Survey:
The Relationship between Angels and Venture Capitalists in the Venture Industry

Tony Stanco
Chair
Council on Entrepreneurial Tech Transfer and Commercialization (CET2C)
The George Washington University
Stanco@gwu.edu

Uto Akah
Graduate Student
The George Washington University

Join the discussion on Angel-VC best practices at the A2VC list. For VCs and angels only. [http://lists.lab2ipo.org/mailman/listinfo/a2vc]

Overview

The venture capitalist and angel investor information presented here is based on a survey conducted to explore the relationship between angel investors and venture capital firms. The 2-part survey contained 12 questions for the angels and 9 questions for the venture capitalists, consisting mostly of multiple choice, with a few open-ended, questions. The survey was conducted via email between February and May 2005. It was sent out to 2156 venture capitalists and angels across the country. The combined response rate from both groups was about 14%.

Question: Do VCs generally consider angel investors beneficial to the venture capital industry?

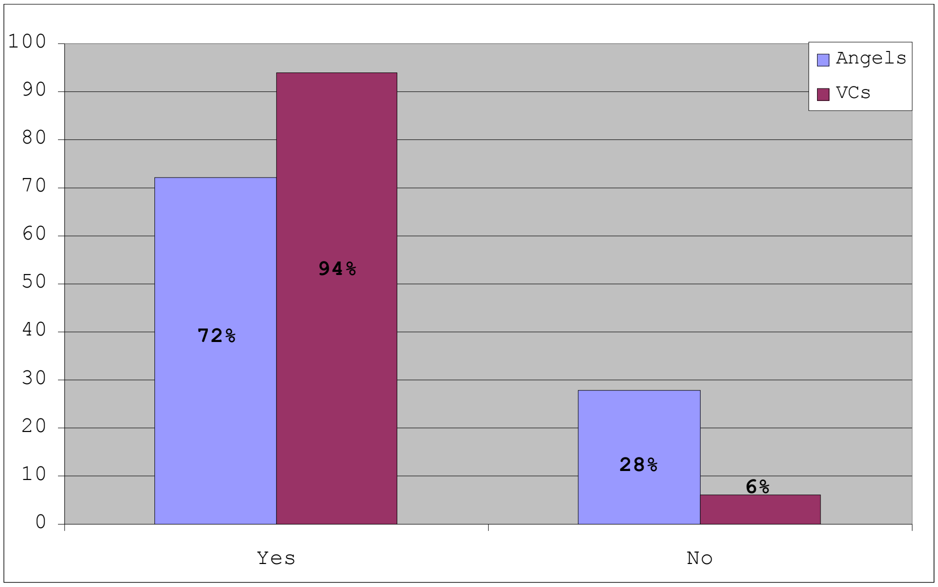

Figure 1: Do VCs consider angels beneficial to venture industry

The venture capitalists surveyed overwhelmingly believe that angel investors play a significant role in the venture industry and that their involvement in the industry is indeed beneficial, with 94% of the VC respondents answering "Yes" to this question. **See Figure 1.**

Some written comments by VCs included:

> "We love good angels."

> "Angels are a valuable resource and serve as excellent deal flow to institutional series A investors."

> "Angels are a necessary and beneficial component of the entrepreneurial community. I would like to see them spend more time learning the interests, constraints and expectations of traditional venture capital investing so that their investments were better prepared for follow-on investments by VCs."

> "In general, we need more of it. The VC community is moving more toward only wanting to invest in companies that have some customer traction and developed product. We need Angel money to get companies to that point."

> "Angel investors provide critical early stage capital and play a vital role in the venture capital world."

> "In my 2 funds, I have 88 angels in one and 68 in another and, if managed correctly, [angels] can be a huge asset but it takes work ... Angels can be a great source of deal flow, due diligence, on-going board/advisory board seats, etc., but should never be viewed as an on-going source of capital. If most funds could figure that out, they'd generate better returns and greater investor appreciation (assuming they have some angel investors in their funds)."

> "Angels are critical to bringing companies to a venture-backable stage. As long as angels invest at appropriate valuations (that is, not so high that the angels and entrepreneurs won't accept the market terms of a VC later), and don't put in place (irreversibly) management teams that can't scale, the partnership with incoming VCs can work very well."

> "I have had in the past good experiences but it is generally when, early on, the Angels are working with the VCs to set up the next round, or [they] give us visibility."

> "Many angels are great and are a huge help to their companies."

> "Angels can be a huge help to companies They often have great experience, advice and contacts for companies. Because of the personal nature of the angel investor they have to be managed to ensure efficient process is maintained and professional decisions are made."

Angels, on the other hand, were harsher on themselves than were the VCs, with only 72% of the angel respondents believing that VCs thought that they were beneficial to the industry. It is very interesting to note that over a quarter of the angels surveyed had the erroneous opinion that VCs did not have a high regard for them as beneficial and significant players in the venture capital industry. One angel put it in very harsh terms:

> "In general, I think the VC industry looks at the angel industry with disdain."

While other parts of the study show that there are significant issues to be resolved between the two groups, and that the two groups could do a much better job working together, the evidence shows that there is a healthy foundation of goodwill and respect by the VC community towards angels upon which to build a better working relationship.

Question: Can angels and VCs do a better job working together?

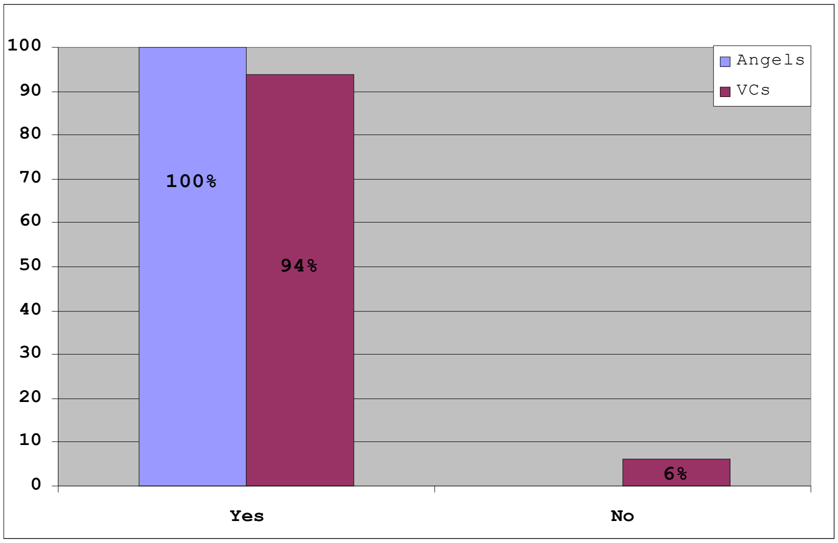

Figure 2: Can VCs and angels do a better job of working together

All of the angels (100%) surveyed agreed that VCs and angels can do a better job in working together. A strong majority of the venture capitalists (94%) also believed that the relationship between both parties could be better. **See Figure 2**.

WHAT IS THE CURRENT WORKING RELATIONSHIP BETWEEN ANGELS AND VENTURE CAPITALISTS?

For the most part, the results of the survey support the view that angels and VCs do not compete, but are rather complimentary players in the venture arena. **See Figure 3.**

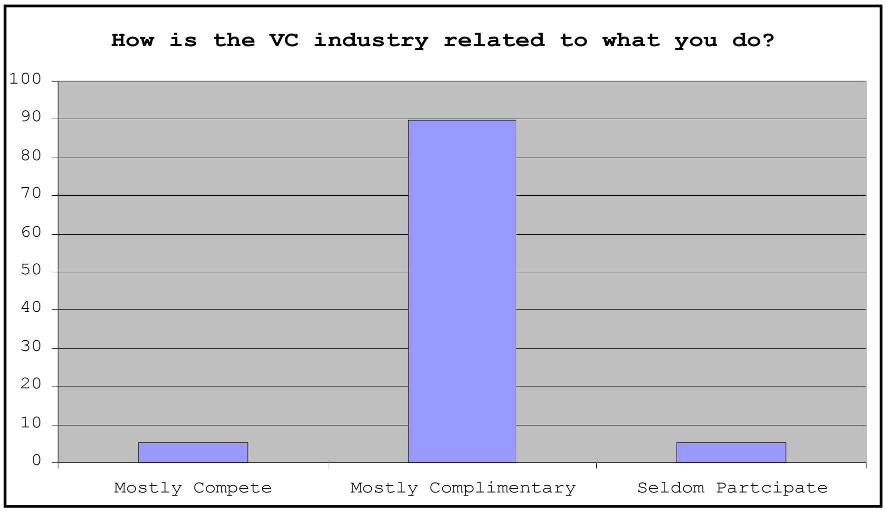

Figure 3: How angels related to VCs (Angel Only Question)

The prevailing view of how angels fit into the venture community is that they are the seed and very early stage investors who “feed” deals to the VCs, creating a “Conveyor Belt” effect.

Written comments from respondents highlighting this view include:

> “The angel space is in general the feeder system for companies looking for institutional VC money.” [Angel respondent]

> “They are an incredibly important part of the private company ecosystem. As funds have become larger over time, the opportunity cost of investment professionals has become too great to focus on

opportunities where substantially some cannot be invested upfront. Angels and smaller funds fill that gap.” [VC respondent]

“Angels are a necessary part of the ecosystem. Many successful VCs get too busy or have gotten much larger over time, so there is still a need for smaller funds or angel investors to fund entrepreneurs at seed stages. Overall, there is not enough seed capital in the industry but too much later stage capital chasing few hot deals.” [VC respondent]

“Angel investors can be very beneficial to start-up companies at an early stage of their development. We often invest with angels and appreciate their willingness to take risk at an early stage.” [VC respondent]

“Without angels, there would be fewer deals for them to invest in.” [Angel respondent]

“We often ask our VC members to react to an investment we're considering. We want to be sure it might be attractive for future VC funding. If it is not; we'll decline.” [Angel respondent]

“We invest in true early stage technology deals--deals that most VCs won't touch—i.e., pre-revenue, so the right VC likes the buff and polish our deals have at the next level. We need each other and have good relationships with the VC firms where we will take the next funding.” [Angel respondent]

“I am in Tech Coast Angels, and in general TCA is reasonably sophisticated and we structure our deals to be attractive for follow-on funding.” [Angel respondent]

Question: Do VCs and angels co-invest in portfolio companies?

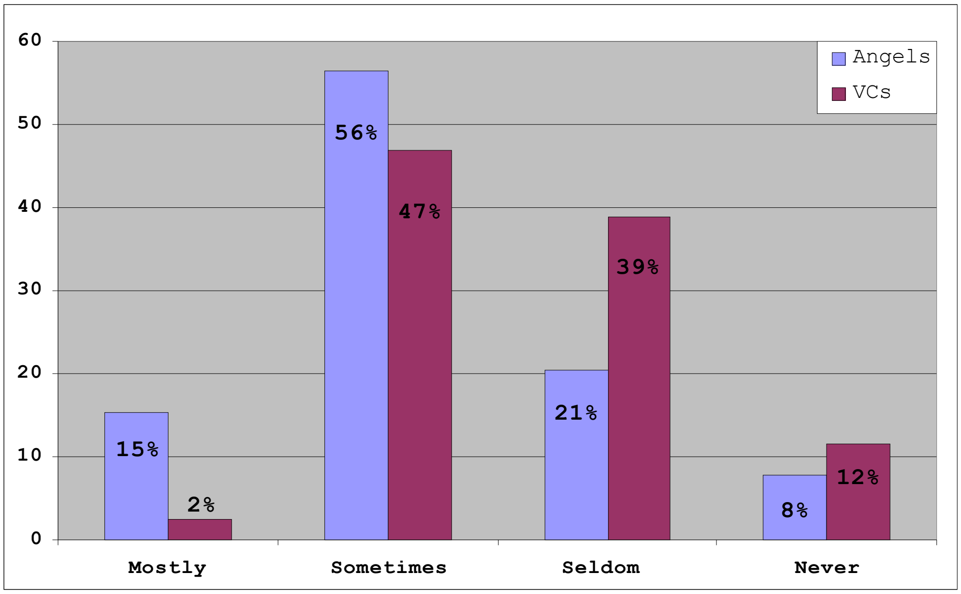

Figure 4: Do VCs co-invest with angels in portfolio companies

56% of angels and 47% of VCs reported they “Sometimes” co-invest in the same round. 15% of angels and 2% of VCs reported that they “Mostly” co-invest. While this result was somewhat surprising given the prevailing view that angels are the “feeders” to the VCs, it could well be that the later angel rounds and the earliest VC rounds overlap in some cases. **See Figure 4.**

29% of angels and 39% of VCs said that they “Seldom” co-invest with each other. 8% of angels and 12% of VCs said they have never co-invested at the same time.

Question: Do VCs make follow-on investments in ventures with prior angel funding?

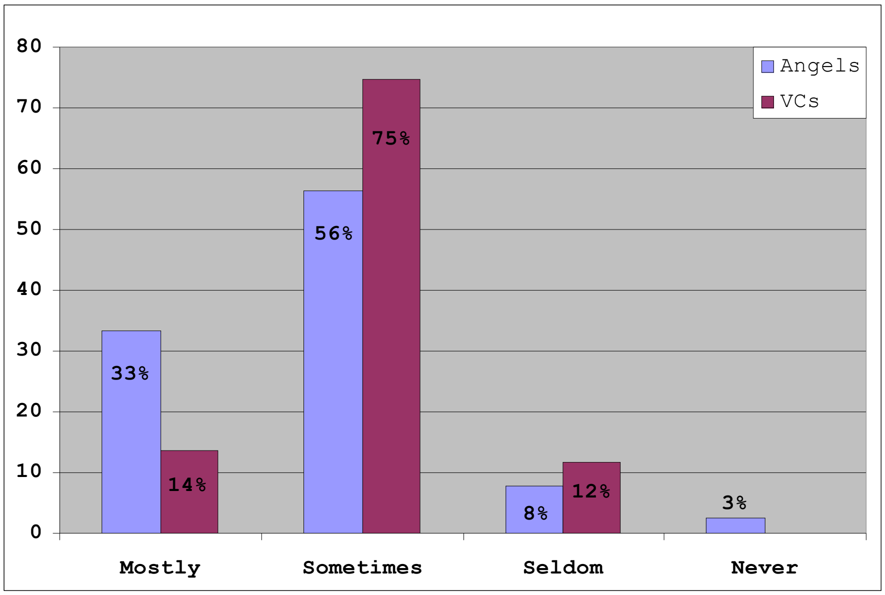

Figure 5: Do VCs make follow-on investments in companies with prior angel involvement?

A combined 89% of the angels and VCs surveyed reported that VCs "Mostly" or "Sometimes" make investments in businesses with prior angel funding. **See Figure 5.** This question appears to validate the commonly held view that angels are a "feeder" system to the VCs.

WHERE ARE THERE ISSUES BETWEEN THE ANGEL AND VC COMMUNITIES?

Even though there is already an active working relationship between VCs and angels, there are areas of potential improvement, as the following survey questions reveal.

Question: Have angel investments in a company made that company unattractive to you?

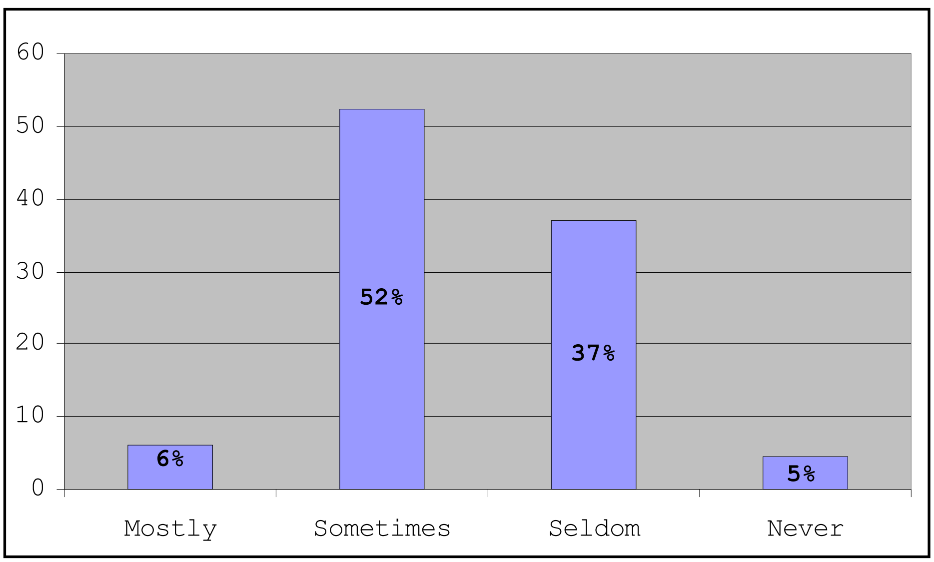

Figure 6: Has angel involvement made a company unattractive to you? (VC Only Question)

58% of VC respondents said that angel involvement “Sometimes” or “Mostly” made a company unattractive. **See Figure 6.**

Question: What reasons have been indicated by VCs as responsible for making a company with previous angel involvement unattractive?

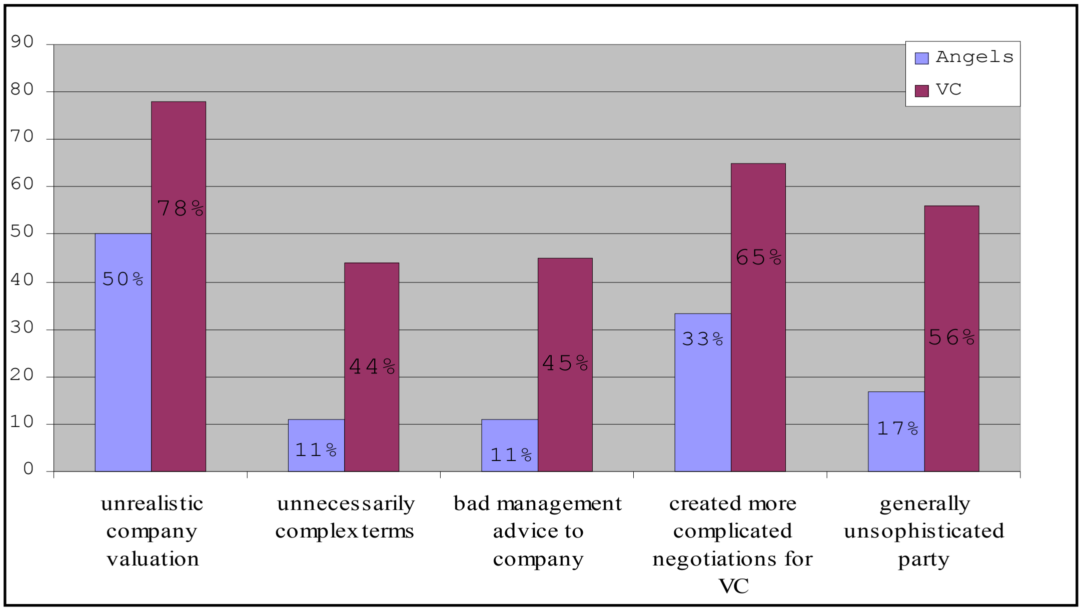

Figure 7: Which of these make a company with prior angel involvement unattractive?

The number one reason for making angel portfolio companies unattractive to VCs is the fact that angels tend to give start-ups overly high, unrealistic valuations. **See Figure 7.** 78% of VCs cited this concern in the survey, while only 50% of the angels (who answered this question; this question had a low angel response rate) reported that this was an often heard VC criticism. Not surprisingly, in answer to the open-ended survey question **"What do angels need to better understand?"**, valuation and valuation methodology was a top ranked response by the VCs.

Even under ideal conditions, valuation will be a matter of market conditions, negotiations and bargaining strength between the parties on opposite sides of the table.

Therefore, it is to be expected that company valuation would be a highly contested issue between angels and VCs, just as it is between entrepreneurs and investors. Valuation impacts the capitalization table and ultimately return on investment for both sets of investors, so it is a critically important factor to both sides. However, care by both communities should be taken to ensure valuation is not subject to unreasonable systemic bias, which sabotages a proper functioning "Conveyor Belt," making both sides worse off. After all, if the Angel – VC relationship is fundamentally a "feeder" system, unreasonably high input costs for the VCs is just as damaging to the system as unreasonably low valuation (with accompanying dilution or cram-down) for the angels.

As one VC wrote:

> "I think the venture industry should think more about protecting the rights and investment value of angels; there is a tendency to think a cram down and conversion to common is 'necessary' for follow-on venture financing. This is a short sighted tendency."

On the other hand, over-valuation can make an otherwise attractive investment financially untenable for the VC because of the impact over-valuations can have on return on investment for the overall portfolio.

One venture capitalist suggested that:

> "It would be helpful if [angels] understood the fundamental return assumptions upon which the venture industry is based."

Another added that :

> [Angels need to better understand] "The 'food chain of capital' theory as well as the market dynamics of how the particular industry works. Additionally angels would benefit from understanding the return

> model of VCs and the hurdle rate expectations that institutional LPs have of VC funds in which they are invested."

Clearly, valuation is a legitimate issue for both parties, but is not an intractable one. For a "feeder system" to properly work (and both sides agree that a properly functioning feeder system helps everyone), the system must benefit both sides long-term without systemic bias that routinely over-values nor under-values companies at the Angel-VC hand-off stage. As such, the creation of community standards and protocols of fair and appropriate market-based behavior for both groups would be useful all around.

The second most common reason for VCs viewing an angel-backed company as unattractive was that angels made "negotiations with company more complicated." The reason ranked third at 56% was that VCs felt the angels were "generally unsophisticated" and did not adequately understand the industry. "Unnecessarily complex terms" and "bad management advice" were the next ranked reasons coming in at 44% and 45% respectively.

From the Angels perspective, the percentages differed to some degree. Interestingly, however, the ranking of the reasons was the same as the VCs.

All the non-valuation factors that make angel-backed companies unattractive to VCs can be easily overcome by better angel education of best practices, and as such are not a systemic problem to a properly functioning Angel-VC feeder system.

Question: Do you support angel investor education on how they can work better with venture capitalists?

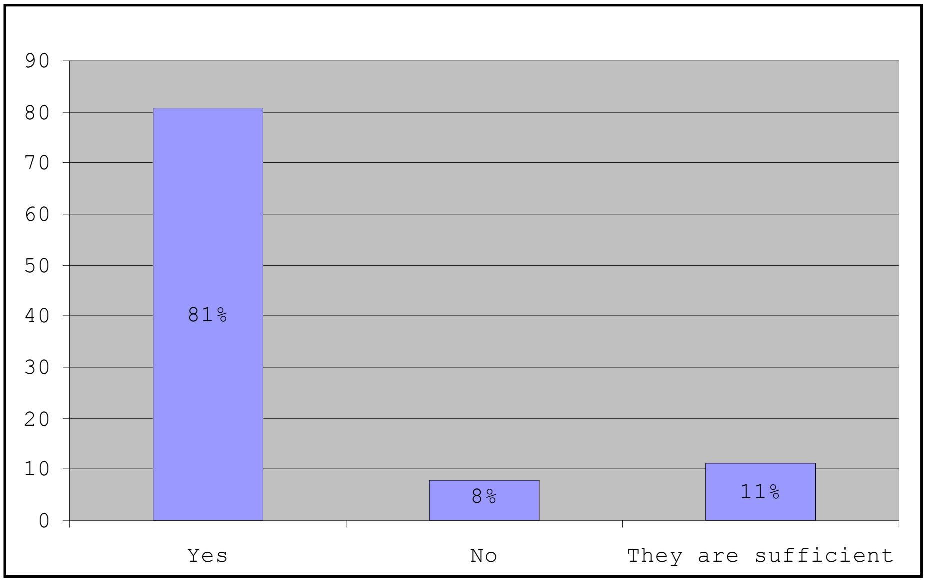

Figure 8: Do you support angel investor education on how they can work better with venture capitalists? (VC Only Question)

Of the VCs surveyed, 81% reported that they do support angel education on how angels can work better with VCs. **See Figure 8.**

Question: What areas of the venture industry would you suggest angel investors need to better understand?

Some VC written comments on what angels need to better understand include:

> "Rarely can angels fund a company to exit, and thus, they need institutional money to support their companies. Angels need to understand what institutional money needs to have in place (management, terms, valuation, etc.) to invest in their companies."

> "Necessity of follow-on investments and understanding that dilution is better than loss of investment. Better understanding of capital structure. Better understanding of how venture money can benefit their own money that has been sunk into a deal."

> "Need to better understand valuation methodology. Need to understand how preferences, etc., can make investments unattractive."

> "The primary mistake is valuation and inadequate amount of funding. The milestones are missed which then puts the company in a very poor position for the next round. The angels generally do not offer up enough money to work through a problem."

> "Valuation and how it relates to stage of the company & exit potential. The need to preserve some capital for follow-on investments."

> "Inappropriate terms for VC funds; excessive numbers [of angels] may require voting trust; securities law complications."

> "Too many angel investors/unaccredited investors in the company that makes the capitalization table difficult to manage."

> "Angel investors need to understand better how venture capital funds make money and what motivates a venture fund to get involved with a deal. That way they could work to better position a company to receive institutional money. Angel investors could also benefit by clearly understanding the milestones that create value within a company. One of the best things angel investors can do better is to work to put together a top notch management team prior to seeking venture money."

> "Deal structuring so that terms don't complicate a VC round that follows. Creating the structure, driving the company to key milestones, etc., to make follow-on VC rounds cleaner and more likely."

"Realistic valuations (going in too high, creates inflated valuation expectations from the company & angels)."

"Valuation expectations. Ownership expectations of angel and management after venture financing (related to valuation expectations). Competitive landscape and how that will drive valuation expectations."

"Too many investors makes things complicated and more challenging to resolve given big numbers."

"Need to understand they often lose some investor rights and/or a board seat once institutional capital is placed. Since many angels are former CEOs they tend to have trouble yielding power to VCs, particularly if they have been active in the early stages of a company."

"Creating appropriate valuations, financing strategies like convertible debt as opposed to pure equity investments. Use of appropriate legal counsel in creation of underlying corporate structure, counsel familiar with VC transactions. Creation of a corporate structure that makes an investment attractive to venture financing."

"Valuation and need to forfeit control are the biggest issues. Also there has to be an understanding of the risk reduction that angel money can accomplish. In many cases the angel round does not do any significant risk reduction, and deserves no premium (indeed it is often overpriced in that situation)."

"Angels sometimes have unrealistic expectations about what the company can accomplish and what their investment is worth. They also can be unreliable partners, as they often don't reserve any capital for follow-on investing in future rounds or when the company really needs the money."

"Angel investors mostly end up loosing in down rounds. Down rounds are part and parcel of typical VC investments and angels get diluted due to lack of deep pockets."

"The importance of value creating milestones for early company progress to obtain further financing. Terms and follow-on financing. Board responsibilities. Exit valuations as viewed by VCs."

"Valuations, prepping the company for the next round, 'breaking in' management on institutional controls/monitoring."

"The fiduciary duty that VCs have to LPs generally requires more control than if the investor were an angel."

“What milestones are required by A round venture capital. Change in board make-up post venture A round. Acceptable influence of angels after A round.“

“Typical Venture Capital Deal Terms. Best Practices for Fundraising.”

“Corporate governance. Capital reserve for follow-on rounds.”

“Avoiding financial structures that make it unattractive for follow-on venture financing. Bad deal terms – [angels] purchased common stock at a high price, destroying ability to maintain low common price for employees and higher pref. price for investors.“

“Term sheet structures (i.e., structure angel investments as a convertible note, not as an ownership percentage). Valuations are based on demonstrated success, not potential (i.e., customer validation, prototype, etc.).”

“Creating deal structures that don't create problems for venture investors. Charting clear milestones that their companies should hit before seeking VC funding.“

“Proper due diligence. How to be good directors. Deal structure so that they can persevere in the investment. Valuation. As I write this they need help with it all.”

“They need to attract expert managers to run the business. They need to address the likelihood of the business requiring additional funding when they make their first investment so that incremental rounds of funding are not so convoluted and expensive to raise. They need to abstract themselves from the business and, if they want to attract other investors, not see it as a hobby or a chance to find employment for their siblings and relations.“

“The need to hire a management team that can meet the VCs expectations - oftentimes not the team that the angel investor invested in. Down rounds exist and could be painful to non-participants.”

“Oftentimes they do not know how to build a great company and in fact are advocating actions that will detract from the development of the company. A common problem is that they do not look at how to increase the size of the pie, but are focused on their piece of the pie - a certain way to ensure you do not build the best company possible.”

“The presence of non-accredited investors which creates significant securities issues . Too many investors which makes it cumbersome and lengthy to get shareholder approvals when required.”

“The deal where we had difficulties with angel investors involved a situation where there were many angels (about 20) who had invested. When we went to take them out, it became very complicated because each angel investor had different goals. It works much better if angels invest as a group and have a representative, or if only a few are involved in a single investment.”

“Inability to invest in follow-on rounds. Not always realizing companies need more rather than less capital, although capital efficiency is excellent thinking. Too loyal to founders / CEO's.”

“Unfortunately, I have also too often observed angels in local groups who are 'washed up' entrepreneurs who couldn't cut it as top-quality executives. They have found a home in an angel group which enables them to get involved with inexperienced entrepreneurs (stay busy in a pseudo-career) at the seed level of these ventures and not offer the best advice or mentorship (because they are incapable). This occurs at such a critical time, when you can either create great value with the right advice and assistance or create great harm through bad advice.”

“Some percentage are focused on control and virtually shut off the company from VC investment.”

“TERM SHEETS, SECURITIES LAW, FREE CASH FLOW - NOT OPERATING CASH FLOW, CORPORATE GOVERNANCE, ARTICLES, BY LAWS, INTELLECTUAL PROPERTY, SALES PIPELINE, CHAIRPERSON'S ROLE.”

“Valuations that do not match 'market' conditions. Equity structures that leave too little room to satisfy VC ownership needs/economics. Use of [legal] counsel that complicates the financing transaction due to lack of experience in venture finance.”

“Angels tend to be people who have been successful at a company that went public or was acquired at a high valuation. They have money to invest and time on their hands. Since they have generally been part of a success or two in the past, they tend to be overly optimistic. As a result, they overpay, they underestimate problems and overestimate their ability or need to respond to problems proactively. They often invest in people they know which is good, but they also tend to want to stick with that person even if the person isn't performing (I've seen these drag out for years).”

Relationship Issues From The Angel Perspective

Question: What are your experiences with VC investments in your portfolio companies?

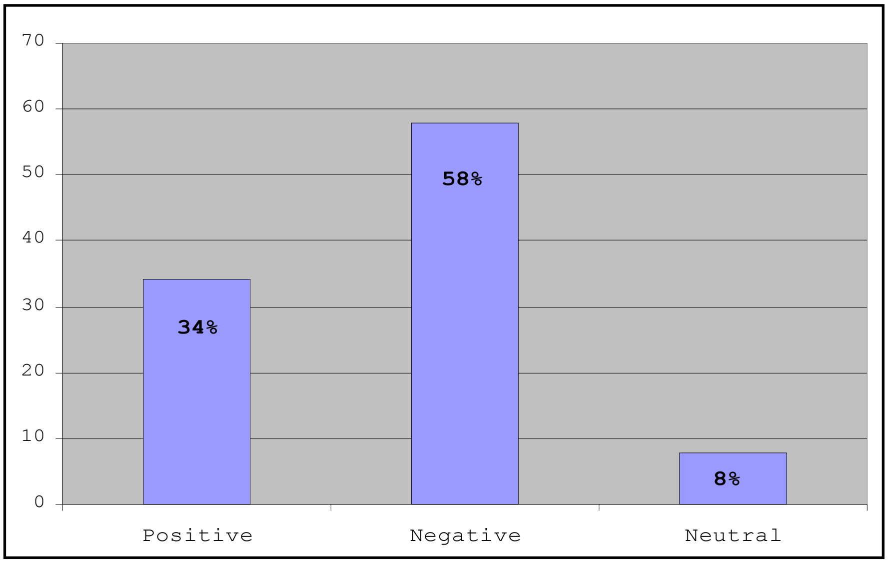

Figure 9: Angel experience with VC investment in portfolio companies (Angel Only Question)

58% of the angels surveyed reported that their experience with VCs have been mostly negative. **See Figure 9.**

Question: Which of the following make working with VCs difficult?

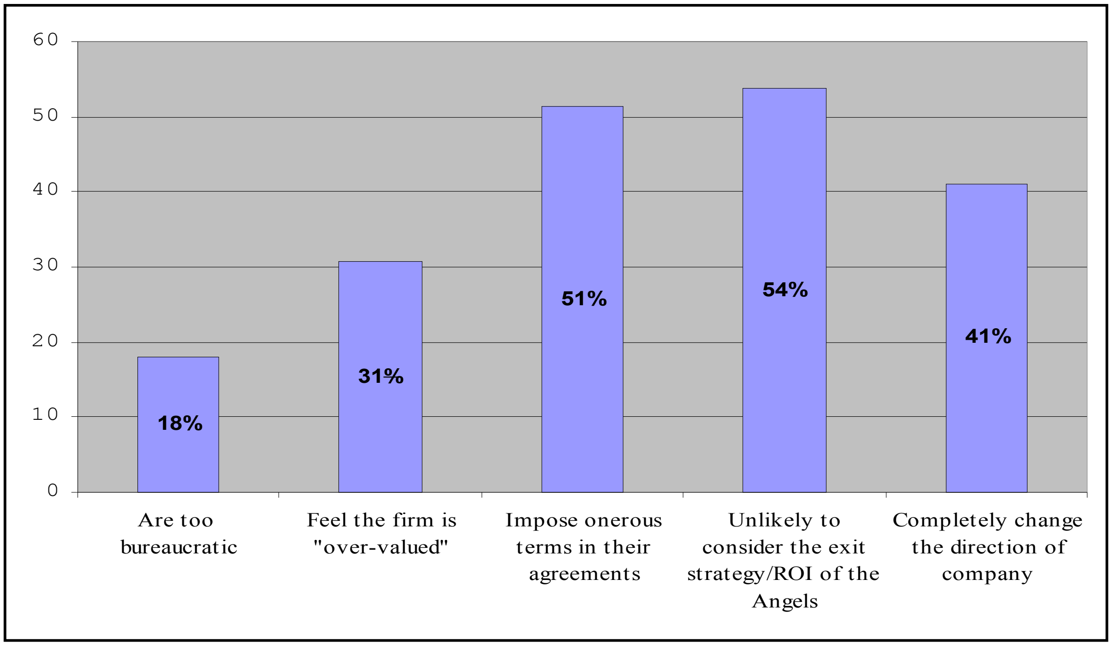

Figure 10: Reasons that make working with VCs difficult (Angel Only Question)

54% of angels reported that the VCs were unlikely to consider the exit of the angels as the top reason that makes working with VCs difficult. According to angels surveyed, VCs have the tendency to impose onerous terms during negotiations and they may want to completely change the direction of the company by altering strategy and replacing key management personnel. **See Figure 10**.

Question: What areas of the angel industry do VCs need to understand better in order to improve the relationship between angels and VCs?

Some angel written comments on what VCs need to better understand include:

"Importance and relationship of angel capital to the development process."

"More definition of business or product models where angels investing can be specifically helpful."

"They need to be aware of how much early deal flow is dependent on angel investors."

"VCs need to work closely with angel networks to develop clear channels of communication; more communication and opportunities to work together can yield benefits for both angels and VCs."

"Angels are very early stage investors for the most part. We look at the company from a very difficult early stage view. There are likely to be many changes in the company direction/management by the time a VC would become interested."

"Many angels are very experienced."

"I think it's actually angels that need to understand VC and VC criteria better. Angels need to take a longer view with respect to the investments, and in fact, should maybe get a VC assessment before investing. The VCs we have worked with have been willing to do this."

"VCs need to realize that angel investment groups can be very sophisticated and can create very good and successful deals."

"Quality of expertise, and level of due diligence."

"Commensurate higher returns needed for angels due to higher risks taken by angels 'earlier' in the game."

"They should be using the background and direct management experience of the angel community. After all virtually all of them have founded a company and made their money from a successful venture."

"How/Why angels invest."

“VCs need a better appreciation for the value (advice more than money) that angels bring to the situation particularly when the angels are working the deal as a group.”

“Only those VCs who value the technology experience of professional angels and know that knowledge is useful to bring the deal to the VC stage and want a continued deal flow from those sophisticated early stage investors will care about their relationships with angels.”

“VCs would be wise to stay abreast of the progress portfolio companies (of angel funds and groups) are making on a regular basis.

“Overall, here in Ohio we're assembling a very effective mosaic of private equity capital sources. We're trying very hard to establish excellent working relationships with the Midwest-based VC firms interested in investing in Ohio's technology ventures.

“VCs would benefit from a more inclusive approach to investing with angels, rather than competitive. It is all part of the same food chain. Without angels, there would be a bigger class division and only companies started by individuals with their own money or access to large sums of money would likely be able to start companies that require any kind of start-up capital (like infrastructure).”

“That angels are professional investors and have ROI goals much like VCs.”

“We're moving away from looking to VCs and instead investing in companies that have shorter roads to liquidity events.”

“Amount of capital available for investment; the fact that angels can only do a single round in most cases.”

“I think the movement to avoid VC funding for the companies we invest in is growing on both coasts. Angels and serial entrepreneurs have had bad experiences with VCs. We're structuring deals differently.”

“A lot of VCs are not aware of the need to treat minority shareholders in a responsible, fiduciary manner.”

“Better links/relationships need to be formed between the organizations that represent angels and VCs so each can understand the other's views.”

“More relationships, communication. Generally, VCs less likely to wash out and dismiss investors they know.”

“The VCs we work with tend to fall into two different camps - those that see themselves joining their portfolio companies vs. those that see their portfolio companies as prey. In my experience, the former tends to be a more successful fund."

"Angels and VCs could do a much better job in communicating or educating each other."

"I would like to see more blended investments at the seed stage between VCs and angels."

"Closer, longer-term working relationship would improve joint productivity."

Conclusion

Angels and venture capitalists both play key roles in the venture industry. Angels rarely fund a company to exit, and thus, they need institutional money to do so. On the other hand, VCs seldom provide the seed capital and time commitment to start-up entrepreneurs in order for those companies to get to a place where they are venture worthy. As a result, angels and VCs are essential components to the "Conveyor Belt" that takes start-ups from creation to exit, and the venture industry and the nation would benefit from an Angel-VC framework that fosters more understanding, and a more efficient working relationship, between the two groups.

Invitation

As a result of this paper and the apparent need for better direct lines of communication between VCs and angels, we have created a A2VC list to help foster an on-going discussion between the two groups. If you are an angel or venture capitalist, please join the A2VC list at [http://lists.lab2ipo.org/mailman/listinfo/a2vc].

Appendix

VC side of Survey

1. Do you see Angel investors as beneficial to the venture capital industry?
___ Yes
___ No

2. Can angels and VCs do a better job working together?
___ Yes
___ No

3. Do you co-invest with Angel investors?
___ Mostly
___ Sometimes
___ Seldom
___ Never

4. Do you invest in companies that have prior Angel investments?
___ Mostly
___ Sometimes
___ Seldom
___ Never

5. Have Angel investments in a company made that company unattractive to you?
___ Mostly
___ Sometimes
___ Seldom
___ Never

6. If yes, how have Angel investors made a company unattractive? (check all that apply)
___ unrealistic company valuation
___ unnecessarily complex terms
___ bad management advice to company
___ created more complicated negotiations for VC
___ generally unsophisticated party
describe any others: ________________________________

7. Do you support Angel investor education on how they can work better with venture capitalists?
___ Yes
___ No
___ They are already sufficiently knowledgeable

8. What areas of the venture industry would you suggest Angel investors need to better understand: ____

9. Add any general comments you want to make about Angel VCs relations here: ____

END OF SURVEY

Angel side of Survey

1. In your opinion, do you think that VCs generally consider Angel investors beneficial to the venture capital industry?
___ Yes
___ No

2. Can angels and VCs do a better job working together?
___ Yes
___ No

3. In general, how do you see the VC industry in relation to what you do?
___ We mostly compete for the same companies/dealflow
___ We are mostly complementary

4. Do VCs co-invest in your portfolio companies?
___ Mostly
___ Sometimes
___ Seldom
___ Never

5. Do VCs do follow-on investments in your portfolio companies?
___ Mostly
___ Sometimes
___ Seldom

___ Never

6. What are your experiences with VC investments in your portfolio companies?
___ Positive
___ Negative
___ Neutral

7. If positive, how were they positive? ________________________________

8. If negative, how were they negative? ________________________________

9. Which of the following make working with VCs difficult? (check all that apply)
___ VCs are too bureaucratic
___ VCs feel the firm is "over-valued"
___ VCs tend to impose onerous terms in their agreements
___ VCs are unlikely to consider the exit strategy/ROI of the Angel investors
___ VCs may want to completely change the direction of company before they agree to invest
Other _________________________

10. Have VCs indicated that you have made a company unattractive to them for any of the following reasons? (check all that apply)
___ unrealistic company valuation
___ unnecessarily complex terms
___ bad management advice to company
___ created more complicated negotiations for VC
___ generally unsophisticated investor
describe any others: ________________________________

11. What areas of the Angel industry do VCs need to understand better in order to improve the relationship between Angels and VCs? ________________________________

12. Add any general comments you want to make about Angel - VCs relations here:
____

END OF SURVEY