture

Example of a Funding Life Cycle

**Company
creation**

**Angel
Investments**

**Venture
Capital
Investments**

Exit

Year 0:
Employees get
common stock

Years 1-2:
Angels make loan
(convertible
debt) to company
or buy preferred
stock

Years 3-5:
VCs buy
multiple rounds
(A/B/C..) of
preferred stock.
Angel debt
converts to
preferred stock.

Years 7:
Investors and
employees can
cash out

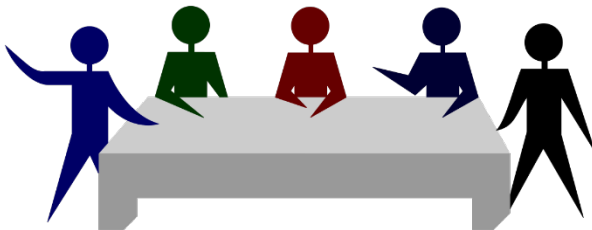
Ways Investors Can Make a Return



**Loan: Revenue-based
Financing or Venture Debt**



**M&A – Merger
and Acquisition**



**Become Partner
in an LLC**



**IPO – Initial Public
Offering of stock**

Key Concept - Valuations

$$\begin{array}{|c|} \hline \$2\text{M pre-} \\ \text{money} \\ \text{valuation} \\ \hline \end{array} + \begin{array}{|c|} \hline \$1\text{M} \\ \text{investment} \\ \hline \end{array} = \begin{array}{|c|} \hline \$3\text{M post-} \\ \text{money} \\ \text{valuation} \\ \hline \end{array}$$

Result: Investors own 1/3 of the company

- “pre-money valuation” is used for equity investments, e.g., Series A
- “valuation cap” defines a maximum pre-money for convertible-debt conversion and can be different (lower or higher) from the equity pre-money.



Common Investment Instruments

Equity based

- Convertible Debt
- SAFE Notes
- Preferred Stock

Loan based

- Revenue Based Financing

Typical Investment Instruments

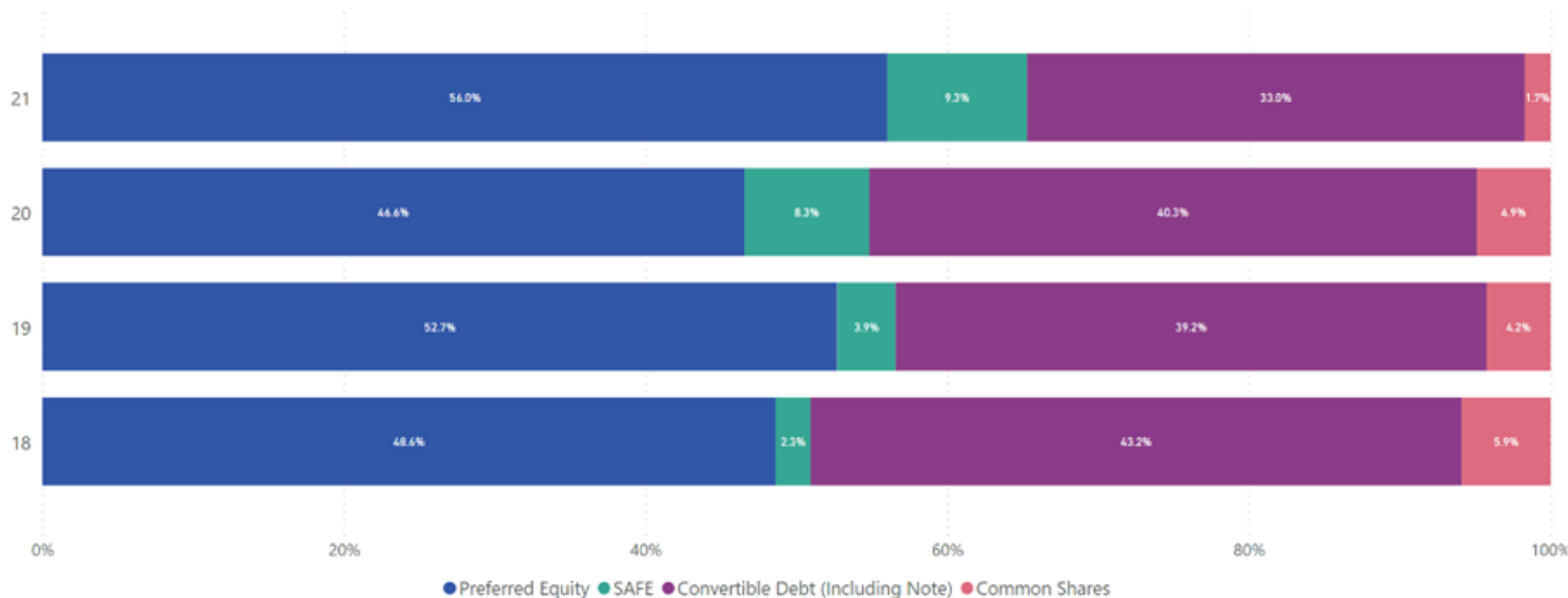
Stage	Bootstrap	Pre-Seed/Seed	Series A > B > C ...	At IPO or M&A
Founders	Common stock	Few additional shares		Shares become liquid
Employees	Common stock option grants.			Options convert to liquid common stock
Equity Investors		Mostly Angels Typically: convertible debt, or SAFE	Mostly VCs: preferred stock	Preferred stock converts 1:1 to liquid common stock

Instruments used by ACA Angel Groups

Preferred Stock and **Convertible Notes** are predominant

FIGURE 4: % OF ANGEL DEALS BY DEAL STRUCTURE

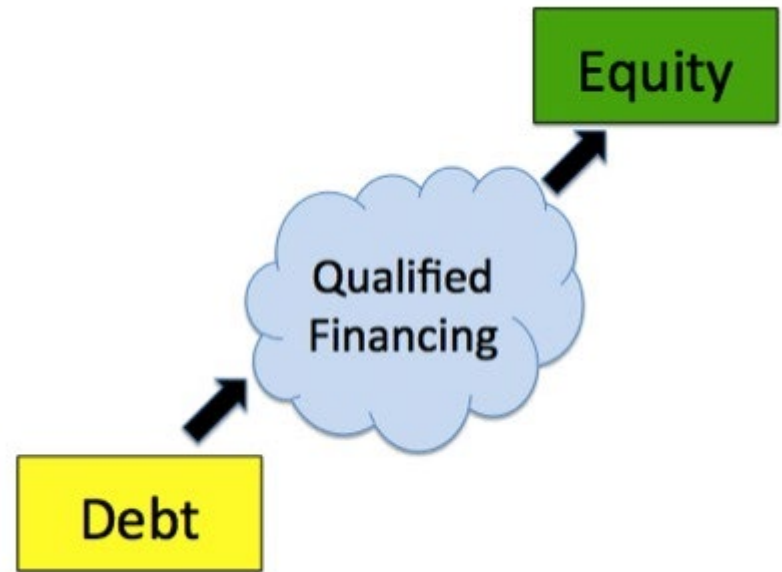
% of Transactions by Security & Year



Source: Angel Funder's Report, 2022

Convertible Debt

- The loan automatically buys series A preferred stock when A is issued, at better terms than the series A investors receive
- Debt is unsecured (unrecoverable) if the company fails
- No pre-money valuation is set



How Convertible Debt Works

(Convertible Debt \$ + Interest \$ earned)

typically
5-8 percent

buys Series A preferred Stock at a discount

typically a 15-20% discount
and with a
pre-money valuation cap

Convertible Debt – Key Terms



- **Valuation cap**

- Impacts the number of shares issued at conversion
- Example:
 - If series A investors offer a pre-money of \$8M, then \$1M of their money buys 1/9th of the company
 - But if the Notes's Cap is \$4M, then \$0.5M (the angels' prior convertible note amount) also buys 1/9th of the company when series A occurs

- **Discount** on series A price (~15%)

- **Interest** rate (~ 3 to 8%)

- **Conversion trigger**

- A series A of a certain \$ size (e.g., \$2M)

- **Maturity date**

- Investors can ask for repayment at that date
- Or sometimes, a forced conversion at that date using the valuation cap

What Convertible Debt Valuation Cap makes sense?

Investor Cap Objective: apply standard rules of thumb

Pre-revenue	ARR < \$100k	ARR < \$500k	ARR > \$1M
\$1.5 to \$3M	\$2.5M to \$5M	\$4M TO \$8M	\$6M to \$1xM

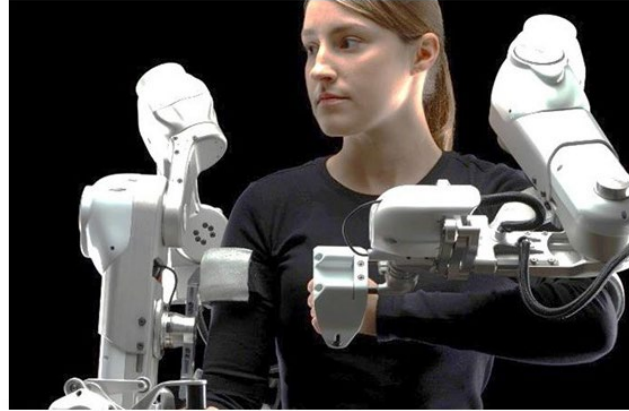
Ideally satisfy both objectives: A pre-revenue company raises \$500k and offers a valuation cap of \$3M. (Post of \$3.5M. ~15%).

Company Cap Objective: Give pre-seed investors no more than ~15% ownership

Conversion Example – Harmonic Bionics



Chris Prentice
CEO



- 2019 Convertible Note
 - SWAN invested \$140k
 - \$8M valuation cap
 - 10% interest
 - 20% discount
- 2021 Preferred A Raise
 - \$13.5M pre-money valuation
 - \$0.9217 per share for new investors
- We converted our \$140k at \$0.5462 per share, resulting in:
 - \$264k valuation
 - \$124k unrealized gain
 - 1.9x increase in valuation
 - 68% unrealized IRR

More Convertible Debt Terms

- **Use of Proceeds:** Allowable uses. Includes: cannot be used to pay off prior debt
- **Closings:** Is there a minimum \$ amount for 1st closing?
- **Change of Control:** Payout protections
- **Most Favored Nation:** If future Conv. Debt has better terms, then we get those also
- **Pre-Payment:** allowed only if investor agree
- **Information Rights:** Details are specified
- **Protective Provisions:** Actions by company that conv. debt investors must approve
- **Board of Directors:** Do we get a seat?
- **Key Person Clause:** E.g., CEO will continue full time for 5 years
- **Conditions to Closing:** List of required steps, e.g., conversion to C-Corp
- **Fees and Expenses:** Who pays legal transaction fees



**In Summary, the three most
important Convertible Note terms**

Valuation Cap
Interest rate
Discount



“Standard” Safe Notes

- Are not a loan
- Conversion at any size of preferred stock financing
- Are basically a warrant
- Optional structures:
 - No valuation cap and no discount **(Just say no)**
 - A valuation cap, but no discount **(Just say no)**
 - A discount, but no valuation cap **(Just say no)**
 - A valuation cap and a discount **(same as Conv. Note)**

What a Convertible Note has that SAFE lacks

- Always a Cap and a Discount
- Loan terms:
 - Interest earned **(Yes!!!!)**
 - Maturity date **(Yes)**
- More conversion triggers **(Yes)**
 - Equity round of a certain size
 - Maturity date
 - Exit
- Other investor rights **(Yes!!!!)**
 - Possible Board of Directors participation
- All the other terms from previous slide

Preferred Stock



- Successive priced rounds: Named Series A, Series B, Series C,
- Typically: VC-led and a Delaware C-Corp is required
- The marketplace sets the price/share
- Price/share can be higher or lower than in previous round
 - “Down” rounds are terrible for prior investors

Why is it call “Preferred”?

- Preferred stock holders have rights that common stock holders lack
 - Most notably, upon acquisition investors have the option to get 1 to 2 times their investment back before common gets anything
 - If a company raise \$3M and get acquired for \$2M than common stockholders may get nothing
- The preferences are why investors pay more per share than stock option strike prices



Preferred typically get to approve:



- Change the primary business of the company
- Annual budgets, business plans, and financial plans
- Hiring of all officers
- Compensation for officers
- A merger or acquisition
- Liquidation, wind-up or dissolution;
- Increase or decrease the number of directors
- Standard company employment agreements
- Equity incentive programs as well as issuance of all stock and stock options
- Paying of dividends
- An increase in the authorized number of shares
- Real estate transactions
- Capital equipment purchases greater than \$500,000
- Debt in excess of \$500,000

Additional Preferred Stock Terms

- **Pre-Money:** Sets how pre-money valuation is calculated. Includes unallocated option pool.
- **Anti-Dilution Protection:** if the company sells additional securities at a price less than the price paid by current investors
- **Participation Rights:** Investors will have the right to participate in future rounds of financing, to maintain their ownership percentage in the company.
- **Board Composition.**
- **Drag Along:** Investors may require common shareholders to vote in favor of a company sale if it is approved by preferred shareholders
- **Pay to Play:** requires that Investors participate in the present financing or future financings to retain anti-dilution or other rights.
- **Dividends:** Accrued dividends are paid upon a sale of the company



EQUITY INVESTMENTS



- The important question: Can company grow to ~\$40,000,000 in revenue and get acquired?
 - Half of angel-funded start-ups will return \$0
- Dilution is significant (valuation cap/pre-money)
- The SEED Fund analyzed their 70 investments and found that the best predictor, by far, of a company's success was company-friendly terms
 - Companies with the best products, the best teams and large markets can demand the best deal terms

Non-Equity Revenue-based Funding:

Loan repaid with % of revenue



Amount loaned	25% to 33% of annualized revenue
Repayment rate	4% to 8% of gross revenue
Total repaid	1.5x to 3x the amount loaned

Benefits to company

- Company does not give up equity [non-dilutive]
- No M&A pressure from investors [no exit required]
- Repayment amounts scale with revenue [no fixed monthly payment]

Typical funding criteria

- \$300k+ annualized revenue
- 40%+ gross margins
- Repayment is projected to occur in 3 to 5 years
- Product-market fit is established
- Funding will be used only for growth
- Company has no high-interest debt
- Often, comes after series A, and helps company increase value before B



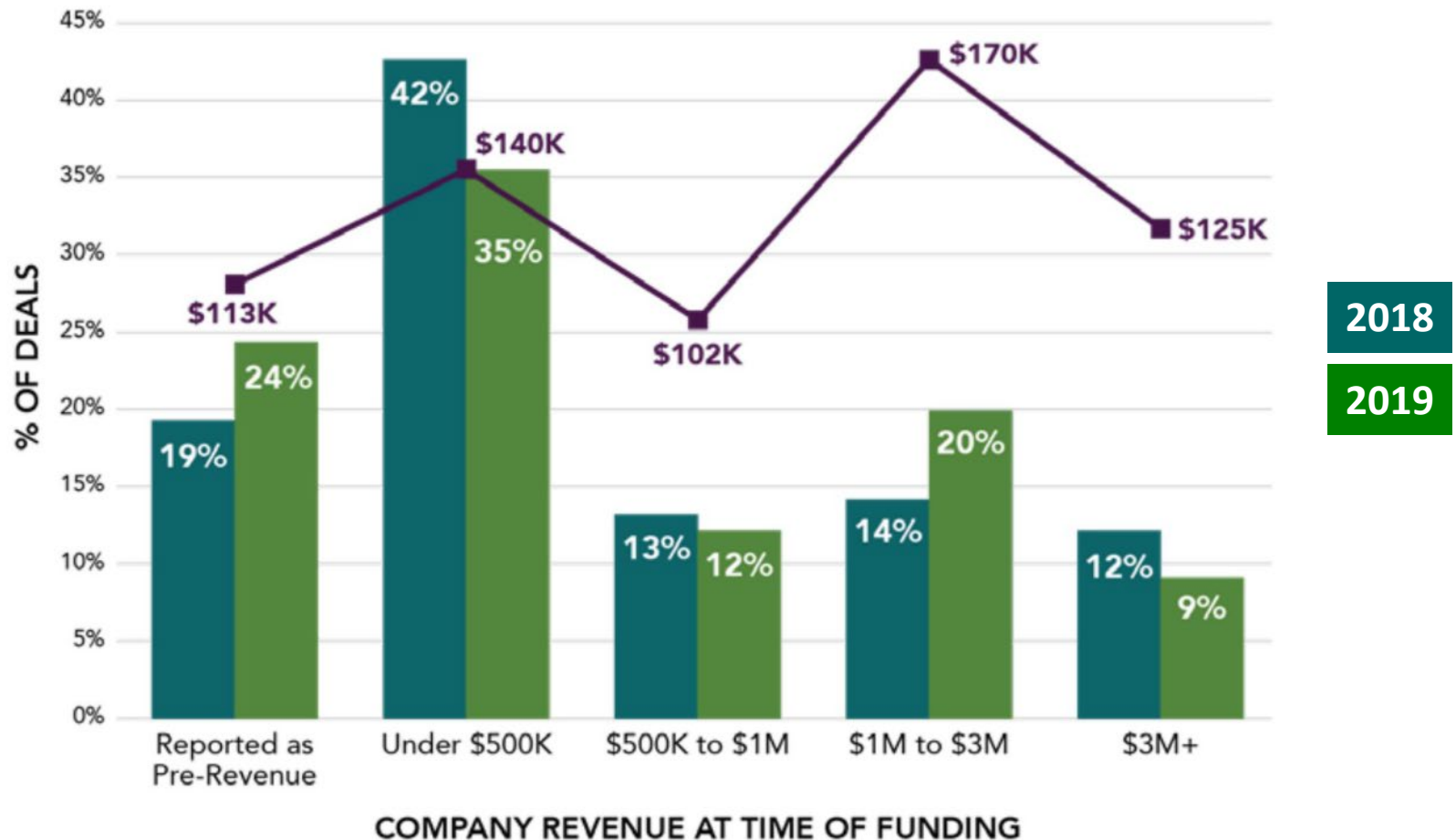
Angel Investing Norms



November 2022 Perspective from Founders Institute

Stage	Pre-Seed	Seed	Series A
Traction	Customer Validation	Product-Market Fit	Expansion
Growth Rate	0 - 20% MoM	15% - 30% MoM	25%+ MoM
Monthly Revenue	\$0 - \$75k	\$75k - \$200k	\$200k+
Team Size	2+	10+	20+
Product	MVP	Robust	Commercial
Investors	Friends & family, Seed Accelerators, Angels, Pre-Seed/ Micro VC Funds	Seed Accelerators, Angels, Seed VC Funds	Series A/ Growth VC Funds, Existing Investors
Round Size	\$25k - \$750k	\$750k - \$4m	\$4m+
Company Valuation	\$1m - \$5m	\$5m - \$12m	\$30m - \$60m
Investment Vehicle	SAFE/ Convertible Note	Priced Round	Priced Round

Angels typically invest early in revenue cycle



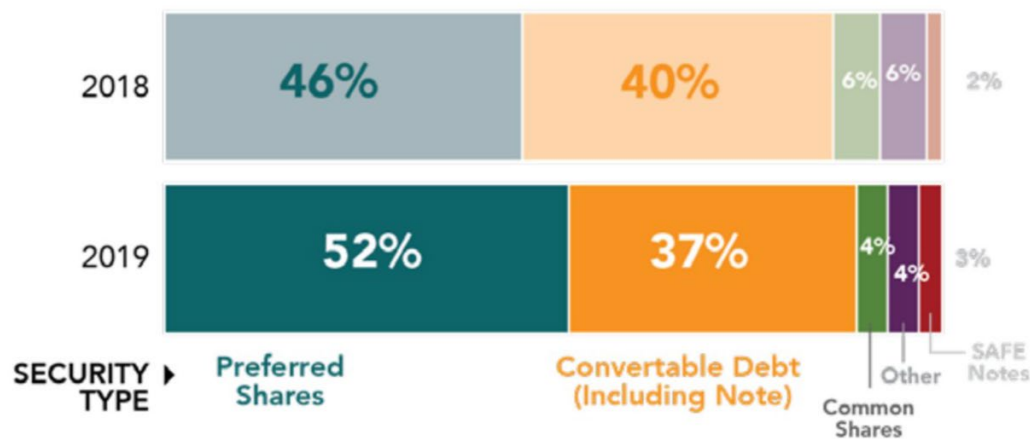
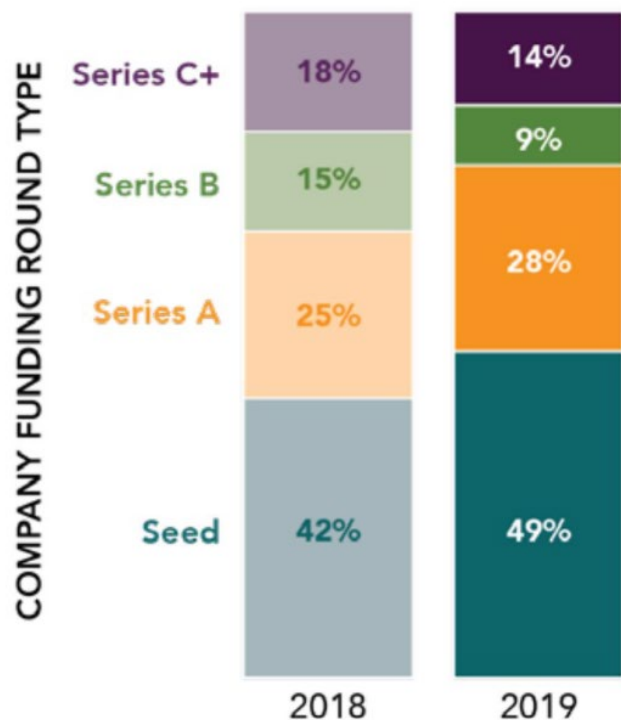
Source: ACA

Angels typically invest when Companies have less than 20 employees



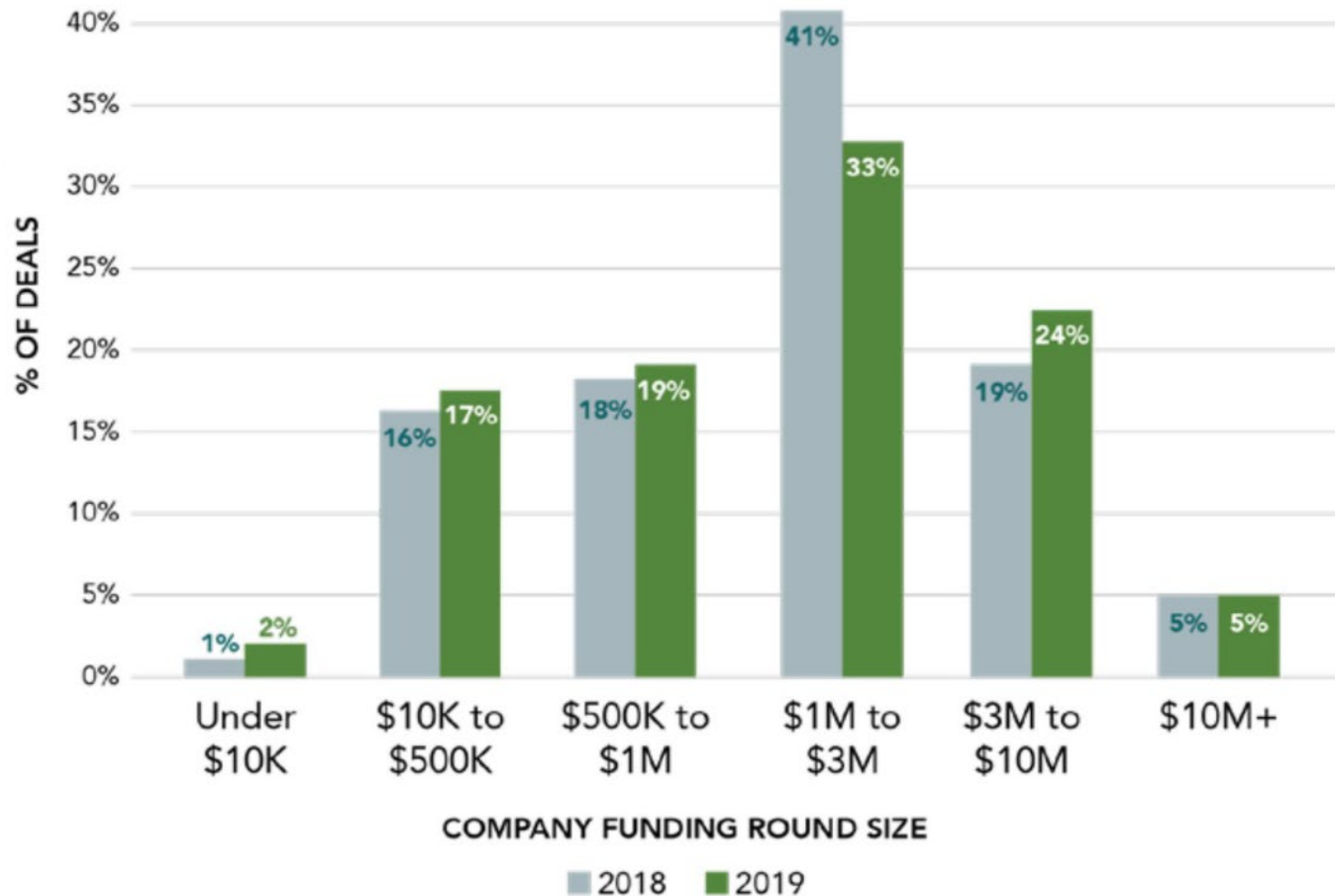
Source: ACA

Angels typically invest at Pre-Seed, Seed & A Stages



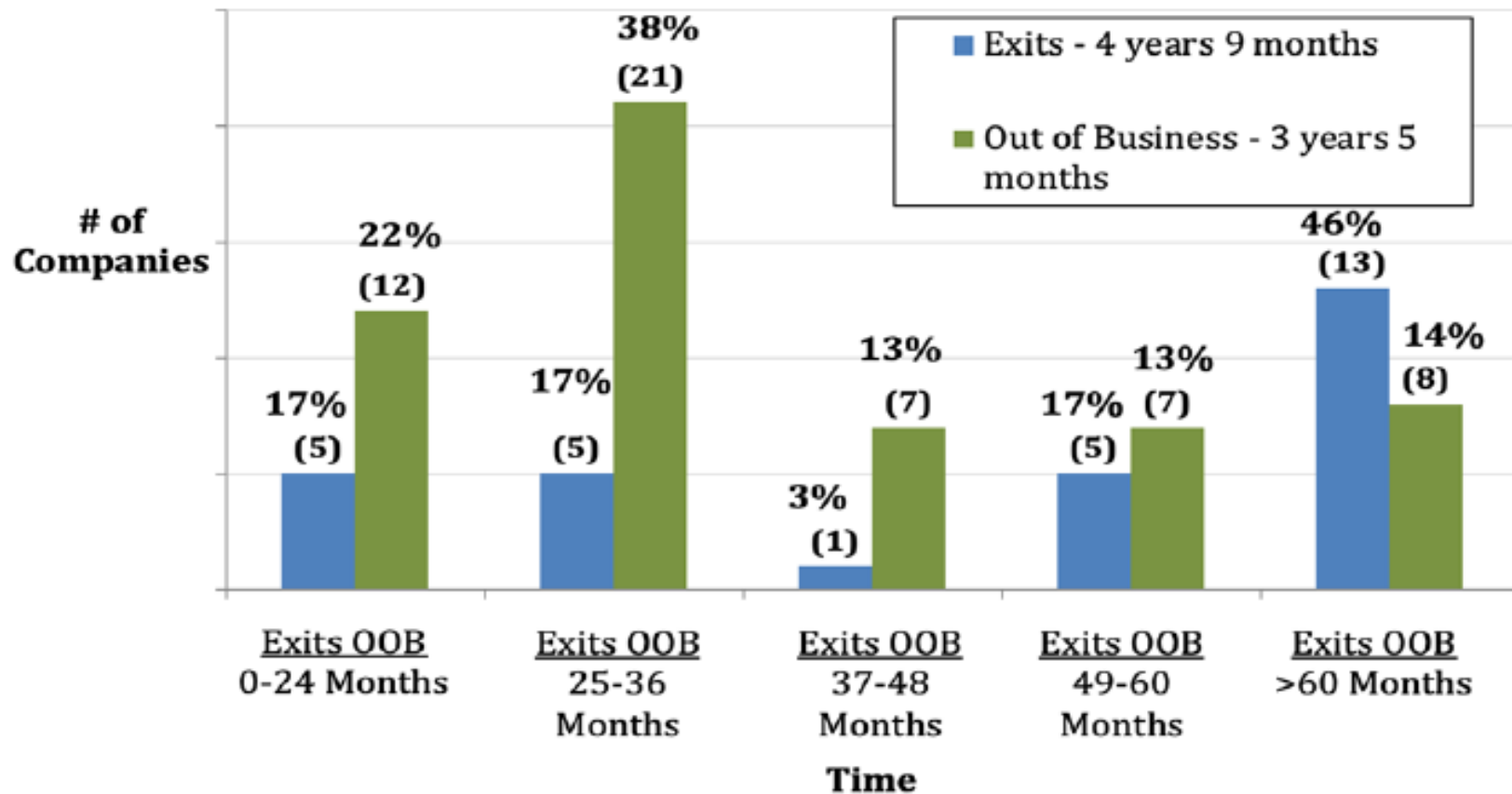
Source: ACA

Total Funds Raised When Angel Participated

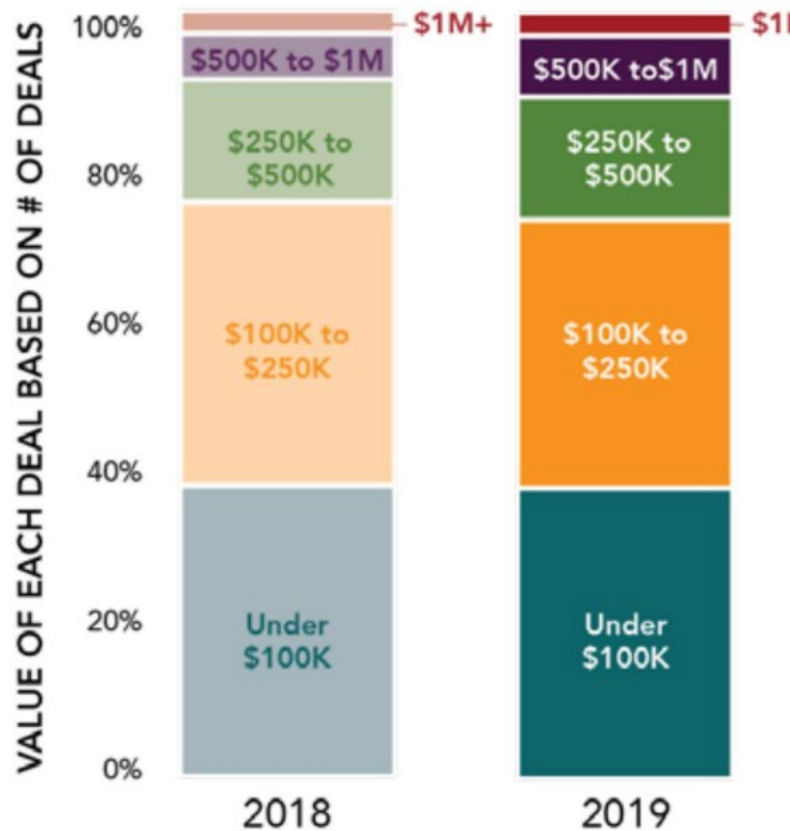


Source: ACA

Angels are Patient Investors



~75% of Angel Deals are \$250,000 or less



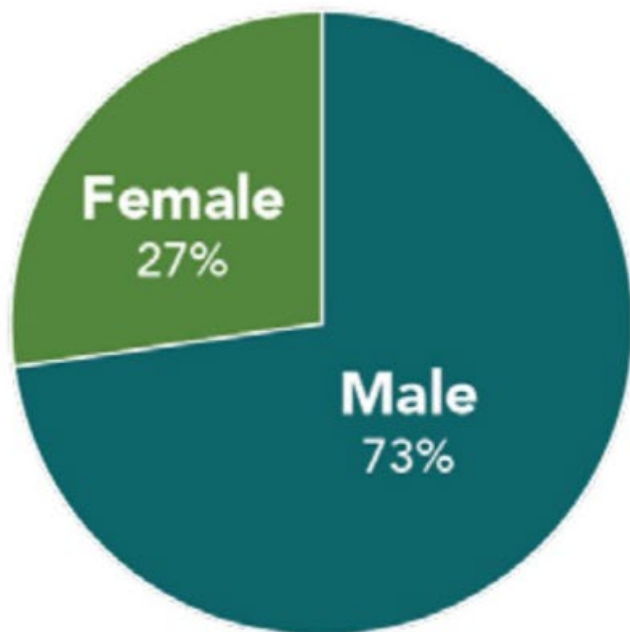
A smart Seed Round investing practice is for all of the investors to collectively own, initially, 15% to 25% of the company.

For example:
a \$1M total Seed investment by all investors implies a maximum valuation cap of \$4M to \$6.7M

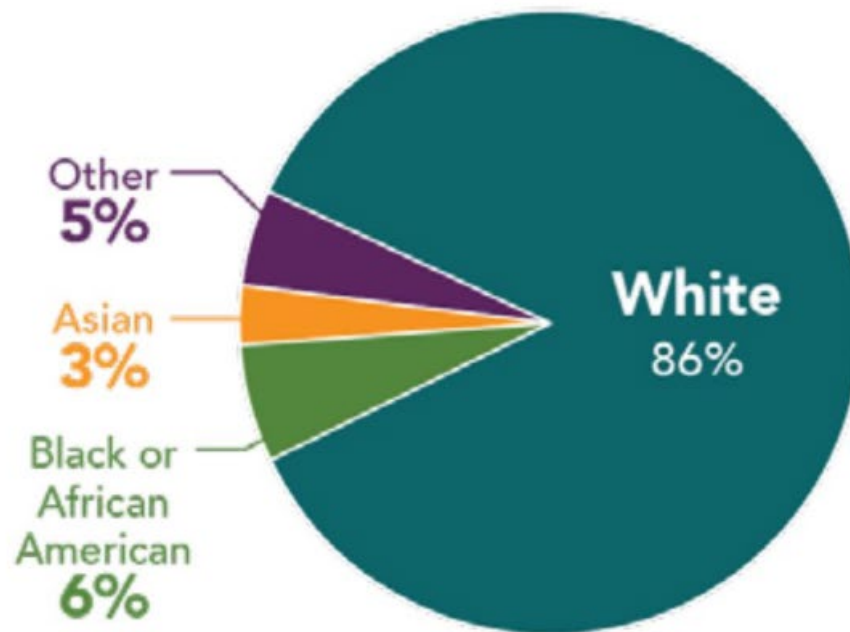
Source: ACA

Angels typically invest in white male CEOs

GENDER BREAKDOWN

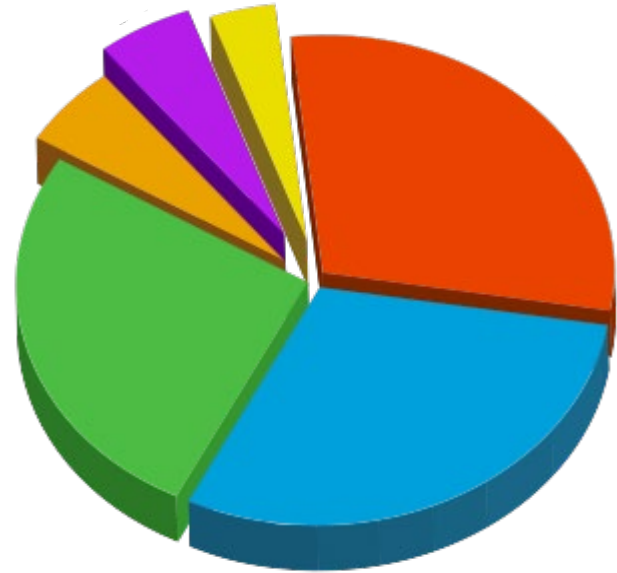


RACE BREAKDOWN



Source: ACA

Cap Tables, Valuations, Percent Ownership, Potential Returns



Cap Table	Capitalization table. Who owns what part of the company. Considers future ownership: stock options, warrants
Valuation	Total value of the company. If stock has been issued, valuation equals the number of shares time stock price.

Example of a Cap Table



Common stock	CEO	2,000,000	44%
	co-founder	1,000,000	22%
Stock Options Granted	CTO	100,000	2%
	CFO	80,000	2%
Preferred Stock	Investor	200,000	4%
	Investor	400,000	9%
Unallocated stock options		800,000	17%
Total - Fully Dilluted		4,580,000	100%

- What we like to see:
 - Option pool of 15% for new hires
 - Vesting schedule for all founders
 - CEO has more shares than each individual co-founder

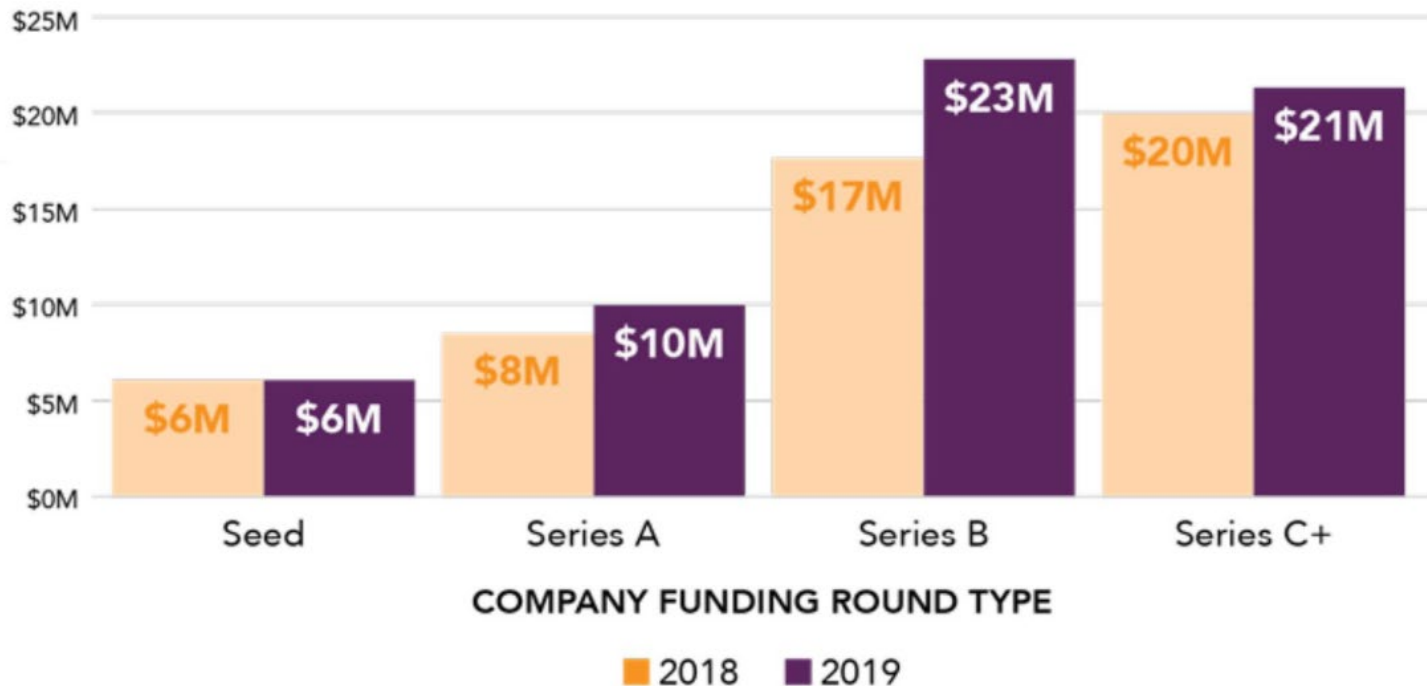
A company's valuation is determined by the marketplace



- A negotiation between the buyer (investor) and the seller (the company)
 - What valuation will the lead investor agree to?
 - What percent ownership will the lead investor agree to?
- Companies shop around to get the best terms
- A valuation that is higher than market norms can set a company up for a valuation decrease at the next round (a painful down-round)

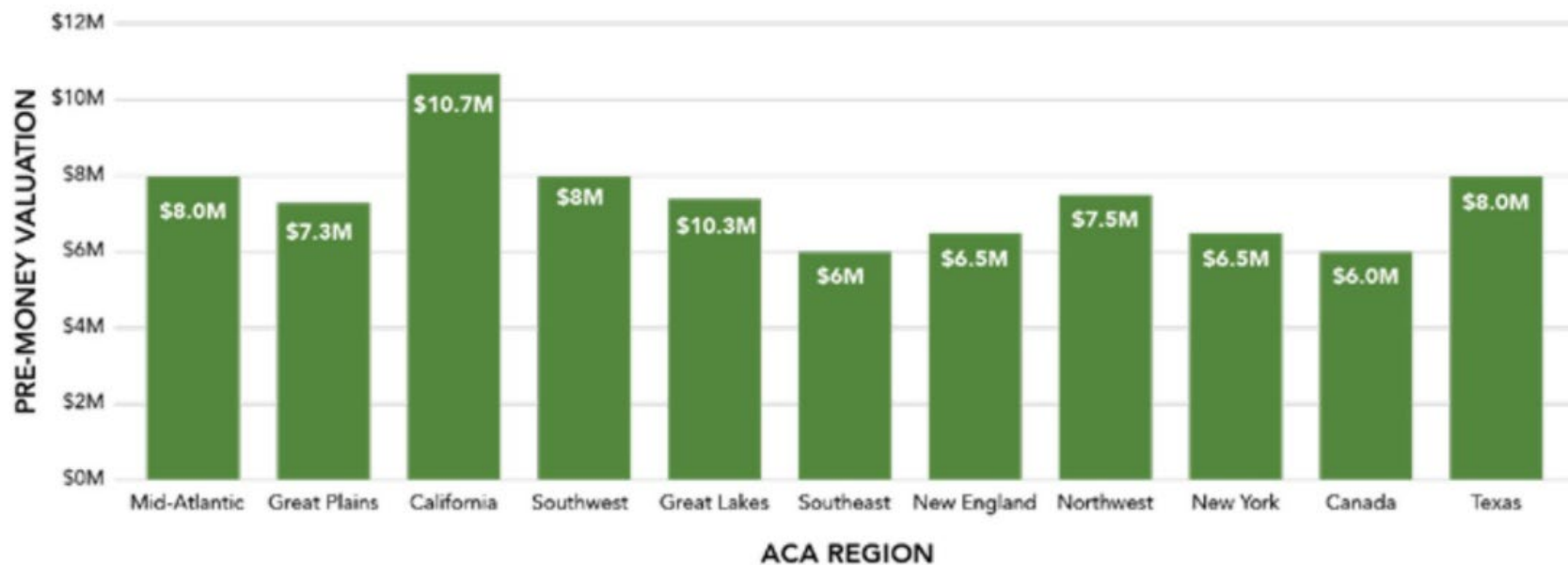
Median Valuations

(what the company is worth)



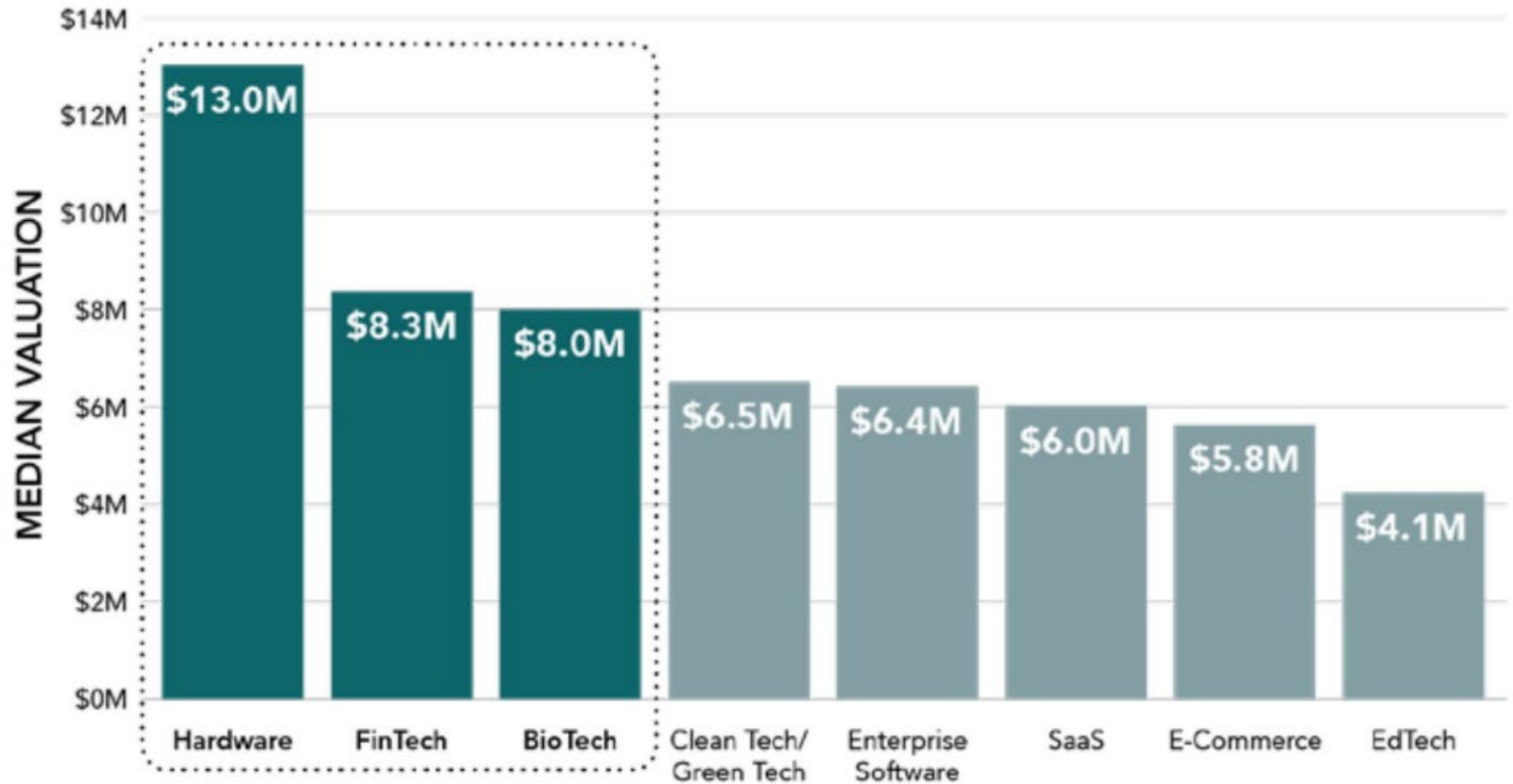
Source: ACA

Valuations Vary by Region



Source: ACA

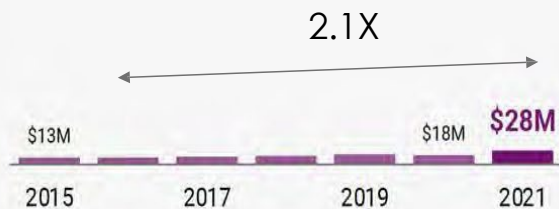
Initial Valuations by Industry



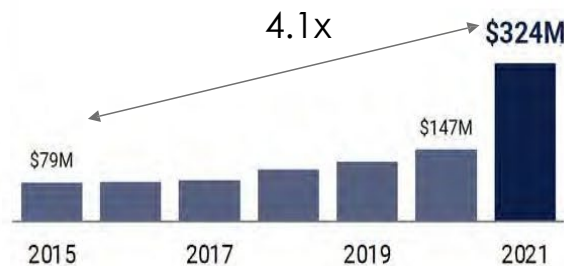
Source: ACA

Some History: Median Valuations Grew Dramatically in Seven Years

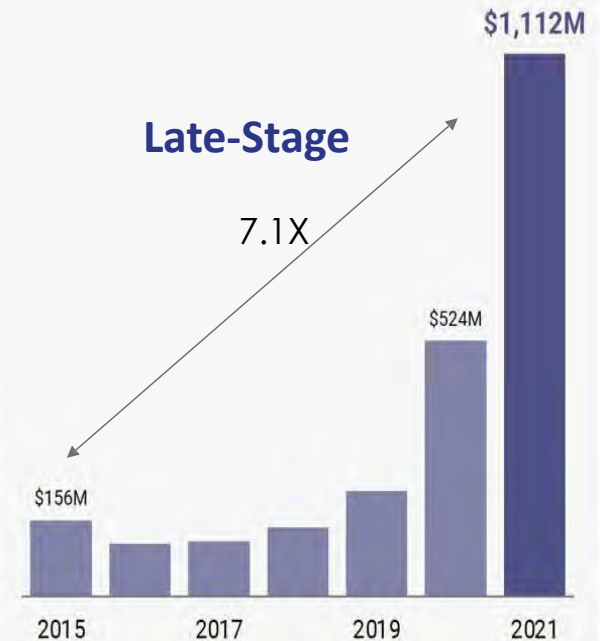
Early-Stage



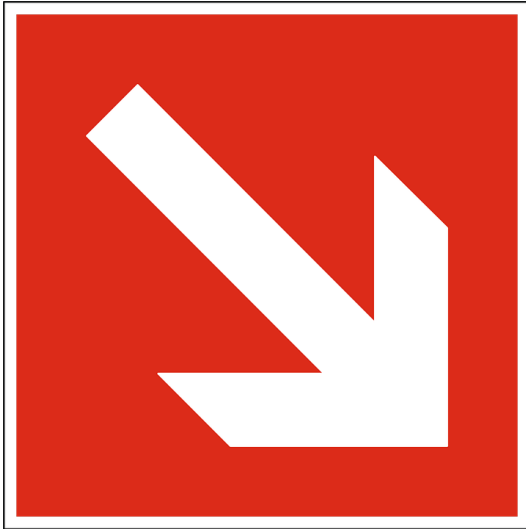
Mid-stage



Late-Stage

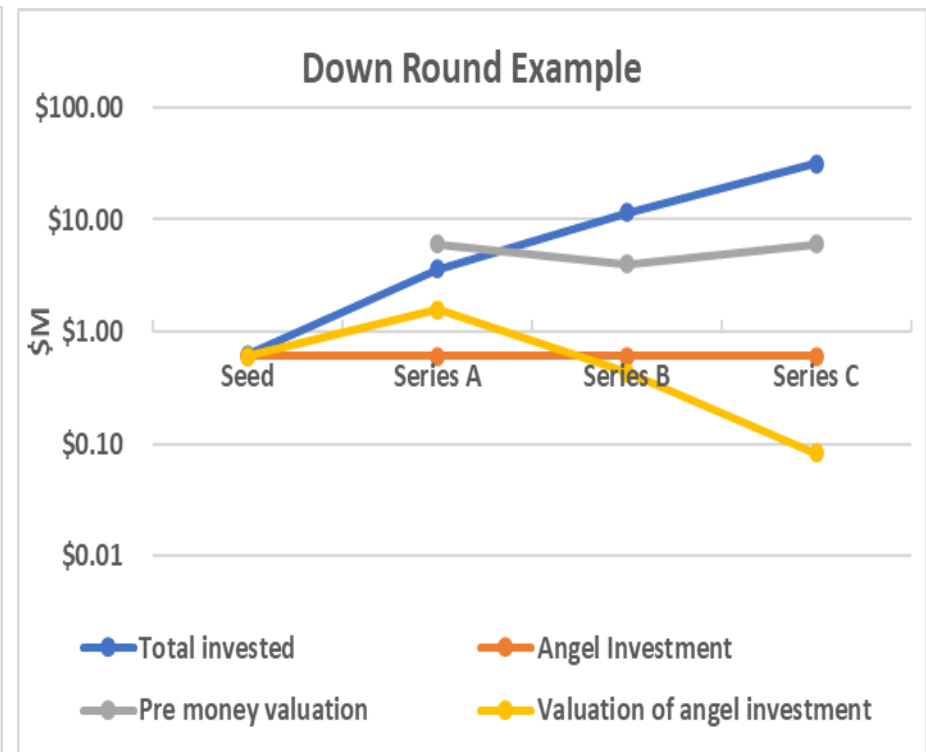
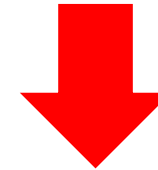
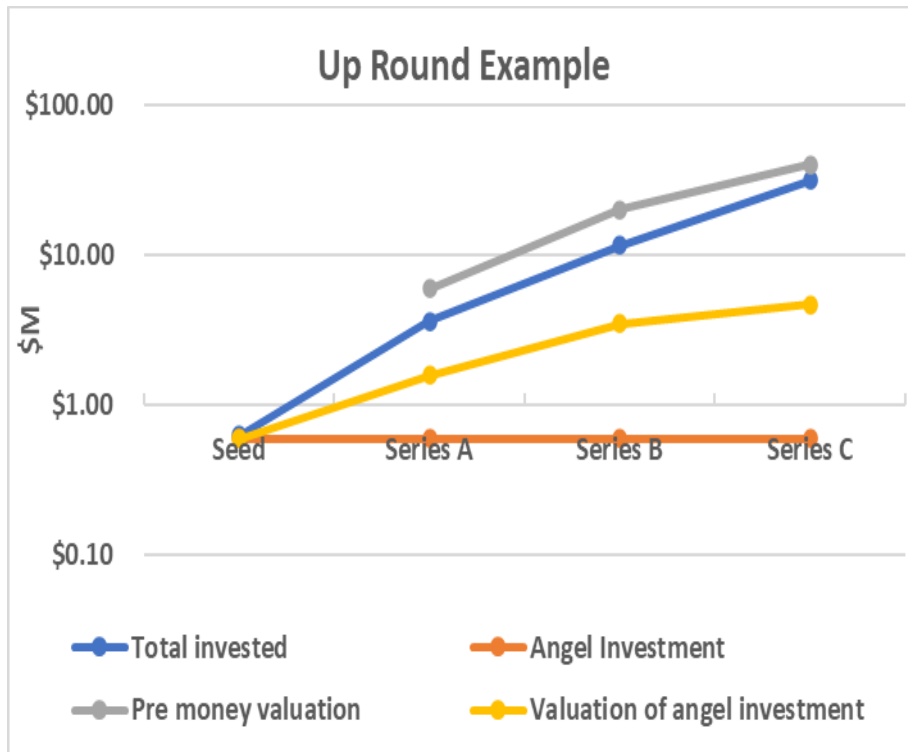


Advice for Negotiating Valuations in 2023



- Ignore the recent valuation craziness
- 2021 valuations are not a guide for 2023
- A prior round valuation may have little relevance to a new round in 2023
 - Some sectors have seen valuations drop by 50%
 - Especially for later-stage companies

Valuations can go Up or Down



SWAN Valuation Results

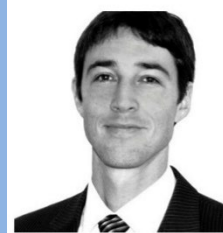
Flow Below – Acquired, 36% IRR



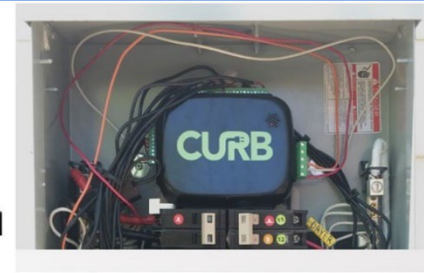
Josh Butler
CEO/Founder



Curb – Merger, unrealized 5% IRR



Erik Norwood
CEO/Founder



Acadeum – Conversion, unrealized 13%



Josh Pierce
CEO/Founder



Yotta – Conversion, unrealized 17% IRR



Omeed Badkoobeh
CEO/Co-Founder



Brobe – Repaid loan, 10% IRR



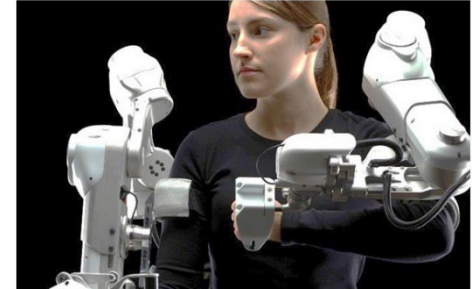
Allison Schickel
CEO/Founder



Harmonic – Conversion, unrealized 69% IRR



Chris Prentice
CEO



Valuation, Dilution, Return Example: Angel 7x return.

Every round has a
higher stock price
(up rounds)

Invested (\$M)	Bootstrap	Seed
VC Series C		
VC Series B		
VC Series A		
Seed (Angel)		\$ 0.60
Employees	\$ 0.03	\$ 0.03
	\$ 0.03	\$ 0.63
Valuation	Bootstrap	Seed
Share price		
Pre-funding Valuation (\$M)		
Post-funding Valuation(\$m)		
Shares	Bootstrap	Seed
VC Series C		
VC Series B		
VC Series A		
Seed (Angel)		
Employees	1,000,000	1,000,000
	1,000,000	1,000,000
% Ownership	Bootstrap	Seed
VC Series C		
VC Series B		
VC Series A		
Seed (Angel)		
Employees	100%	100%
Angel Bottom Line		
Angel Post valuation (\$M)		
Multiple on investment		

In this example:
Seed round is led by
angels (\$600k) using
convertible debt

Angels have no
ownership

No valuation is set

Valuation, Dilution, Return Example: Angel 7x return.

Every round has a
higher stock price
(up rounds)

Invested (\$M)	Bootstrap	Seed	Series A
VC Series C			
VC Series B			
VC Series A			\$ 3.00
Seed (Angel)		\$ 0.60	\$ 0.60
Employees	\$ 0.03	\$ 0.03	\$ 0.03
	\$ 0.03	\$ 0.63	\$ 3.63
Valuation	Bootstrap	Seed	Series A
Share price			\$ 4.04
Pre-funding Valuation (\$M)			\$ 6.00
Post-funding Valuation(\$m)			\$ 9.00
Shares	Bootstrap	Seed	Series A
VC Series C			
VC Series B			
VC Series A			742,574
Seed (Angel)			389,851
Employees	1,000,000	1,000,000	1,100,000
	1,000,000	1,000,000	2,232,426
% Ownership	Bootstrap	Seed	Series A
VC Series C			
VC Series B			
VC Series A			33%
Seed (Angel)			17%
Employees	100%	100%	49%
Angel Bottom Line			
Angel Post valuation (\$M)			\$ 1.57
Multiple on investment			2.6

In this example:
Series A equity
investment by VCs
(\$3M and
\$4/share)

Pre-money of \$6M
and post-money of
\$9M

Conversion with
20% discount &
5% interest

Option pool
increased

Debt converts with
discount and
interest and angels
own 17% of \$9M,
valued
at \$1.57M

Valuation, Dilution, Return Example: Angel 8x return.

Every round has a
higher stock price
(up rounds)

Invested (\$M)	Bootstrap	Series B	Series C
VC Series C			\$ 20.00
VC Series B		\$ 8.00	\$ 8.00
VC Series A		\$ 3.00	\$ 3.00
Seed (Angel)		\$ 0.60	\$ 0.60
Employees	\$ 0.03	\$ 0.03	\$ 0.03
	\$ 0.03	\$ 11.63	\$ 31.63
Valuation	Bootstrap	Series B	Series C
Share price		\$ 8.95	\$ 12.05
Pre-funding Valuation (\$M)		\$ 20.00	\$ 40.00
Post-funding Valuation(\$m)		\$ 28.00	\$ 60.00
Shares	Bootstrap	Series B	Series C
VC Series C			1,659,751
VC Series B		893,855	893,855
VC Series A		742,574	742,574
Seed (Angel)		389,851	389,851
Employees	1,000,000	1,100,000	1,300,000
	1,000,000	3,126,280	4,986,032
% Ownership	Bootstrap	Series B	Series C
VC Series C			33%
VC Series B		29%	18%
VC Series A		24%	15%
Seed (Angel)		12%	7.8%
Employees	100%	35%	26%
Angel Bottom Line			
Angel Post valuation (\$M)		\$ 3.49	\$ 4.69
Multiple on investment		5.8	7.8

Series B and C
have higher
price per share

Series B & C
have a pre-
valuation which
is higher than
previous
round's
post- valuation

Option pool is
increased to
keep
employees
engaged

After series C,
angels own 8%
of \$60M,
valued at
\$4.7M

Angel 0.1x return example.

Company survives
but struggles
during A and B.
Series B & C are
down rounds.

Employee option
pool increased to
retain employees.

Angel's \$600K
investment now
valued at \$80k

Invested (\$M)	Bootstrap	Seed	Series A	Series B	Series C
VC Series C					\$ 20.00
VC Series B				\$ 8.00	\$ 8.00
VC Series A			\$ 3.00	\$ 3.00	\$ 3.00
Seed (Angel)		\$ 0.60	\$ 0.60	\$ 0.60	\$ 0.60
Employees	\$ 0.03	\$ 0.03	\$ 0.03	\$ 0.03	\$ 0.03
	\$ 0.03	\$ 0.63	\$ 3.63	\$ 11.63	\$ 31.63
Valuation	Bootstrap	Seed	Series A	Series B	Series C
Share price			\$ 4.04	\$ 1.10	\$ 0.21
Pre-funding Valuation (\$M)			\$ 6.00	\$ 4.00	\$ 6.00
Post- funding Valuation(\$m)			\$ 9.00	\$ 12.00	\$ 26.00
Shares	Bootstrap	Seed	Series A	Series B	Series C
VC Series C					94,339,623
VC Series B				7,272,727	7,272,727
VC Series A			742,574	742,574	742,574
Seed (Angel)			389,851	389,851	389,851
Employees	1,000,000	1,000,000	1,100,000	2,500,000	20,000,000
	1,000,000	1,000,000	2,232,426	10,905,153	122,744,776
% Ownership	Bootstrap	Seed	Series A	Series B	Series C
VC Series C					77%
VC Series B				67%	6%
VC Series A			33%	7%	1%
Seed (Angel)			17%	4%	0.3%
Employees	100%	100%	49%	23%	16%
Angel Bottom Line					
Angel Post valuation (\$M)			\$ 1.57	\$ 0.43	\$ 0.08
Multiple on investment			2.6	0.7	0.1

Post-investment Goals

- A wildly successful company
- Company closes their entire round
 - SWAN can help syndicate the deal
- CEO receives the most-needed assistance
 - Coaching, introductions, hiring C-level
- Good ongoing two-way communication between company and investors



Post-investment Activities

- Receive quarterly reports for company
- Involvement opportunities

Board of
Directors seat

If we led the deal and invested significant amount.
Has some legal risks.

BoD Observer

Attend board meeting but don't vote
on board resolutions. No legal risk

Formal Advisory
Board seat

May include stock options

Mentor /
informal advisor

Not compensated

Paid Consultant

Unusual





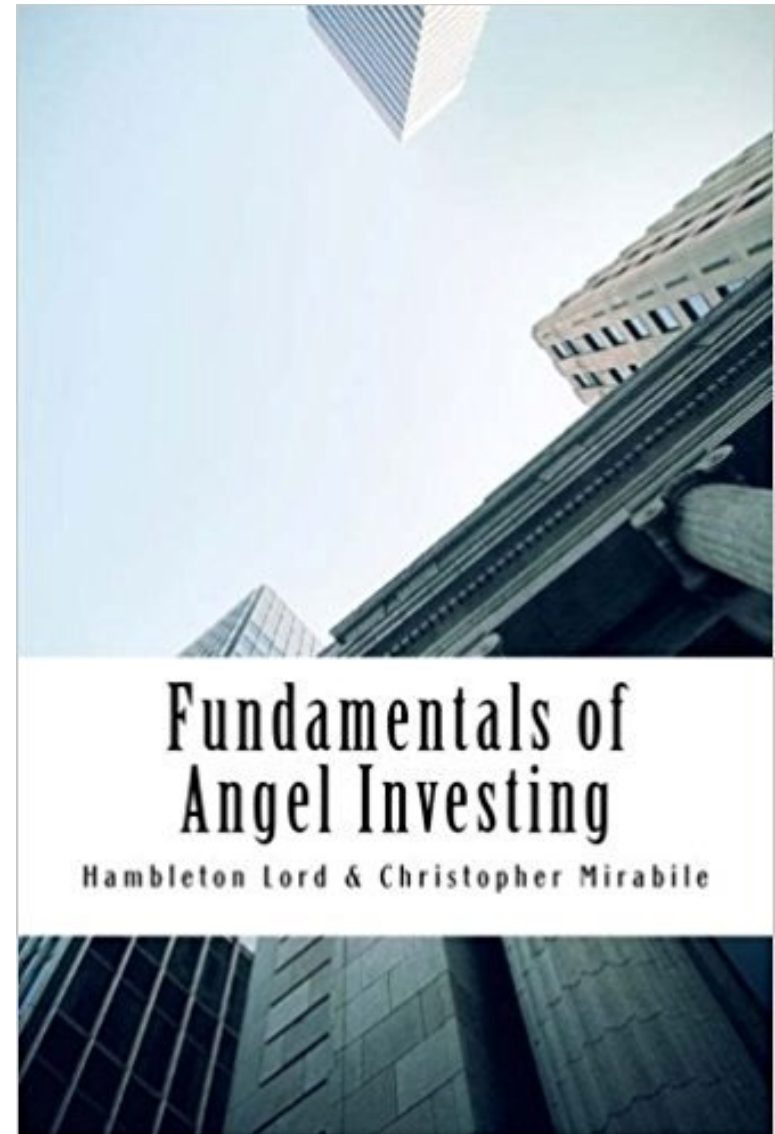
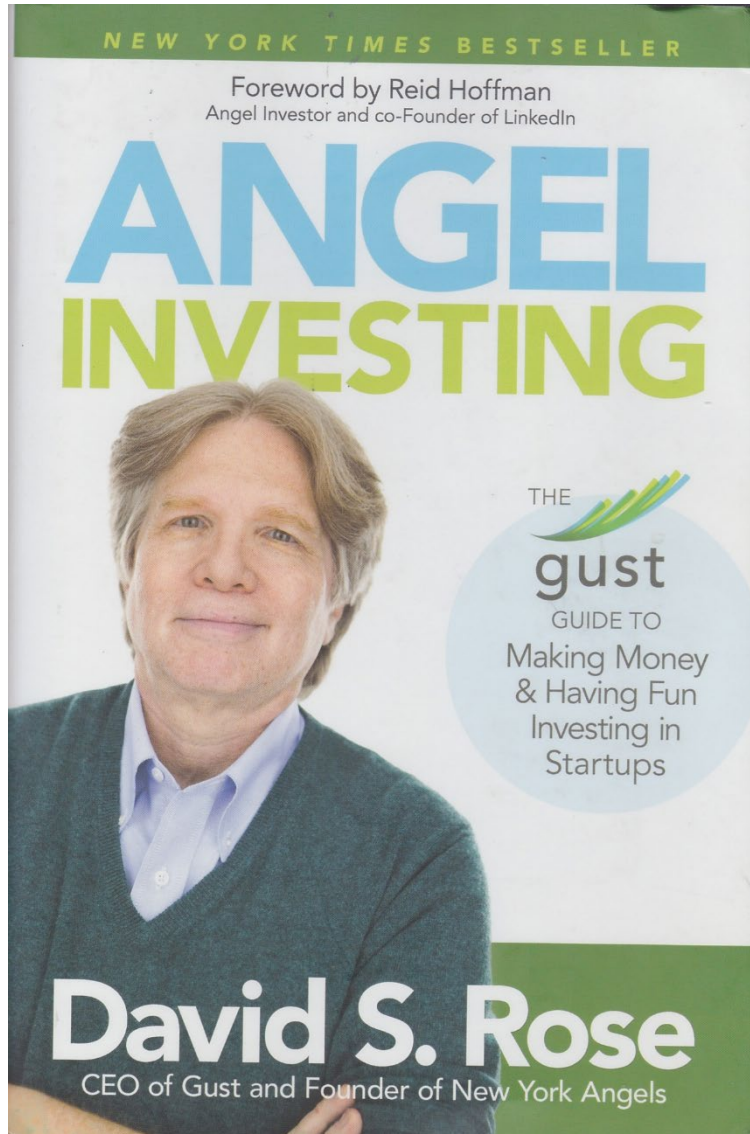
Tax considerations:

Laws can change yearly.

Consult a tax attorney!!!!

- QSBS:
 - A Qualified Small Business Stock. is a domestic C Corporation in which the aggregate gross assets of the corporation at all times up to the time of issuance do not exceed \$50M
- Section 1202
 - Can exclude 100% of QSBS capital gains from taxes if stock (not convertible debt) is held for five years
- Section 1045
 - Capital gains can be avoided if you put all of the gains from a QSBS in a new QSBS investment within 60 days
- Section 1244
 - If your investment is part of the initial \$1M invested in a QSBS company, the loss can be used to reduce your earned income (vs. reducing capital gains)

Good Resources



More Resources

- Angel Capital Association web site
 - Click on the “Education” tab at <https://www.angelcapitalassociation.org/>

Additional Webinars



Angel Investing 101

- The Angel Experience: What is an Angel Investor? What motivates Angels? What are examples of typical Angel investments? How does the SWAN operate?



Angel Investing 201

- The Big Picture: Basics of building an Investment Portfolio, and an introduction to how to do Due Diligence



Angel Investing 203

- Measuring Impact and Results: A Discussion of Metrics and Tools, and examples of SWAN impact assessments

Webinar Feedback



Any final questions?



What was most helpful?



What was less interesting?



What would you like to learn more about?



To receive your webinar refund, please send your mailing address to bob.bridge@swanimpact.org



This webinar will start when participants join

Please enable your microphone in
zoom and announce that you have
joined the webinar.

I look forward to meeting you.



Bob



**The Angel Investing 202
webinar has ended.**