

EARLY-STAGE INVESTING

Early stage investing is all about *serendipity!*

The three philosophical questions every ambitious investor must ask himself before he embarks on his investing journey are:

- What is my appetite for risk?
- How much risk can I bear?
- How do I get a fair return for my risk? And what is a fair return?

Angel investing is a specialized investment approach taken by business angels prepared to invest their money, often starting from as low as GBP10,000 to GBP 250,000, and more importantly their time, contacts and skills to help nurture the venture they are backing. Angel investment is perhaps the next best thing to being an entrepreneur!

The key difference between angels and VCs is that angels invest their own money whereas VCs invest other people's money. Hence, angels tend to be more patient than VCs with their capital, more tolerant of companies that do not show the potential to grow to millions of users in just a couple of years, and have a less controlling style than VCs in managing the company.

Of course, as with all startup ventures, early stage investment is risky and typically around 40% of all startups fail both for reasons that can be fixed, and those that cannot be. Angel investors assume this risk for a share in equity, and the promise of discovering the next google or Apple. Your ability as an investor to extract a lucrative return lies in your ability to differentiate these reasons and minimize the risk of backing a deal that screams 'reasons that cannot be fixed'.

What can you do to improve your odds once you have decided that angel investing is for you?

Those who succeed at early stage investing tend to do more than rely on good judgment alone.

As a first step, you could make your idea screening process more efficient by ensuring that your 'gatekeepers' who bring you the deals exercise sound judgment. They should have a knack for sniffing out investments that could potentially return over 10x – innocent smoothie, lastminute etc

The Best Gatekeepers protect the angel investors' time by picking only those ideas with a *survival bias, a sustainable differential advantage, and a team that can deliver* all the fantastic things that the business plan promises. They offer *good guidance* and *mentoring* to the entrepreneurs post-funding so that your investment makes the returns that you dream of.

They help draft tight shareholders agreements with appropriate clauses to protect your interest in the business should the business start to go down the treacherous path due to reasons that have nothing to do with your judgment – such as management's decision to abandon the idea and leave.

We at Genius Incubator aim and strive to be your *preferred gatekeeper*.

"Early stage investing? Hope you are doing it for fun, because there is no money in it!" – a skeptic

Findings of a 2009 research by NESTA on angel investing in UK prove the skeptics of angel investing wrong.

Median Profile of an UK business angel

Years of investing	5
Ventures founded	2.5
Age	53 years
Years with large company	13
Investors who had never founded any new venture in their lives	27%
Investors with less than 8 years investing experience	70%
Gender	93% male
Estimated angel investors in UK	4000-6000
Average Investment Size	£42,000
Angel's average stake in the venture	8%

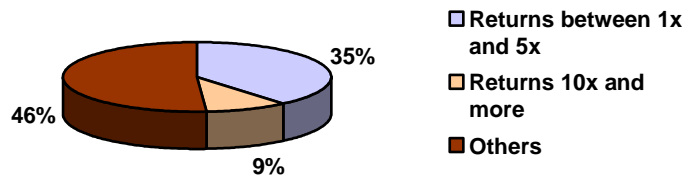
Co-investment is the norm

Investment with or without co-investors	%
With co-investors	83%
With more than 10 co-investors	21%
With no co-investors	17%

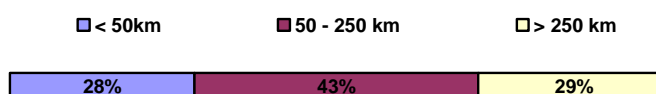
** Two thirds of co-investors are other angel investors*

Investment Preferences of a UK business angel

- 35% of angel investments produced returns of between 1x and 5x of the initial investment, and 9% produced returns of multiples of 10x or more.



- The mean return was 2.2x investment in 3.6 years and an approximate internal rate of return of 22% gross.
- Incentives are important. Enterprise Incentive Scheme (EIS) was used in 57% of the investments, 24% of the investments would not have been made without incentives
- A relatively small proportion of angel's wealth - 10% is invested in angel investments; 44% of the sample had invested only 5% in angel investments and have capacity to invest more
- Local investment is important: 28% only invest within 50km of home, 43% are prepared to invest within 50km, 25% are prepared to invest outside UK



The 2009 NESTA study was based on a survey of 158 UK-based angel investors, who have invested £134 million into 1,080 angel investments, and have exited 406 of those investments. 'Exit' in this study refers to any termination of an investment, including a venture going out of business, being acquired, or going public.

How can you maximize returns from your early stage venture and minimize the risk of failure?

1. Invest in your area of expertise

- 45% of the exits studied had angels with specific industry expertise in their investments, and 55% reported having none.
- Strong positive correlation was observed between industry expertise of the angel and higher return on the investment as well as fewer failures. Therefore angels with no entrepreneurial background or expertise should be particularly careful about investing in early-stage ventures and in sectors they do not know.

2. Conduct Due Diligence - even a small amount of due diligence such as 20 hours helps avoid failure

3. It helps to have prior experience in founding ventures if you are eyeing returns over 10 times your investment

- All the investments in the NESTA study that had made more than 30X returns at exit, had angels who had founded more than three ventures. Angels with entrepreneurial background will have an edge in picking the winning teams as well as coaching them.

4. Make use of incentives such as the Enterprise Investment Scheme

- The EU has argued in support of incentives that the unattractive risk-return profiles of investments in early-stage businesses are a 'fairly permanent' market failure and that for the foreseeable future public incentives will be needed to correct it. Read more on EIS in the *Appendix*.

5. Provide active support to your ventures.

- Offer help in your areas of expertise: business advice, your contacts, advice on commercial development, help with establishing license agreements, recruiting teams and legal support.
- Provide hygiene factors including services such as accounting, human resources and physical space help startups, which may not otherwise be economical for them.
- Active mentoring and support reduces risk for investors, and increases the amount of time that a company can allocate to its core business – a win-win approach for both investors and entrepreneurs.

6. Negotiate for a win-win: Understand valuation divergence, the no dilution illusion and be able to explain to entrepreneurs for successful negotiations

- Valuation divergence is key to pre-money valuation: Investors assume that as the venture valuation increases, the value of the shares will increase proportionately. However, reality is that even if the venture achieves a 30x valuation at exit, the investors can hope to get 6x to 10x return. Divergence is the difference between the growth rate of the company's valuation and the valuation of the shares investors receive due to dilution by subsequent investors and other factors. Features such as 1x participating liquidating preference protect investors.
- No Dilution illusion: Entrepreneurs often believe that no subsequent financing rounds are needed to reach their financial targets - so dilution won't occur. But entrepreneurs are born optimists while reality is that most ventures lose money in the initial years and will need capital infusions for survival and growth.
- Negotiate for preferred stock instead of common and for other financing terms such as board seats, controls, warrants, and dividends.
- Negotiations will be smoother if both parties realize that investors' returns based on the company valuation at exit may be off by a factor of 3x to 5x from initial assumptions, due to successive rounds of finance

APPENDIX

EIS* Incentive – Income Tax Refund

Initial Investment	GBP 20,000
Tax Relief 20%	GBP 4000
Real Investment	GBP 16,000

If the company goes bankrupt

Further Tax Relief (50%)	GBP 8,000
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Capital at Risk	GBP 8,000
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Capital Gains Tax Free

Inheritance Tax Free

Companies will need to satisfy some criteria to qualify for EIS. A number of trades are excluded from EIS such as property, retail, leasing and banking.

We would love to hear from you. Please feel free to share any concerns you may have on angel investing and we will try to find an answer for you. Write to us at investors@geniusincubator.com

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Reference: "Siding with the Angels" by NESTA <http://www.nesta.org.uk/assets/Uploads/pdf/Research-Report/siding-with-the-angels-report.pdf>