THE KEMBALL GROUP
Achieve More. Keep More.

The Dog's Bark

Returns from Angel Investing: An Uncommon Approach for Uncommon Results

Common wisdom holds that the less time spent on due diligence, the lower the return multiple.

Half of all angel investments will lose all capital: eight of ten will lose it all or return less than 1X capital. That sorry statistic has been the standard for decades despite many minds working on how to reduce risk and increase multiples. The common wisdom suggests more due diligence yields higher returns. Yet, we may have achieved all that is possible with due diligence as we have come to practice it. Simply to do due diligence better and expect significantly better returns as a result smacks of doing the same thing over and over again while hoping for improved results, a popular definition of "crazy."

Clearly, it is time to think about doing something differently. In this issue of *The Dog's Bark*, we will explore how a different approach to opportunity assessment and post-investment collaboration can deliver improved results for both the angel and the entrepreneur.

Common wisdom is producing unfortunately common results

During a workshop held in November 2013 by The Angel Resource Institute, Bill Payne presented several facts that seemed to support the common argument that the less time spent on due diligence, the lower the multiple.

First, Payne noted that angel groups typically take 30 to 90 elapsed days and about 100 actual hours to complete a deal. Second, Payne also provided informative

Half of all angel investments will lose all capital, and another 30% will return less than 1X. Clearly, something different needs to happen.

figures relating the time spent on due diligence and outcomes as a multiple of investment, and not surprisingly, the less time spent on due diligence, the lower the multiple:

- less than 20 hours = 1.1 X
- more than 20 hours = 5.8 X
- more than 60 hours = 7.1 X

Payne emphasized that the due diligence process is a "huge commitment" and underlined this point when he set out the demanding requirements for the ideal due diligence team and its project management, particularly his emphasis on the need for experienced, rigorous and competent hands-on oversight.

To make his point, Bill provided the workshop participants with three sample due diligence checklists that illustrated the factors that were the most important and took the greatest amount of time. In reviewing these checklists, it become obvious that anything less than 20 hours of real effort would likely result in poor returns.

Payne did not, however, note that five of ten investments lose all the capital, an odd omission considering that this ratio also typically plagues early stage venture capitalists, and that therefore it's not unreasonable to infer that insufficient due diligence might have been a contributing factor. Yet, venture capitalists earn fees for performance of due diligence and are known to boast of its quality.

But is longer due diligence the answer to improving investment outcomes? A thought provoking paper included with the session materials, James Geshwiler's *Best Practices for Due Diligence in Angel Group Investments*, took an investment lifecycle perspective – selection, due diligence, and post-investment "regular check ins." The lifecycle concept suggests an alternative to seeking better returns by increasing both the time spent on due diligence and adding time for post-investment management contributions.

As almost an aside, Geshwiler, Managing Director of CommonAngels, also stressed the point that the conduct of the processes should "foster mutual respect and a strong working relationship," drawing attention to the importance of interpersonal dynamics to the process. Specifically, Geshwiler included a comment that angels should respect the scarcest resource of both the angel and the entrepreneur – time. He also touched on the relative importance of the people, saying that "if you have limited time and can only focus on one area of due diligence, [the people] would be it," doubtless a very critical issue given that CommonAngels typically fund to cash flow breakeven, even if it means that syndicates are sometimes necessary.

Payne's talk on longer due diligence and Geshwiler's lifecycle view, and particularly his glancing reference to the importance of people, got us thinking. All through the give-and-take of the session, there was little to disagree with the solid advice provided. And yet, we had a nagging sense of unease. Over the past 20 years of putting over $200M of financing into small businesses, some of it with angels, we did not lose all capital on half our deals. That 50% of all angel investments lose all capital is in stark contrast to our own track record over 20 years. What is it about our

approach that makes a difference, and how does it fit into Payne and Geshwiler's views?

First, let's review some of our observations that were contributing to our unease.

1. In their recommended best practices, the Angel Resource Institute places the bulk of the burden of securing good returns on the quality of the selection and due diligence process, and not on active follow up and support post investment. This implies that a degree of selection perfection is required, particularly in regard to the startup team's ability to do everything successfully – possibly for a decade more – until liquidity occurs.

2. Nobody mentioned the percentage allocation of total hours to be spent on various due diligence topic areas. Nor did anyone raise the possibility of a tradeoff between hours spent before the cheque is written and those to be spent afterward. And other than Geshwiler's aside, no one discussed at any length the importance of doing due diligence on the entrepreneur and his team beyond the reference check.

3. The session and its materials assumed that the business model was correct by the time the angel's cheque was written. While it is possible that extended due diligence will result in significant revisions to the entrepreneur's initial business model in order to make it stronger, it is more our experience that the high potential opportunities that we funded over 20 years were looking to "buy" more time in order to change and implement a revised strategy and approach.

4. The comment regarding the importance of who is on the due diligence team presumed that the opportunity was understood – the technology, product/service, the market, competition, sales environment and so on. Yet, the role of those conducting the due diligence and their fit with the new venture and the entrepreneurial team was never mentioned. This is in contrast to the Angel Resource Institute's report noting that lack of faith in the management team was the primary reason for turning down a deal.

5. Interestingly, the second reason noted was the perceived size of the opportunity, likely a holdover from past VC days when an exit mentality was driven by use of common shares that demanded liquidity and an assumption that the larger the opportunity, the greater the margin of error. Surely, we ask ourselves, is it not opportunity size in relation to capital required that angels should consider.

6. No mention was made of the conflict between the quality of the relationship sought and a) the pre-money valuation fight over price when value is unknown and unknowable to both; and, b) lack of alignment of long term incentives rooted in the investors' need for liquidity when purchasing shares. (And really, convertible debt is a shot of lubricant to get the deal done.)

7. A subtle but pervasive assumption that advice based on age and past "experience" (opinion, really) should trump youth and skill lacks the subtlety

needed to deal with the complexities of the interactions of the people involved within the context of the opportunity and the creation of a new venture to do so.

While we generally concluded that Geshwiler's investment lifecycle perspective provides a sound basis upon which to think about improving returns, we also realize that for angels the selection and due diligence process will remain primary. The nature of our approach may address both issues: Focus on the people and the opportunity fit at the due diligence stage, and then continue to assess that fit over the lifetime of the investment. A focus on fit, we suggest, could provide an exponential positive impact on returns.

There are two broad means of beating the odds against getting a return of capital and earning a mid-double digit return, and both are very dependent on the fit between the management team and the opportunity:

1. Avoid the grasp of the past on today and tomorrow. Time spent on unproductive entanglements after the cheque has cleared has high opportunity costs and worse dynamics, and a return of capital is then a hard-won victory in a battle that should not have had to be fought.

2. Ensure that a continuing corporate capability for course corrections and supportive action exists post financing based upon a "trust but verify by observation" position, a stance established during selection and due diligence.

Assessing the previous performance of people is relatively simple, and avoiding any nasty hangovers from the past is the purpose of classic due diligence work performed by examination of the management team's individual track records. It is essential: knowledge of the past informs the future. But angels personally do not have to spend the hours to do the digging. An hours' review of the personal and corporate background check reports as summarized in a *Show Stopper Report* prepared by an angel who is part of the due diligence process should enough to identify critical problems, such as lack of integrity.

In contrast, assessing course correction ability is forward-looking and people-based. Making judgments on what people will do under novel circumstances when under pressure is its essence. The extent of necessary course correction ability is contingent on the opportunity. It requires perceiving, recognizing, conceiving, judging, reasoning, and imagining to establish a basis for judgment calls about the future and to take action based on those judgments. No records exist, only expectations.

In keeping with Payne's comment about the importance of a good due diligence team, assessing future course correction ability is no place for untested assumptions made by the inexperienced or inept. Nor is it any place for snap judgments on the two-part central question: a) what is the fit of the founders and the management team with the funders? and b) does that fit, in particular the CEO's fit, align with the demands of this high growth rate opportunity. The first question is the domain of highly-skilled CEOs who have founded and built high-growth rate organizations or those with extraordinary people radar tuned in high growth rate environments. The

second question is generally held by common wisdom to be the domain of industry experts. We suggest that this is not necessarily true. For example, what if there is no established industry in which the opportunity comfortably sits. Let's recall Lord Kelvin who stated that heavier-than-air flight was not physically possible shortly AFTER the Wright brothers' first flight. What really matters, we suggest, is domain expertise in the dynamics of organizational design, people selection and performance of a new entrant in a new space in hot pursuit of a return of capital plus {M}X return.

Room may exist to perform the classic due diligence work more efficiently but doing so, we think, cannot increase portfolio yields to any significant extent. Significantly increased yields require one of the eight of ten deals which lose all capital or return less than 1X to become a 10X. Given the years of thought and effort underlying the Angel Resource Institute materials, we suggest that simply doing the same thing better in the phases leading up to writing the cheque does not appear to hold out much promise. A different approach offers a more promising route.

An uncommon approach for uncommon results

Different approaches flow from thinking differently about the problem of increasing returns. It is not about screening out entrepreneurs, which most entrepreneurs are convinced angels excel at. We think it is really about funders and founders buying in for the long term. We believe that planning to earn all returns from one event, typically the sale of the company, drives short-term thinking and speculation. While we always focused on the exit at the outset, we also believed that it should be a long-term exit over which we exercised significant control. Consequently, our view is that, in fact, angel investors are "hiring" founders to manage their money under a long term contract.

Since the point of managing money is to provide a good and liquid return on investment, the "money managers" should provide their investors with a return of their capital from an "exit" that the money manager can directly control, royalty payments over a period of years conditional on sales exceeding breakeven levels. To make allowances for funds for growth of the business, sales levels should exceed that required to provide the target multiple of X by a factor of two.

Deceptively simple in concept, a successful royalty exit requires a well-designed and functioning organization to produce payment-triggering sales levels, an organization capable of undertaking a demanding series of post-funding course corrections to achieve and sustain those sales. Post-funding events provide a foundation for corrections based on a more accurate view of the future than was the case at inception. Almost inevitably, they require them. The purpose of investment based on organizational performance is to obtain and maintain a competitive advantage dependent on seeing the opportunity more quickly and clearly, implementing faster and staying more nimble than the competitors. People working together generate that performance and competitive advantage, and money is the handmaiden. The solution to today's failure rates is not simply to spend more time on classic due diligence or inject more money afterwards: it's to do a better job of assessing and

fostering the ability, the ongoing wit, to use money well. In fact, the wit to use money well is the secret sauce of organizations that outperform over the long term.

Let's return to our analogy of a hiring process in which the funders "hire" founders to manage their money. Framed this way, the basic question to be answered becomes whether we would hire these founders to manage our money in this opportunity, knowing:

1. That the outcome will range between loss of all capital plus much time, to a high multiple return 20X plus; and,

2. The odds are eight out of ten against the latter?

To answer this question, we propose a "hiring" approach that draws upon hiring best practices.

Initial Assessment: Pitch the Pitch

Most angels ask for a pitch backed by a business plan. This creates a time vampire for both parties and the content is almost always dysfunctional, all pitch and no plan. Worse, almost every pitch is dreadful and thus does the entrepreneur a great disservice. After all, you are trying to assess the fit between an opportunity and the capability of those you hire to manage your investment, not the showmanship of the founder.

Instead of a pitch meeting to select applicants for a presentation, invite each of those in the deal flow (who have submitted the required five profiles and passed the initial review) to meet with two or three angels for a six-hour working session to discuss the opportunity.

To start the process, ask applicants to provide specific profiles of themselves in addition to their detailed resumes. We suggest looking for four different personal profiles:

1. Hermann Brain Dominance Index (HBDI) which depicts the person's basic mental profile amongst four quadrants – analysis and diagnosis, planning and review, idea generation and strategic thinking, communication to others - and how their balance shifts in reaction to stress.

2. A sales aptitude profile available from Callidus Software

3. A sales knowledge profile also available from Callidus Software.

4. Jaques Cognitive Capacity Profile which shows the level of judgment of which they are capable measured by the complexity of problem they can solve under uncertainty.

Three of four are required to enter the deal flow stream. For founders seeking to be the CEO, a very strong preference is given to applicants who provide all four.

In addition to individual talents and weak points, a wise hirer also looks for an accurate knowledge of the work the person will perform. Consequently, in hiring a money manager, also ask for a profile of the opportunity, specifically a Critical Factors Assessment which profiles the pros and cons of their opportunity at the very earliest stage. Developed by the Canadian Innovation Centre at the University of Waterloo, The Critical Factors Assessment instrument is suggested because its primary design purpose was to provide technology entrepreneurs with an early opportunity for reflection: do they wish to invest their time in the opportunity as they have it in mind. For opportunities where $100K or more has been invested and unanimity exists that the business model is the right one to fund, a 360-degree profile that incorporates customers' perceptions as well as those of the management team's direct reports is more expensive but provides greater insight into where the additional funding should be allocated and insight into how well past funds have been utilized .

We strongly recommend a no-report, no-discussion policy. A priority invitation to a working session will be given to those who submit the full CFA profile, the most demanding of the three available CFA levels. The value of the session to the applicant is free advice from angels who have now obtained significant knowledge of the opportunity and the people. The value offered to founders -- if billed at $200 per hour per angel -- is $5,000.

Upon receipt of the completed application and profiles, qualify prospective money manager applicants by informing them that a return of {M}X in the form of annual royalty payments, each equal to the sum sought from the angels, are to be paid for Y years. The initial payment is expected in three years, but that time varies according to the nature of the opportunity. Applicants would be asked simply to state when submitting their CFA report that they believe their venture would create sufficient sales and profits so that the royalties could be paid. To finalize the date of the working session, applicants should confirm that they believe they will be able to demonstrate how they will use the funds appropriately, pay the royalties and increase their net worth and that of the founders to everyone's satisfaction.

Note that prior to the point of reviewing applications and profiles, funders have not spent time or money on direct deal selection, due diligence, listening to pitches or coaching applicants on needed presentation improvements. Applicants, however, have spent time preparing and varied amounts of money on items of long term value to founders and funders rather than on deal structures or preparation of financial projections. The total spent provides a basis for angels to establish an initial selection priority. The quality of this estimate should be probed by calling applicants in priority and offering a personal phone response from a selection committee member within a week upon the applicant confirming a key condition, the return to be provided should they be hired. To demonstrate a quid pro quo for the applicant's expenditures, this call is based upon a canvas of angels so the founders can obtain an estimate of the amount of funds likely to be available from the call. We estimate a half day of effort to review the materials submitted and arrive at an initial estimate of overall fit with the

angel(s). Based on that estimate, we issue an invitation for the call with the angels. Upon receipt of the personal profiles, the CFA report and accompanying the applicant's confirming the ability to demonstrate how returns will be achieved, the time for the working session is at hand.

The working session

With both parties now agreed to proceed, the working session is convened, preferably within ten business days subject to the proposed CEO being in attendance. The agenda would be built around the feedback from the CFA as the basis for a discussion about the opportunity. The intended output would be a business model to be funded with an accompanying dashboard for monitoring post investment progress, plus a judgment call on the likelihood of this business model being the one that would produce the required royalty stream.

More specifically, the session's objectives would be to:

1. reach a decision on whether or not to hire the applicant as a money manager based upon the profiles and observation of team dynamics during the session; and,

2. create the basis for a long term relationship based on trust keyed to a long term alignment of incentives.

Using the CFA report, the participants would identify a list of unknowns requiring a positive answer if profits are to be generated. A dashboard keyed to the testing of these unknowns in priority according to their anticipated impact on profitability should be established and the costs of "testing" established. If no key unknowns are identified and there is agreement that the business model could reasonably be expected to produce the required royalties, then the term sheet should reflect that by focusing on execution.

If a positive but conditional hiring decision is made at the end of the session because a basis for trust is now apparent, test it by the terms of a draft term sheet. It should be presented in writing for consideration by the founder within three days of the session in order to allow the angels 48 hours to reflect and note their thoughts. In fact, all observations should be written down by all both for the record and for syndication. We also recommend that a competent observer whose critical contribution is to monitor and assess the dynamics of the session should be present, take notes and provide a debriefing at the close of the session followed by a written assessment within two days in order to ensure that everyone has the same memories, assumptions and understanding.

The offer becomes effective upon signature by the lead angel. When the term sheet is accepted via the appropriate signatures, funds are then deposited in trust for a period of 30 days in order to allow for any showstoppers that may be lurking in the past undetected.

Potential show stoppers having origins rooted in history may lurk undetected at the end of the session, hence the conditional offer and placing the money in trust. This thirty-day period can then be spent doing a more traditional due diligence as a means of a double check on the assumptions and estimates made earlier. Reviews of corporate documents are the key and should detect

- existing shareholder issue
- IP issues such as ownership or protection
- corporate agreements limiting opportunities or founder non-competes and credit scores
- financing obligations
- tax issues.

An extra day or two of effort by those not involved in the working session by those who routinely do such work, is wise and should serve in particular as a double check on the integrity of the money manager. In the absence of a showstopper, personal reference and credit checks would follow before removal of all conditions.

As an aside, if the founder were not to be the CEO, the CEO would have to be identified and profiled prior to the offer becoming effective. That does not mean that financial support cannot be provided. There often exist opportunities for non-equity interim advances for specific purposes with repayment of capital and a return on it tied to specific events such as receipt of a receivable or fulfillment of a purchase order.

Time, Costs and Value.

An applicant/founder has spent a minimum of $300 on third parties to get into the deal selection stream. A motivated applicant will have spent about $4,300 on third parties for their personal profiles including the $1,500 for the CFA. This maximizes their chance of entering into a working session. Given the odds of securing angel funding are about one in a hundred in the current pitch/diligence model – and we have heard of 148 rejections before a successful close - the expenditure to improve the odds is warranted. A significant amount of self-qualifying based on the entrepreneur's motivation is anticipated as a result of the suggested triage approach -- no expenditure on profiles and CFA, no acceptance into the deal flow stream. In our assessment, the varied levels of motivation from casual to the really committed will be obvious from behaviour.

To the end of the session, the time consumed by angels per opportunity would be about 40 hours collectively, plus 8 to 16 hours of classic due diligence at the end to remove conditions on the funding. At $200 per hour, this is about $8,000 in time plus any out-of-pocket expenses. Now, using Payne's model, with this amount of estimated time and cost, it is apparent that a 5.8X return should be achievable.

To exceed a 5.8X return, and the target should be at least triple that, post-funding support appears to be the missing ingredient. How much post-funding angel time is necessary in any situation is contingent on the specific contributions required of the

money manager to exploit the opportunity given their capability and the skills of the financing angels. Post funding, an ongoing commitment of one day a month of angel time on all deals until the royalty payment stream starts or the worst is known is the minimum level of effort required in our judgment, over the years about $80,000 per funded deal.

Prevention can be carried to excess, and this leads to deals lost that should not have been. Post-funding amelioration could prove more effective in increasing yields than a prolonged due diligence and a keep-us-informed-of-progress stance. Pragmatically, it may simply be more in accord with the investors' desired use of their time and or skill sets to invest a larger sum to fund the necessary post- due diligence /term sheet cheque issuance support from part time professionals and experts who are hired as long-term team members.

Despite a tenfold increase in portfolio costs, at the portfolio level there would be no significant difference between the returns produced by ARI's best practices and the one obtained following the suggested approach, provided that the additional post funding hours increased returns in accord with the ARI figures, 5.8 to 7.1 X. for example, substantial upside results if the investment in post-funding time provided to all 10 firms in a portfolio increases the typical two of ten to three of ten deals each yielding a 7.1 X return. In this case, portfolio returns increase by almost 60%. In sum, a nominal portfolio downside is exchanged for a potential major upside.

Approach Highlights

The key highlights and milestone in the approach are:

1. Creation of a relationship of trust between founders and funders before the hiring process is consummated with a cheque.

2. Acceptance of uncertainty as the central fact of life and responding effectively through explicit and shared opinion of the business model risk and structured provisions for testing it against subsequent events as they unfold via a dashboard.

3. Assurance that the human and financial capital required are provided or provided for in the resources committed.

4. A money manager hired by the use of sound hiring practices, including use of third party evidence showing the proposed CEO to be capable of leading and building the business required to generate the royalty payment stream coupled with direct observation of performance in the working session before the cheque is written.

5. Investment in activities to assure that the business model can be reasonably expected to lead to profits and that the organization and those in it are able to and do support implementation of the work required by the current business model. The appropriate provisions should be incorporated into the term sheet and investment documents.

6. A stream of annual payments to investors yielding the desired multiples.

7. A positive experience for those toiling year in and year out in the vineyard including a celebration of the first annual royalty cheque.

***The Kemball Group** focuses on high-growth Canadian entrepreneurs who want to sustain 20% plus year-over-year growth for 10 years or more. We help these Canadian innovators beat the odds in building highly successful businesses, without giving up control.*

We offer entrepreneurs investment banking services in the private equity market place including our angel financing and crowdfunding programs.