

Why Consider Startup Investing

November 2021



Why Consider Startup Investing?

Agenda: Why Consider Startup Investing?

- Why Consider Startup Investing?
- Who can be a Startup Investor?
- Portfolio Theory of Startup Investing
- Non-Financial Benefits of Startup Investing
- Financial Life of a Startup – Angels' Role
- How Startup Investments are Structured
- Tax-Law Benefits for Startup Investors
- How Investors Structure their Decision-Making
- Investing as Part of a Group
- Connecting with your Local Startup Ecosystem



- Angel Investor; former Tech Exec
- Startup investor in over 30 startup companies
- Leader in Sacramento Angels –
 - Board Director – since 2012
 - Selections Chair – 4 years
 - LLC Administrator – last 3 years
- Board Chair, AgStart – non-profit sponsor of The Lab@AgStart incubator
- Investor, Advisor, Mentor to numerous startup entrepreneurs
- Three children & a dog, in Folsom, CA

Mighty oaks – from little acorns grow.
– 14th century English proverb



What is a Startup?



A **Startup** is a **temporary** organization designed to **search** for a **repeatable business model**

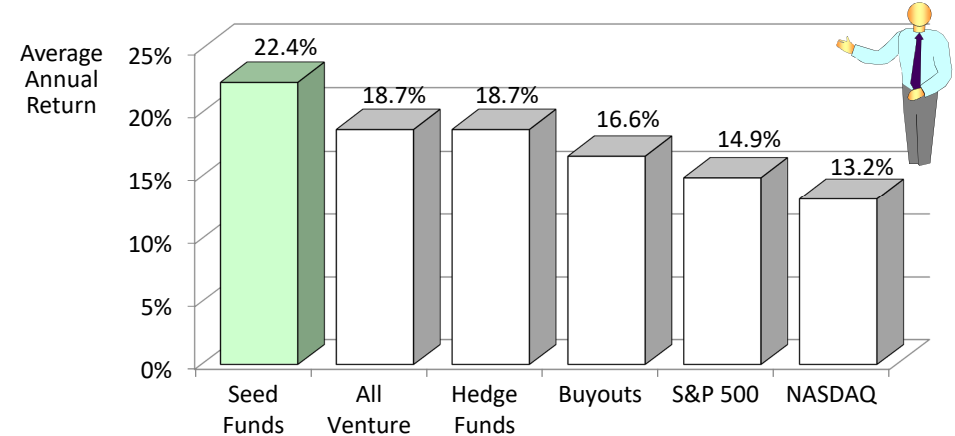


A **Large Company** is a **permanent** organization designed to **efficiently execute** a **repeatable business model**

ref. Steve Blank, www.steveblank.com

Why Consider Startup Investing?

Studies have shown that structured and disciplined early-stage equity investing can have one of the highest returns across all asset classes.



sources: Wiltbank Study (Rob Wiltbank, Willamette University); Venture Economics; HFRI Equity Hedge Index, as published by David Rose, [Angel Investing](#), 2014

Investing in Startups - Not just buying stock



Startup securities are:

- Not liquid
- Pricing is opaque, negotiated for each transaction
- Opportunities to purchase only at distinct points in time. In most cases, securities are not listed securities
- Opportunities to sell are extremely limited and controlled by the company
- Typically, investor funds are tied up for multiple years

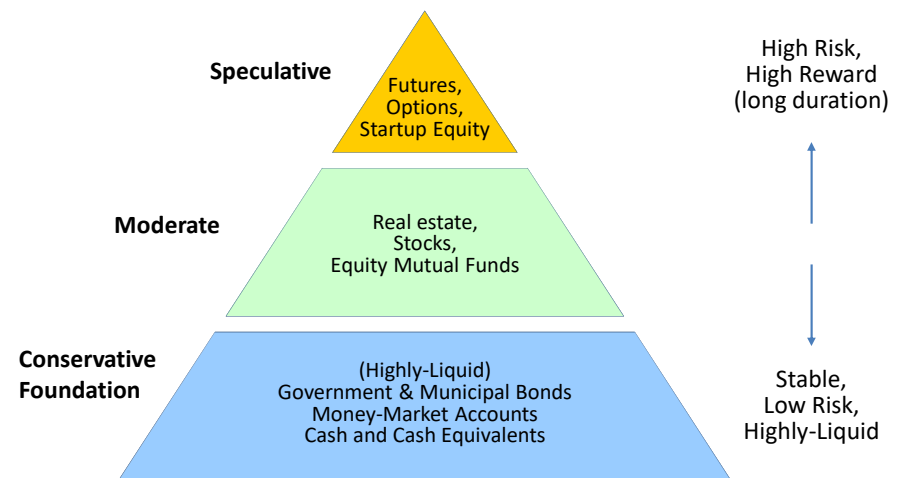


Large Company stocks are:

- Highly liquid
- Prices available online
- Easily purchased and sold through established brokers and exchanges
- Investor funds are available at any time during normal trading hours.

Asset Allocation and Portfolio Construction

Experts recommend that an individual's personal portfolios hold a mix of investments



Who Can be a Startup Investor?



Under the Securities Act of 1933, a company that offers or sells its securities must register the securities with the SEC or find an exemption from the registration requirements. The Act provides a number of exemptions. For some of the exemptions, such as Rules 505 and 506 of Regulation D, a company may sell its securities to what are known as **'accredited investors'**.

Under Rule 501 of Regulation D, an accredited investor, in the context of a natural person, includes anyone who:

- **earned income that exceeded \$200,000** (or \$300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, **- OR -**
- **has a net worth over \$1 million**, either alone or together with a spouse (excluding the value of the person's primary residence).

Other categories of accredited investors, which may be relevant:

- any entity in which all of the equity owners are accredited investors.

source: U.S. SEC www.investor.gov

Portfolio Theory of Startup Investing

Truth #1: Most Startups Fail

Truth #2: No one can predict which startups will NOT fail

Truth #3: Investing in startups is a numbers game

Truth #4: What ends up, usually went down first

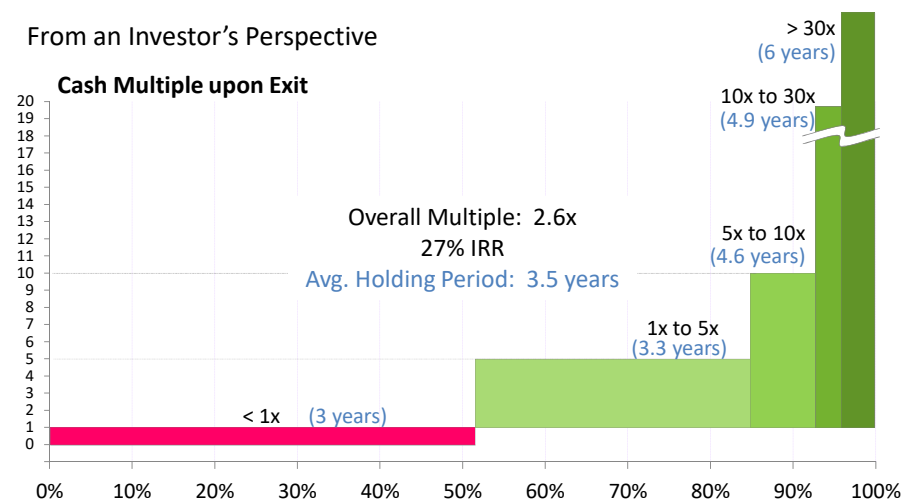
Truth #5: All Companies always need more money

Truth #6: If you understand the preceding,
Startup Investing can be very lucrative

reference: David Rose, [Angel Investing](#), 2014

Distribution of Early-Stage Returns - 2007

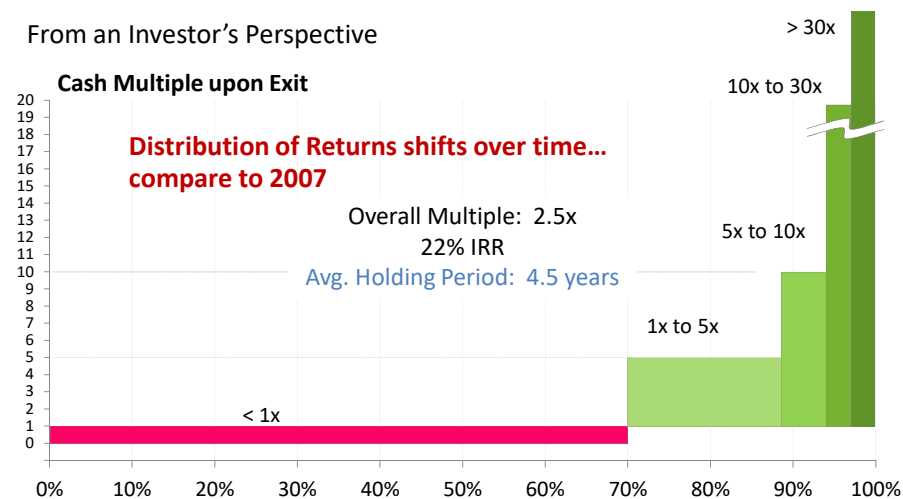
From an Investor's Perspective



Source: "Returns to Angel Investors in Groups" (2007), Robert Wiltbank, Ph.D., and Warren Boeker, Ph.D., with funding and support from the Ewing Marion Kauffman Foundation. Analysis of returns based on 1,137 exits from early-stage Angel investments.

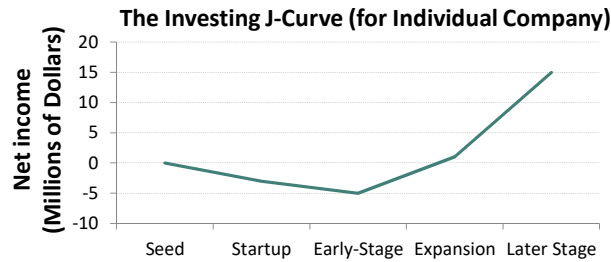
Distribution of Early-Stage Returns - 2016

From an Investor's Perspective

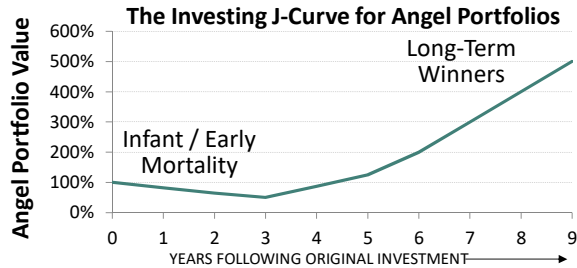


Source: "Tracking Angel Returns" (2016), Robert Wiltbank, Ph.D., and Wade T. Brooks, with funding and support from the Ewing Marion Kauffman Foundation. 2016. An analysis of investment returns based on 245 exits from early-stage Angel investments, 2010 through 2016.

J-Curve of Investor Return



Startup investing Requires Patience



reference: David Rose, [Angel Investing](#), 2014

Non-Financial Benefits of Startup Investing

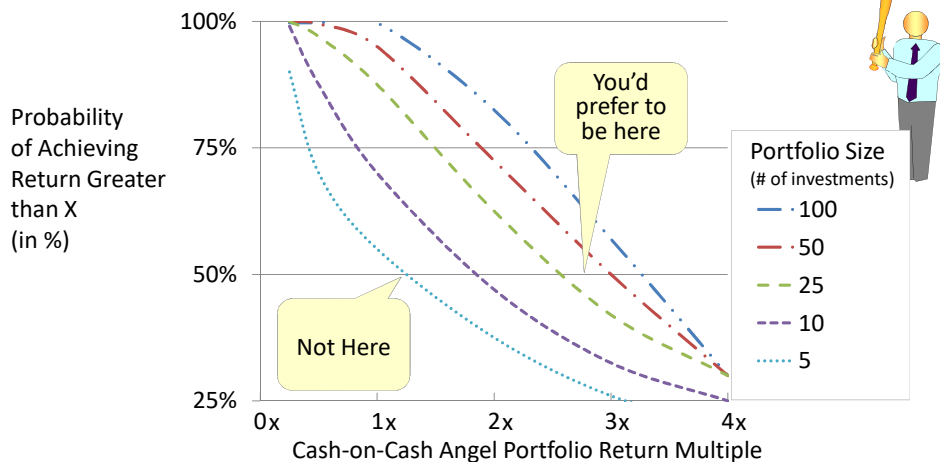
“Doing Good, Having Fun, and Making Money – not necessarily in that order”

– Bob Goff, part of mission statement at inaugural meeting of Sierra Angels in August 1997.

- Keeping up with Innovations and the World
 - Intellectually Stimulating business and technical challenges
 - Education on leading-edge of new technology
- Entrepreneurship without the Responsibility
 - Thrill of overcoming challenges and growing the business
 - No responsibility to make payroll
- Joy of Giving Back
 - Mentoring bright and coachable entrepreneurs
- Social benefit of working with bright people
 - Entrepreneurs and their teams
 - Other angel investors – “Startup Investing is a Team Sport”

reference: David Rose, [Angel Investing](#), 2014

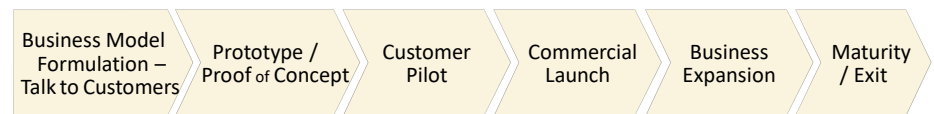
How to Thrive in a Hits-Driven Category? – Lots of ‘At-Bat’s!



Source: “Returns to Angel Investors in Groups” (2007), Robert Wiltbank, Ph.D., and Warren Boeker, Ph.D., with funding and support from the Ewing Marion Kauffman Foundation. Analysis of returns based on 1,137 exits from early-stage Angel investments. reference: David Rose, [Angel Investing](#), 2014

Financial Life of a Startup - The Landscape

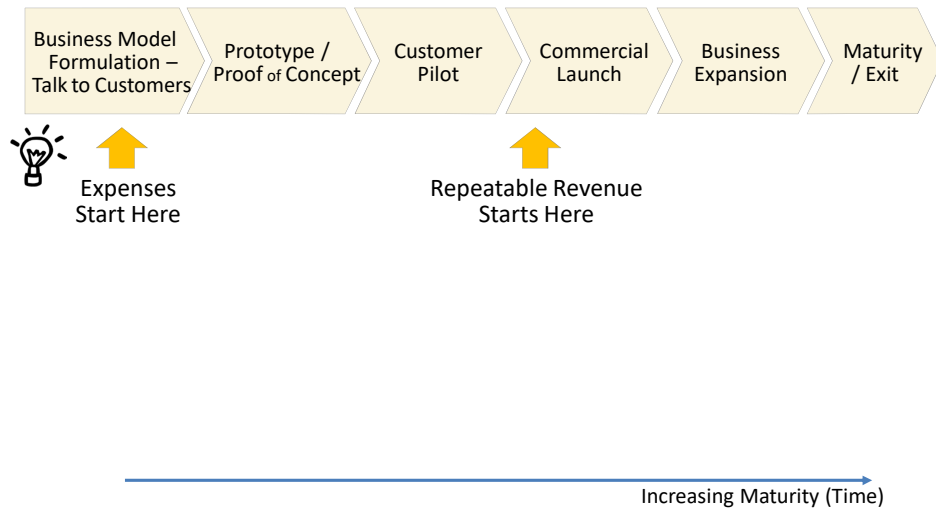
(from perspective of the startup)



Increasing Maturity (Time)

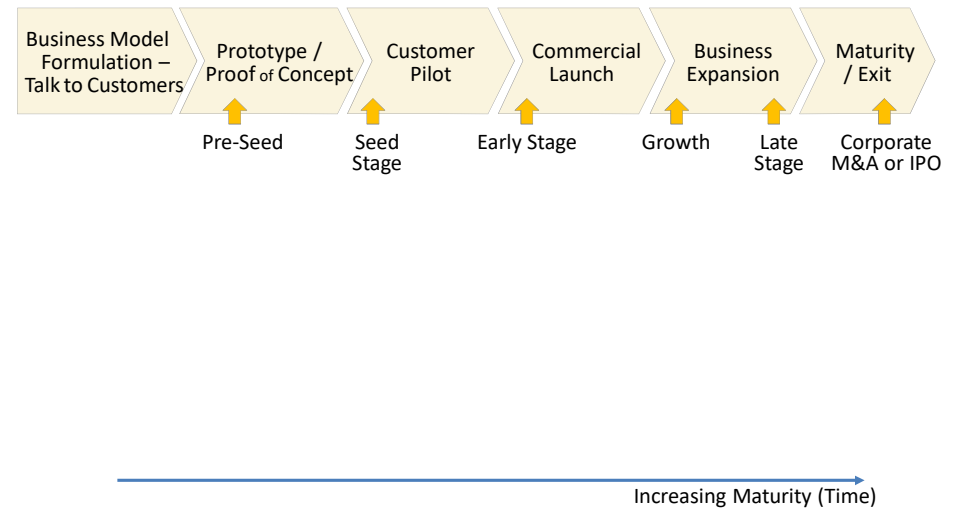
Financial Life of a Startup - The Landscape

(from perspective of the startup)



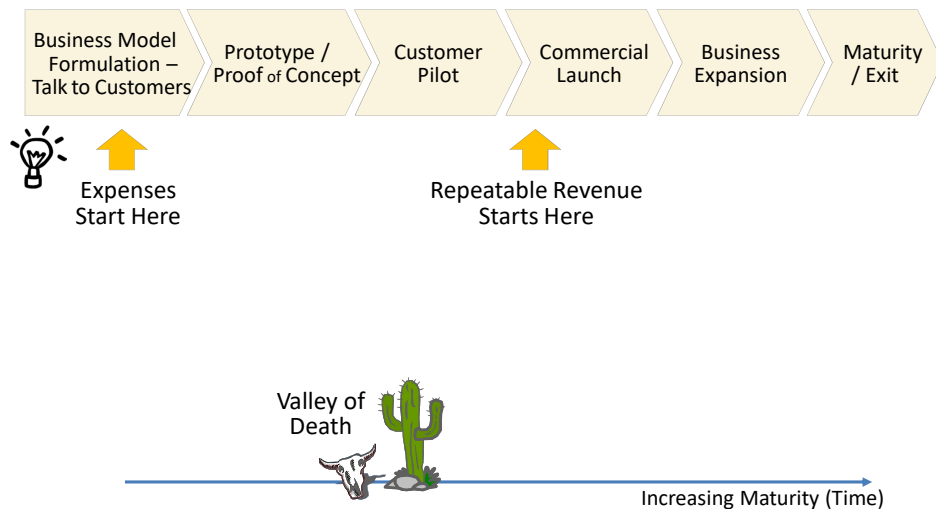
Financial Life of a Startup – Funding Events

(from perspective of the startup)



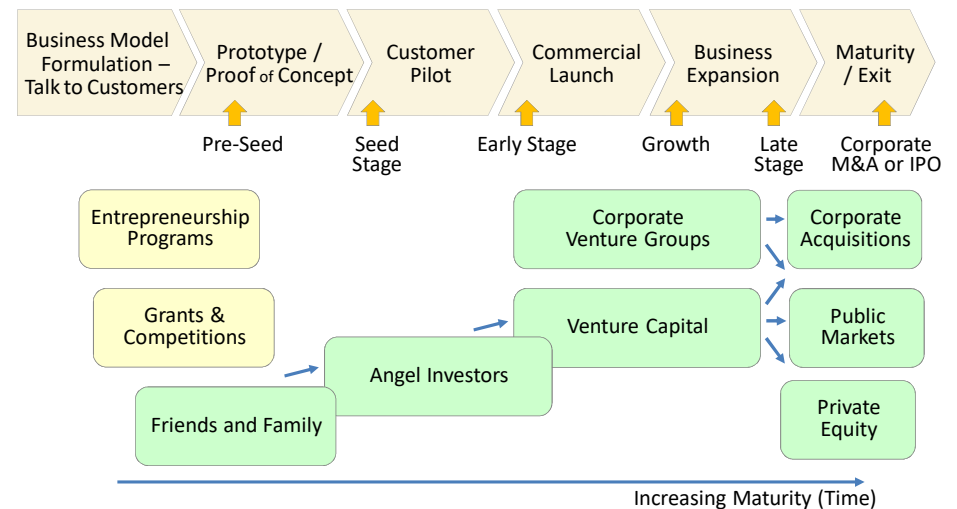
Financial Life of a Startup - The Landscape

(from perspective of the startup)

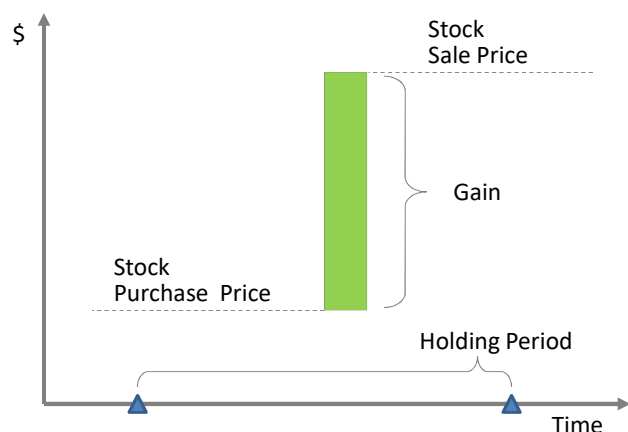


Financial Life of a Startup - The Landscape

(from perspective of the startup)



How Angels Make Money



Structuring the Deal - Startup Financing



S.A.F.E. – essentially, an option
Investors receive an agreement for the future issuance of shares, if trigger conditions met.

Advantages for Investors:

- Simple paperwork
- No shareholder rights, no investor protections
- Not 'debt', so no enforceable provisions in the case of non-performance
- No mechanism for investors to spur action
- No favorable tax benefits, unlike equity.

Disadvantages:



Warrants – an option
Investors receive rights to acquire shares in the future at a nominal price, subject to conditions.

Advantages for Investors:

- Simple. Well-understood legal structure.
- Future acquisition cost for shares is clear.

Disadvantages for Investors:

- No shareholder rights, no investor protections
- Not 'debt', so no enforceable provisions in the case of non-performance
- No mechanism for investors to spur action.
- No favorable tax treatment,
- Benefits of equity ownership begin only after exercise

Structuring the Deal - Startup Financing



Equity – ownership stake
Investors acquire shares, representing a direct ownership stake in the company.

Advantages for Investors:

- Clear shareholder rights & investor protections
- Clear cost-basis for acquired shares
- Tax benefits in terms of capital-loss provisions, capital-gains treatment
- Long-term capital-gains clock begins immediately

Disadvantages:

- Pricing negotiations can be painful



Convertible Notes – debt
Investors acquire a note (provide a loan) with the company. The note later converts to equity in the company, at a value determined by the next qualified financing.

Advantages for Entrepreneurs:

- Perceived to have simpler legal paperwork than equity financing
- Avoids painful valuation negotiations

Disadvantages for Investors:

- Note terms rarely provide shareholder rights or investor protections
- Acquisition cost for shares uncertain at time of investment, may be much higher
- Tax benefits for equity ownership begin only after conversion
- Long-term capital-gains clock begins at conversion, not investment



Equity – ownership stake
Investors acquire shares, representing a direct ownership stake in the company.

Key Terms:

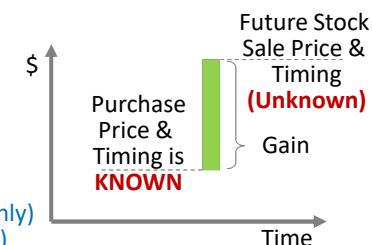
- Dividend Rights
Typically 6-8% but 'optional' (as declared)
Cumulative or Non-cumulative
- Liquidation Preferences
Participating, Non-participating, Multiples
- Protective Provisions
- Redemption Rights
- Conversion Rights / Automatic Conversion
- Voting Rights
- Anti-dilution
Full ratchet (perhaps for first year)
Narrow-based weighted average (Preferred only)
Broad-based weighted average (As-converted)

Typical Security:

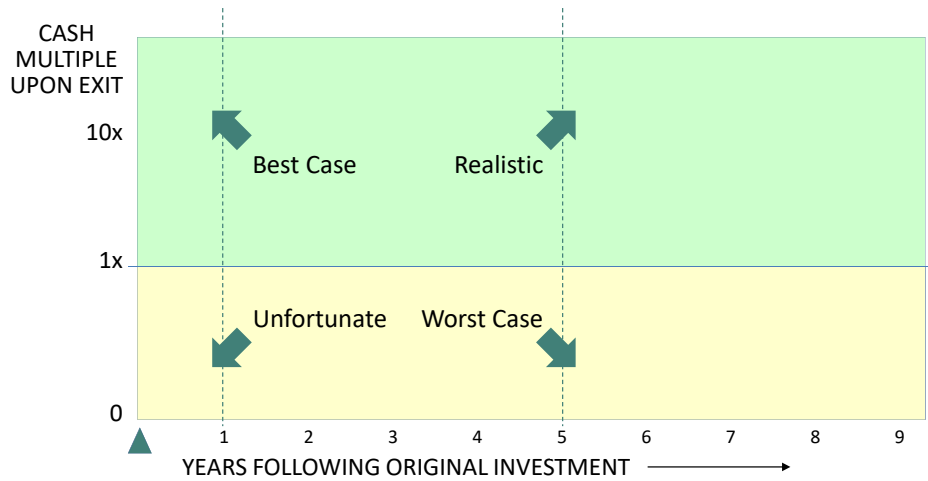
Convertible Preferred Stock

Agreements:

- Stock Purchase Agreement
- Shareholder Rights Agreement
- Shareholder Voting Rights Agreement
- Right of First Refusal and Co-Sale Agreement



Financial Outcomes for Startup Investments



Convertible Note Deal Terms



Convertible Notes – debt

Investors acquire a note (provide a loan) with the company. The note later converts to equity in the company, at a value determined by the next qualified financing.

Typical Security:

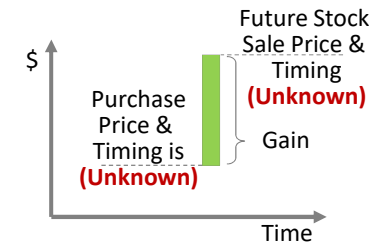
Convertible Promissory Note

Agreements:

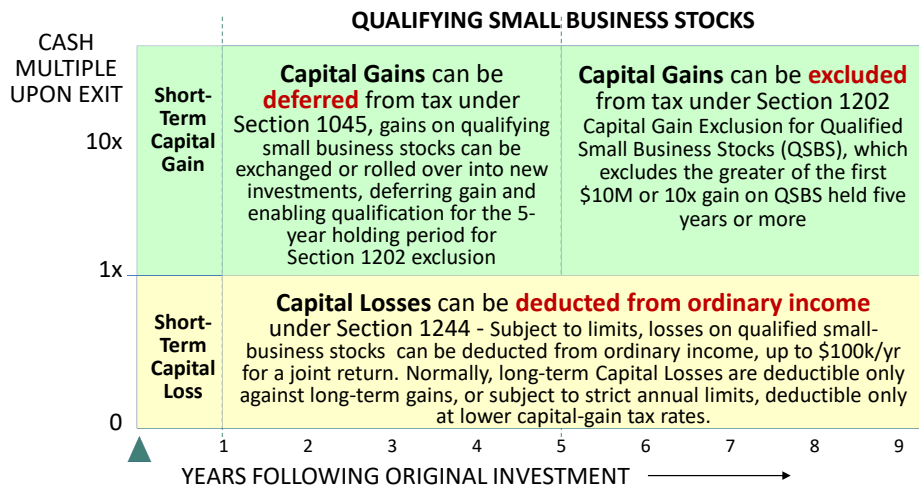
- Convertible Note Purchase Agreement

Key Terms:

- Term & Expiration Date
- Interest Rate
- Conversion trigger (typically financing)
- Discount on Conversion Price
- Valuation Cap on Conversion (if any)

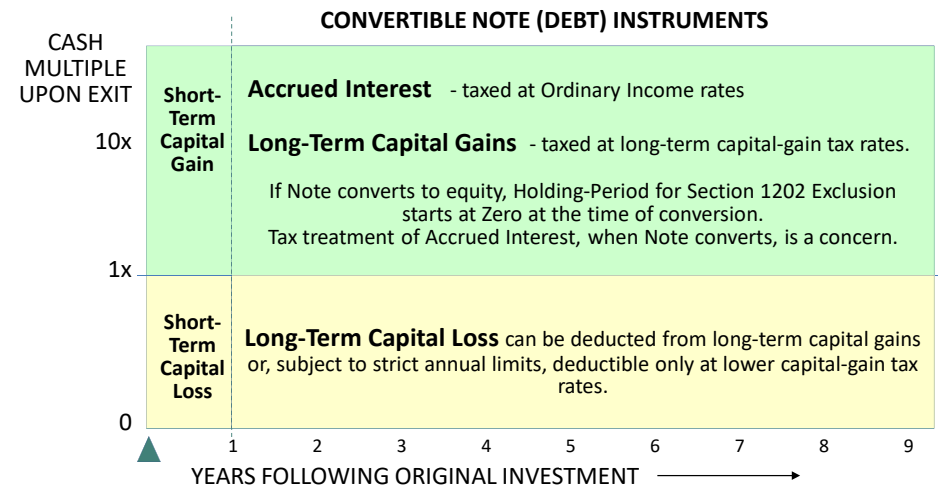


Tax-Law Benefits for Equity Investors



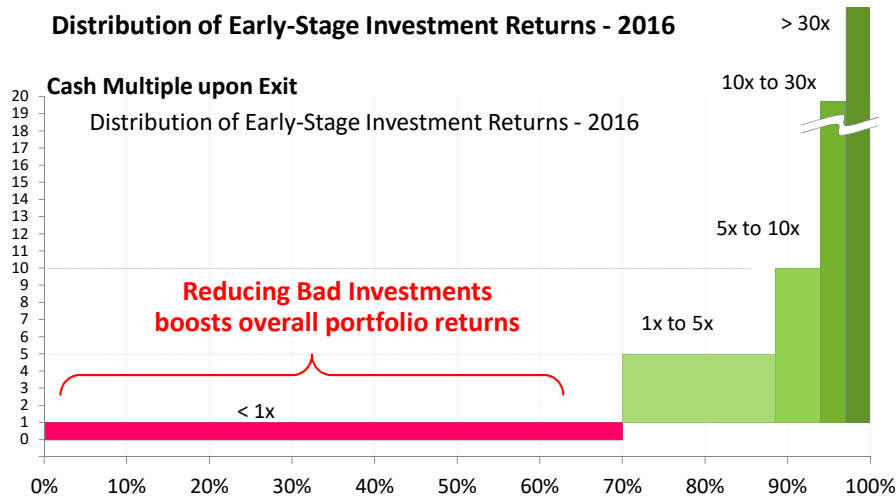
Visualization shown for investments held in U.S. individual taxable account
Consult your tax advisor for details; refer to Internal Revenue Code Section 1045, Section 1202, and Section 1244 for more details on specific provisions.

Tax-Law Topics for Note Investors



Visualization shown for investments held in U.S. individual taxable account
Consult your tax advisor for details; refer to Internal Revenue Code Section 1045, Section 1202, and Section 1244 for more details on specific provisions.

Decision-Making Drives Investor Return




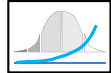
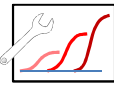


Investing as part of an Angel Group

- Access more and better deals
- A Channel for entrepreneurs who approach you
- Learn the ropes – from experienced investors
- Diversified expertise – benefit from breadth of other angel's experience
- Share the burden of due diligence
- Pooling individual capital
- Returns – with good deals and strong investment process, comes the chance for better returns
- Fun and friends

reference: Marianne Hudson, [The Advantages of Belonging to an Angel Group](#), Forbes, June 2015

Investor Decision-Making Framework

Investors focus on key risk areas:

 <p>Team Do they have the right team? Do they have the experience? Is the team trust-worthy? Are there skeletons in the closet?</p>	 <p>TAM – Market/Customer Is the market real? Are customers willing to pay? Do sufficient customers exist? Is it a bubble? A fad? Early? Late? What will competitors do?</p>
 <p>Traction – Product / Service / Technology Does the product/ service work? What could go wrong? Will it scale? be competitive? Will customers adopt it?</p>	 <p>Timing - Business Model / Financials Does their plan make sense? How quickly will the plan succeed? Do they have resources to execute their plan?</p>
 <p>Terms – The Investment Offer Given the risks and likely potential outcomes, do the terms represent a favorable risk/reward?</p>	

INSYNC Angel Network - Regional Angel Groups



Invest through an Angel Group LLC

- **More & better deals** – access deals with high investment minimums
- **Lower individual-investor minimums** – enables assembling a diversified portfolio more quickly
- **Simplified reporting for Angel investors** – streamlined tracking and reporting annual expenses and gains
- **Streamlined Communications for startups** – single entity for shareholder communications, approvals
- **Additional liquidity alternatives for investors** – membership units can be exchanged between members
- **Increased Group member access to follow-on rounds** – members can access LLC pro-rata rights in follow-on rounds

reference: [Sacramento Angels group make change to fund more startups](#), Sacramento Business Journal, Jan 2019

33 11/11/2021

Startup Investor School

STARTUPSAC

Connect with your local Startup Ecosystem

- Attend events. Go to meetups. Network with entrepreneurs
- Incubators & Accelerators frequently have ‘Demo Day’ events where startups present
- Consider signing up as a mentor or advisor
- Entrepreneurs are as eager to meet you as you are to meet them.

34 11/11/2021

Startup Investor School

STARTUPSAC

Recommended Resources

- David S. Rose, Angel Investing, [The Gust Guide to Making Money & Having Fun Investing in Startups](#), Wiley & Sons, 2014.
- Robert Wiltbank, Ph.D. and Warren Boeker, Ph.D., “Returns to Angel Investors in Groups”, 2007, Willamette University.
- Robert Wiltbank, Ph.D. and Prof. Wade T. Brooks, “Tracking Angel Returns”, 2016, Ewing Marion Kauffman Foundation, Willamette University.
- Alexander Osterwalder & Yves Pigneur, [Business Model Generation](#), Wiley & Sons, 2010.
- Angel Capital Association www.angelcapitalassociation.org - a wealth of resources, webinars, conference proceedings about angel investing tools, tactics, and education.

35 11/11/2021

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Mighty oaks – from little acorns grow
– 14th Century English proverb

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