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deskbook

Emerging Life Sciences Companies

second edition

Chapter 4

How to be Touched by an Angel

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HOW TO BE TOUCHED BY AN ANGEL

Now that you have formed the Company, either from scratch or as a new company spun out from Big Pharma, you may need to begin looking for a source of funding. Most funding for startup life sciences ventures does not emanate from venture funding or broker-dealer–led private placements, but instead comes from a combination of government and quasi-government funding sources such as NIH and private individuals commonly referred to as "angels." Principals of early-stage growth companies are frequently eager to access these sources of funding because even when science can be funded through grants, these rarely cover the administrative costs necessary to commercialize a product. This section briefly describes who angels are, why new ventures seek angels, and what angels seek in investments so that your company can be touched by an angel.

Who Are These Angels?

Simply stated, an angel is any individual who is motivated to invest in private companies. While founders with industry recognition or a track record may have the experience to generate that motivation, the inexperienced entrepreneur has a far more difficult angelic quest. In attempting to obtain financing for their company, founders should first consider what type of person might naturally be motivated to invest in their venture.

Friends and Family

One category of angels includes friends and family, who are often willing to invest in your company at an early stage. Very close friends and family members are usually motivated to invest by an interest in seeing their close friend or family member succeed (or, in some cases, by a sense of obligation), and those individuals who may be casual acquaintances or former colleagues typically are motivated to invest by both financial and personal interests. Of benefit to any founder attempting to obtain financing from friends and family is that such individuals often understand the founder's capabilities and may have a strong belief that the new company will succeed based upon previous personal or business experiences with the founder.

In some circumstances, founders are unwilling to solicit funds from friends and family members, finding it difficult to allow family members and good friends to risk their capital. Sometimes, however, family members not asked to participate may be particularly aggrieved if they were not able to get in on the ground floor of a venture that achieves the success that the founder projects.

The answer to whether a founder should seek funds from friends and family members must lie in the founder's personal sensitivities.

Professional Private Investors

Another angel category includes wealthy strangers who are motivated to invest. These angels do exist. They consider themselves professional private investors of seed-stage and early-stage capital, but many do not have life sciences expertise and thus are unlikely to invest in life sciences startups. This type of angel will invest in a venture for a number of reasons. Certainly, the potential for high returns is a motivating factor; however, many angels find it important to make an investment in a company with a meaningful vision that will have a positive impact on the world. At this point in their lives, they want their money and time to make a difference. Also, many angels in this category are former businesspeople who are anxious to throw their hats back into the ring. In addition to investing capital in an early-stage company, these angels desire to lend their experience and business expertise in a mentoring capacity to the venture as well.

It may be extremely difficult for a founder to attract an investment from this type of angel without outside help. However, lawyers and accountants who specialize in emerging-growth companies often come into contact with such individuals and have a firm understanding of what types of ventures these individuals are willing to support and what their criteria for investment may be. There are also financial advisors who specialize in preparing companies for angel investments and introducing them to angels. A referral from these professionals can help establish a new venture's credibility.

Industry Professionals

The next category of angels includes industry professionals with a strategic interest in such a company. By staying alert and doing industry research, founders may identify investors who have achieved success in the same industry or with the same kind of technology (e.g., someone who has retired after selling a business may be interested in backing similar businesses). An example is the trend of angel physicians and retired pharmaceutical executives interested in growth companies in the medical service, biomedical, and biotechnology industries.

Angel Organizations

Groups of angels often organize to look at deals. These groups form with the specific goal of looking for potential investments. While in the past these groups have been relatively informal and loosely aligned, recently, many angels have formed collaborative investment organizations in which investment decisions are made pursuant to an established set of rules and guidelines. We have found that a great number of new ventures that are initially faced with a challenging search for funding work very well with angel groups; however, many of the formal angel groups do not have members with significant life sciences experience and thus avoid drug development or life sciences companies generally.

Finding an angel requires resourceful research, networking, patience, and boldness.

Why Seek Angels?

In the vast majority of cases, new companies seek angels for a very compelling reason—they are often the only source of available money. Frequently, the amount sought (generally $250,000–$750,000) is too low for the venture fund radar, or the entity is in too early a stage to attract even the early-stage venture funds in the region. In such cases, the remaining options are (i) a strategic alliance with a deep-pockets corporation, which may or may not be suitable; (ii) government grant and loan programs; or (iii) an angel.

In some cases, an experienced entrepreneur with a following chooses to tap individual investors even when venture money is available. Some entrepreneurs believe that venture funds are more demanding and intrusive, or that their company will achieve a better valuation using an angel. This may or may not be the case, depending on the terms and conditions upon which the angel has made his or her investment. Because most professional angels have been crammed down or otherwise pushed around by venture capitalists investing in future rounds of companies, they have become much more aggressive in protecting their future rights.

An angel may be more willing to take risks with an emerging venture without a proven record. For an angel, a failed venture may only mean a loss of capital, whereas a failure for a venture fund could open the door to second-guessing by current investors, and may ultimately affect the fund's ability to attract future investors.

What Do Angels Want?

Once you have found a potential angel for your company, what will he or she be looking for? For purposes of this discussion, we will focus on the criteria used by professional angels to evaluate an investment (and not upon the factors that may motivate friends and family to invest). Remember that there are generally no second chances; you will only have one chance to make your best impression.

Concise Business Concept

An entrepreneur must capture the angel's imagination with a good idea. A presentation to an angel must be crisp and carefully rehearsed and provide explicit reasons why the angel should be motivated to invest in your company. Once you have gotten the angel's attention, the angel begins the due-diligence phase, at which point you will provide the angel with more detailed information about your company.

The Right Person at the Helm

Most angels will require a founder to sell him- or herself as a competent and credible entrepreneur. An angel does not ordinarily perform the kind of independent technical and market due diligence performed by a venture fund (although some do); therefore, it is important that the angel understand the entrepreneur's skills and abilities. Often, the founder is an individual with significant scientific or other technical expertise but relatively little business experience. However, a founder's inexperience may not be fatal to an angel's investment decision if the founder admits his or her limitations and impresses upon the angel that he or she is more interested in the Company's success than in attaining power or position. Because attracting and retaining key personnel (including an experienced CFO at the appropriate stage of development) are necessary to shepherd a commercial enterprise to success, an angel will also attempt to assess the founder's interpersonal and management skills.

Realistic Expectations

Angels are often troubled by a lack of realism, overinflated financial projections, and unrealistic timelines for taking a life sciences product through the clinical approval process. Virtually all products and/or services exist in a world of competition. This fact should be acknowledged and appreciated, and the competition for the Company's product or service assessed realistically. Marketing is also a necessity and must be considered. It is important for angels to know how marketing and distribution (often through a planned strategic alliance) will capture potential customers, generate revenue, and, ultimately, scale to create profits. In the end, it will benefit you to rein in your optimism in presenting projections for growth, as overly optimistic growth projections for a seed-stage or early-stage company are almost impossible to substantiate.

Reasonable Valuation

There is nothing more frustrating than seeing a good business model die because the founders positioned the company with a valuation that was too high and ultimately was not funded. Valuation of seed-stage companies is at best an art and is often random, and general rules should not be the sole valuation criteria. Basically, the value of a company is what someone would be willing to pay for it. Angels take a lot of risk and rightfully demand reward for that risk. With the dramatic drop in venture capital valuations over the past couple of years, the valuations in angel rounds have similarly declined.

An Investment Structure That Will Avoid Cram Down

The angel investor does not want a future venture capital investor to take away his or her future profit potential. In a future "down" round, management can be made whole through additional option grants, all at the expense of existing nonmanagement stockholders who do not or cannot participate in future financing rounds. One way to bridge any valuation gap and reduce the angel's risk of cram down is to structure the investment as a bridge loan convertible into the first venture round, with warrant coverage to compensate for extra risk. This will place the angel at least on par with the initial venture capital and may give him or her the option to participate in future financing rounds. Another mechanism is to bridge any valuation gap and provide the angel with some cram-down protection to provide for full-ratchet antidilution protection for the first venture round and weighted average (or the same as the venture capital) thereafter.

A Pleasant Experience

Angel investors are often seeking psychological as well as financial benefits from their investments. Most angels are wealthy and could realize a similar return (on a risk/return basis) through other types of investments. Even the most professional private investor is seeking to at least stay informed and share in the highs of the growth of a new company. You should be sensitive to this both during the courting process and after the investment has been made.

There are obvious opportunities and challenges, as well as securities and tax law implications, in structuring and offering angel funding. The details of these issues, although important, are beyond the scope of this chapter. We strongly recommend that you seek professional advice to ensure that you maximize your structural opportunities and minimize your legal pitfalls. Remember, an angel investment should not be an adversarial process, but should be structured to set up a win–win situation for both the angel and the new company.