

Houston Angel Network

***What is an Angel Investor
for Houston Chapter of AAII***

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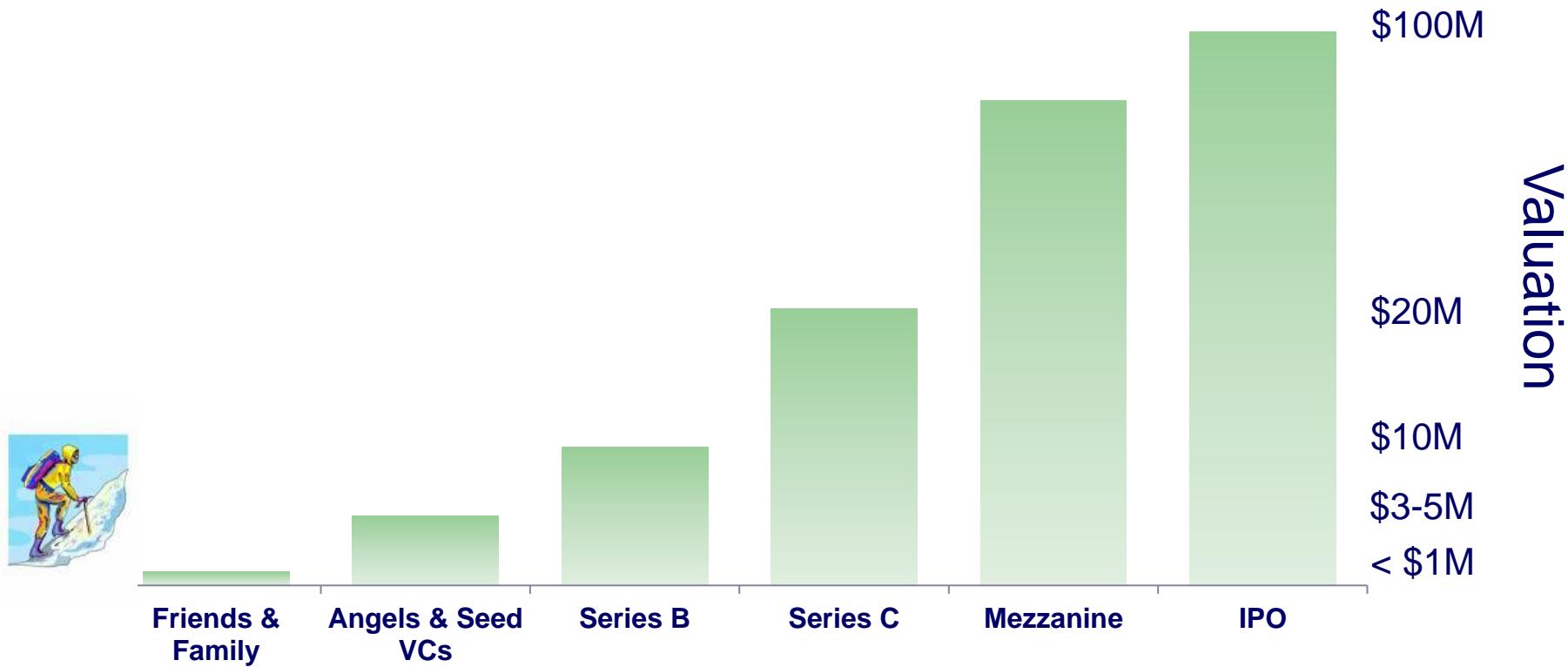
<https://www.houstonangelnetwork.org/membership>

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- **Corporate Career**
 - **Coopers & Lybrand (PWC, IBM)**
 - **Compaq Computer (HP, HPE)**
 - **Reliant Energy (NRG)**
- **Professional Angel Investor**
 - **Houston Angel Network**
 - **Texas Halo Fund**
 - **SURGE accelerator**
 - **Venture advisor on some Mercury Funds**
- **Board Member of 2 SPACs**
- **CFO of energy storage startup**

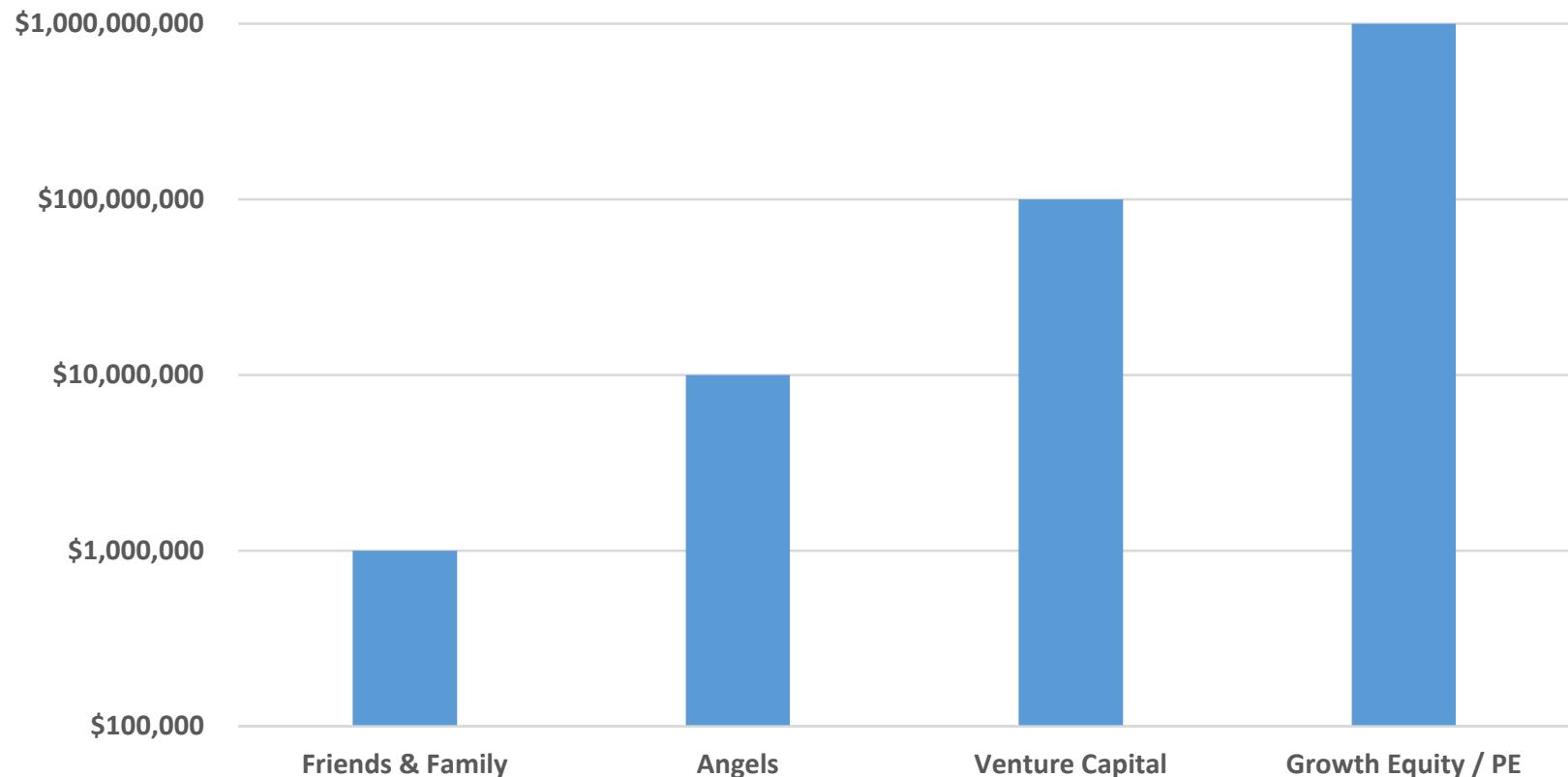
- **Description of Angel vs Venture Capitalist**
- **Angel Investing as Alternative Investment and Overall Portfolio Allocation**
- **Detailed Angel Investing Framework**
- **Case Studies and Question of Regime Change**

Scaling the IPO Mountain



Modified Funding Mountain

Valuation Ceiling



Funding Sources

- **Angel Investor, accredited individual who invests**
 - Individually and singularly OR
 - Through an organized angel group OR
 - Indirectly through an angel or sidecar fund
- **Venture Capitalist, primarily committed capital funds raised from institutional, qualified investors.**
 - Professional management team
 - Classic 2 & 20 fee structure with 1x preference to investors after fees and exp
- **Private Equity, larger pools of committed capital funds providing growth equity as well as buyouts**
 - Professional management team
 - Classic 2 & 20 fee structure with 1x preference to investors after fees and exp
- **Strategic or Corporate Investors**

Expected Returns and Hold Periods

▪ Angel Investors and Venture Capitalists

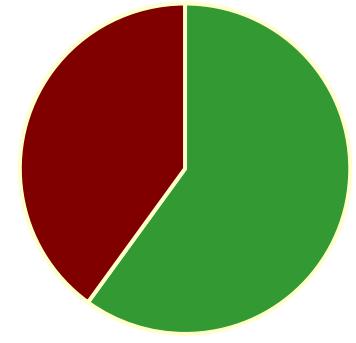
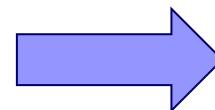
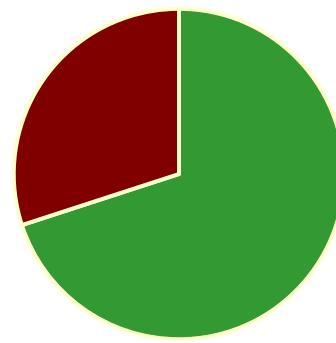
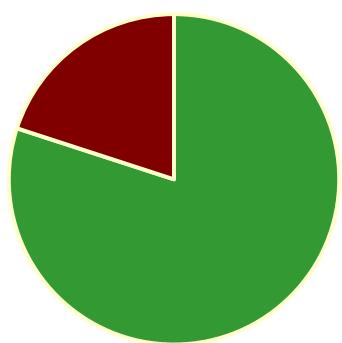
- 10x to 100x MOIC target for each investment
- 70% to 90% failure probability per investment
- Fund or portfolio return > 15% - 20% IRR and 3x to 5x MOIC
- Classic 3 to 5 year hold has transitioned to holds up to 20 years (no IPOs)

▪ Private Equity

- 3x to 5x MOIC target for each investment
- No failed deals
- Fund or portfolio return > 15% - 20% IRR
- Classic 3 to 5 year hold has stretched

Angel Investing as Alternative Investment and Overall Portfolio Allocation

Traditional Allocation

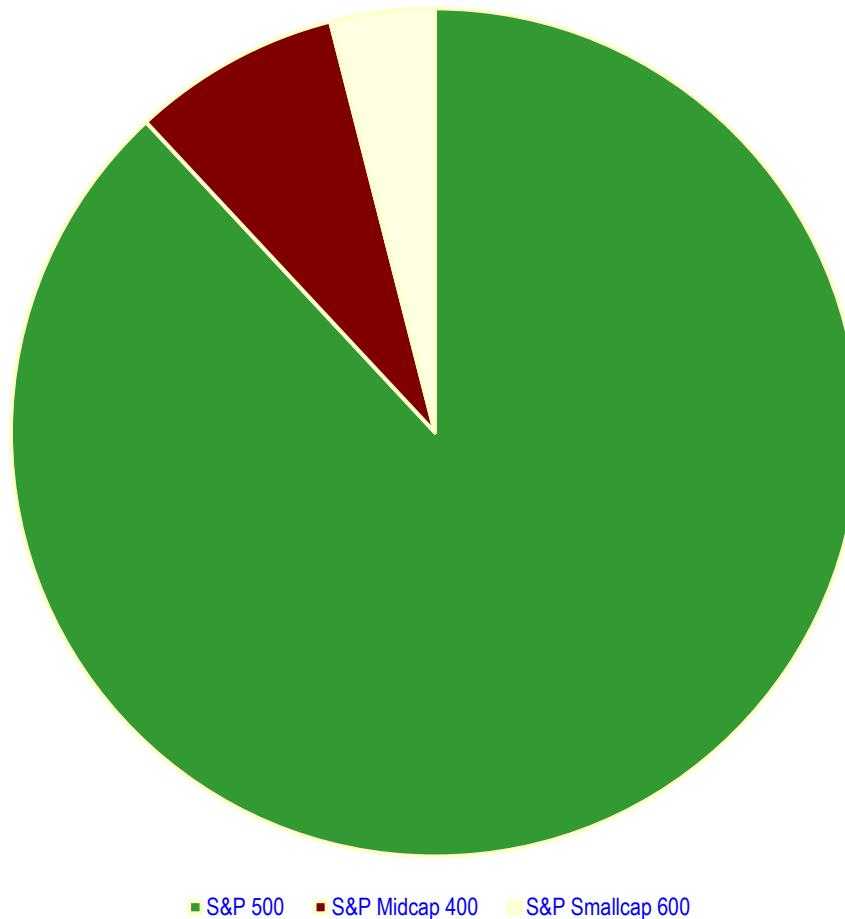


■ Equities ■ Fixed Income

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Equity Allocation by Market Cap



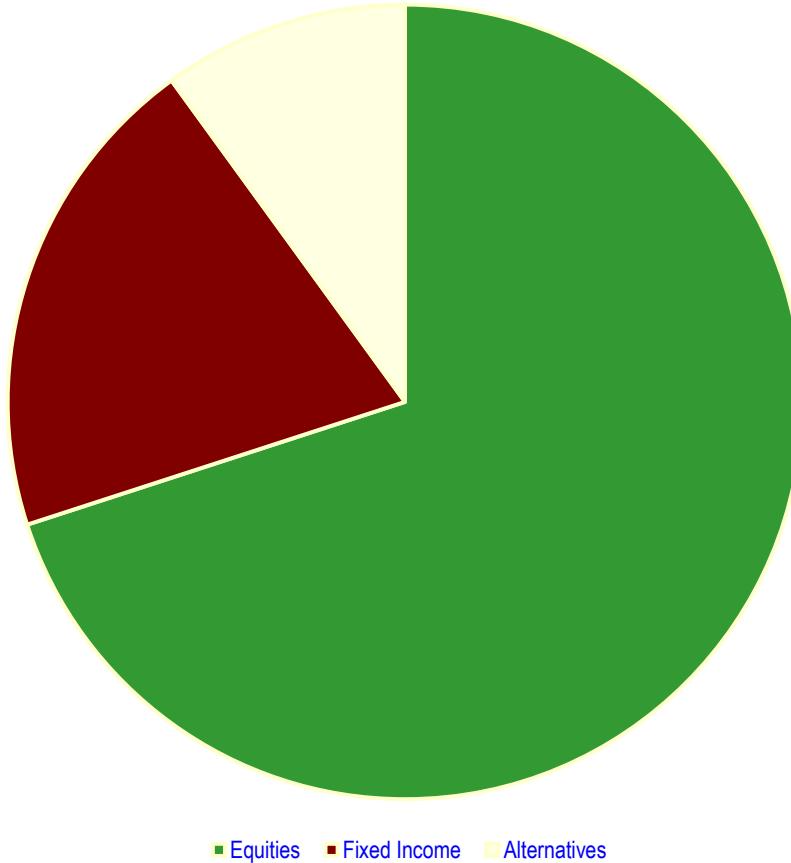
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Uncorrelated Equity Assets

- **Mean-Variance in Portfolio Analysis to generate Efficient Frontier**
 - Modern portfolio theory builds, in part, on creating portfolios that maximize uniqueness of assets or minimizes co-variance
 - Maximize alpha while seeking best Sharpe (Sortino, Treynor, et al) ratio
- **Standard question is how many stocks are required in portfolio to achieve the Efficient Frontier**

This contrasts with holding the entire asset class (e.g. S&P 500)
- **These approaches have led to factor investing and identification of alternative assets**
- **The question, of course, is what does the class of Angel investments provide to this story (extend Efficient Frontier)**

Alternatives Enter the Scene



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Alternatives

- **Real Estate**
 - REIT
 - Direct as LP
- **Energy**
 - MLP
 - Direct as LP
- **Commodities, Currencies, Crypto, Collectibles (4 C's)**
- **Private Debt**
 - BDCs
 - CLOs
- **Hedge Funds**
- **Private Equity**
 - Venture
 - PE

Alternative and Tax Considerations

- **Tax Advantaged**

- **Real Estate**
- **Energy**
- **PE**

- **Pay as You Go**

- **The 4 C's**
- **Hedge Funds**

Tax Advantages of Angel Investing – C Corp

- Section 1244 loss; deducted against income instead of capital gains
- QSBS (IRS 1202)
 - Capital Gains exclusion
 - 1045 exchange equivalent to 1231 real estate exchange
- Tax-Free Reverse Triangular Merger (Section 351)
- NOL carryforward
- PE distribution that returns basis / principal
- IPO and long term hold

Tax Advantages of Angel Investing – LLC

- **Pass-through of early losses**
 - Active, immediately deductible against income (no NOL)
 - Passive, only deductible against other passive gains (NOL held at individual level)
- **Elimination of two-tier taxation**
 - A primary benefit of LLC form
 - Trump tax reforms muted benefit
- **Facilitates asset sale as opposed to entity sale**

Detailed Angel Investing Framework

Who is an Angel Investor

- **Individual Accredited Investor**

- **Some invest jointly with spouses**
- **Can act independently**
- **My focus is through the lens of angel group**

- **Several categories**

- **Classic is someone who has had a successful exit in tech deal**
- **Successful executives or health care practitioners with day job**
- **Retired but not on the golf course full time**
- **Service providers and other involved in tech startup community**

Types of Deals

- **Tech Deals with High Growth Potential**

- **Several categories**

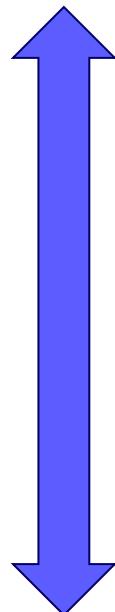
- Energy Tech
- B-to-B software
- Consumer Software Apps
- Science and Life Science
- Consumer Packaged Goods (CPG)

- **Not**

- Oil & Gas exploration
- Real Estate
- Restaurants
- Live Style Businesses
- Small Business

- **Monthly breakfast meeting 10 months each; review 3 deals at each**
- **DEAL SOURCE**
 - **Independent**
 - **HAN member “sponsored”**
 - **Syndicated or referred in from other angel group**
 - **Side-by-side with lead VC or other private equity**
- **TERM TAKER vs. TERM MAKER**
- **INDIVIDUAL vs. TEAM**
- **DEAL LEAD ESSENTIAL IF TERM MAKER**

- **1 and Done**



- **Option on Future Rounds**

- Follow the Leader
- Intuition
- Qualitative
- Analytical / Financial

VALUATION vs. VALUE

Market (1-5)

5 - Large 10's of billions;
(cure for cancer, new
energy source, etc.)

3 – Medium
Hundred Million

1 – Small Niche

$$5^3 = 125$$

$$3^3 = 27$$

$$1^3 = 1$$

Solution (1-5)

5 – Solution to problem;
ironclad IP

3 – Significant
improvement; ahead of
competition

1 – Marginal Improvement

Team (1-5)

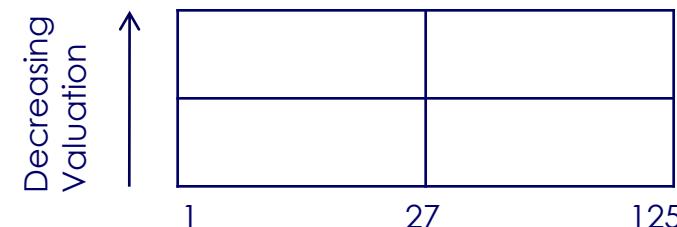
5 – Intel Team

4 – Compaq Team

3 – Experienced Group

2 – Entrepreneur with Idea

1 - Idea



WHAT TO LOOK FOR IN a FOUNDER or FOUNDING TEAM

- **Dynamic Learner but Does Not Twist Whichever Way the Wind Blows**
- **Listener and not just a Talker; Able to Filter Against the Cacophony**
- **Firm but not Overly Stubborn**
- **Both Intuitive and Analytical**
- **Able to Fill Gaps in Formal Business Training**

RANGE OF FOUNDER RESPONSES

Ability
to Take
Action



Obstinate, single-minded
Ego-Centric

Listening Skills
Analysis Skills
Tolerance for Ambiguity

Seeks Exact Answer
Programmatic
Follower

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Traditional Wall Street vs Unit Economics

- **Traditional Wall Street focuses on valuation as function of**
 - Decoding Financial Statements
 - Projected Cash Flows
 - Relevant Industry Metrics
 - Current Market Multiples for those Metrics
- **For us as Angel Investors in very Early Stage, such Valuation Approaches are Highly Speculative Based on Highly Speculative Projections**
- **Suggest it is Better to Focus on Unit Economics as a Starting Point**
- **Valuation is Secondary Exercise**

DISCOUNT CASH FLOW, CAPM, AND VALUATION

$$PV = \frac{FV}{(1 + i)^n}$$

$$FV_N = \frac{FCF_{N+1}}{(i - g)}$$

- **Business Plan Shows EBITDA of \$38.706M in 4th year**
- **Growth in EBITDA**
 - Prior, prior year to prior year 81%
 - Prior year, to 4th year 37%
- **Business plan says that they need \$5M equity investment**
- **How do you value?**
 - Grow decelerates to 8% next year
 - 25% discount rate and 8% growth yields terminal value of \$250M
 - 10x \$5M = %50M
 - \$250M / \$50M = 20% of company

Company was offering 40% for \$5M; good deal

UNIT ECONOMICS

- **Economics around Basic Unit of Sale and the Customer for that Sale**
- **Every Venture is ultimately Selling Something; that Something (Unit) is a Physical Product, Service, Cure, Experience, etc.**
- **Economics of that Unit**
 - Selling Price
 - Price Elasticity
 - Cost to Produce
- **Economics of the Customer**
 - Cost to Acquire / Customer Acquisition Cost (CAC)
 - Lifetime Value
 - How many Available Customers are There
- **How does the Venture Breakeven Given these Economics**

Case Studies and Question of Regime Change

CASE STUDY #1 Nutshell Mail

- Several friends from high school in Houston and college at Penn returned to Houston in the mid-aughts after early NYC banking experience
- Observation was that social media users would want digest of their social media activity delivered in their corporate email box
 - Before true impact of iPhone was felt
 - Early days of social media; 20 and 30 year olds were quite addicted to Facebook
- HAN invested in their formation round
- Company was selected to participate in first Facebook accelerator generating interest as an acquisition by publicly traded Constant Contact

CASE STUDY #2 CSIdentity

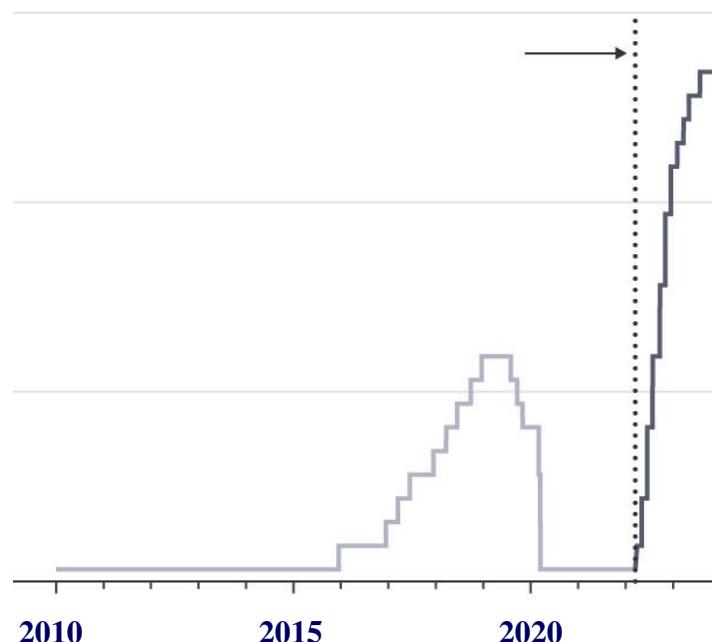
- Identity theft came to the forefront in the mid-aughts leading to the formation of CSIdentity to combat
- Observation was that using AI-driven crawlers of the “dark web” stolen identities could be detected allowing for early remediation
- Experienced entrepreneur became CEO
- HAN invested in their formation round and follow-on round
- Company made great progress before ultimately being acquired by Experian
 - Chosen to be driver behind LifeLock
 - PE recapitalization by Investcorp 2 years after initial HAN investment
 - Ultimate sale by 2016 to Experian

Regime Change

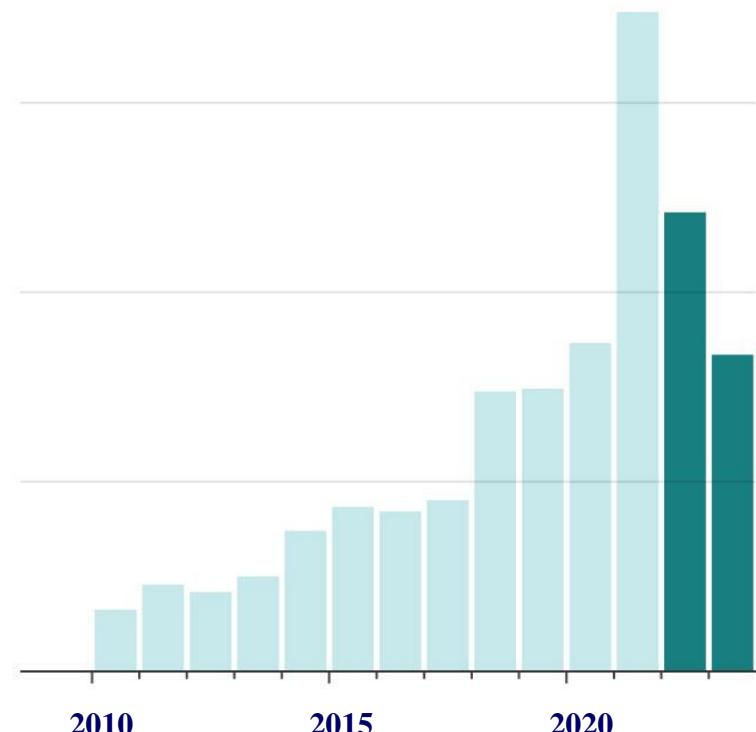
- Past 20 – 40 years has witnessed incredible change
 - SaaS business model and power of software
 - Mobile Devices
 - Power of genomics and personalized medicine
 - AI
- 40 years of quiescent inflation and declining interest rates
- New Regime or just a Blip
 - Everything that can be SaaSed has
 - Mobile devices are now embedded in the fabric of life
 - Genomics continues to the game changer
 - AI is the latest game changer
- Reached the end of gains from secular interest rate reductions

Interest Rates and Venture Capital Deals

Federal-funds rate target since Y2010



U.S. venture-capital deal value since Y2010



Data Points from the Field

- Prior, plenty of deal frenzy; now, everyone has taken a pause
- Valuation multiples for growing SaaS businesses have declined
 - At peak may have touched 15x forward ARR (Annual Recurring Revenue)
 - 10x had been rule of thumb for the past decade
 - 6x to 8x is the new 10x
- Required ARR for Series A venture capitalist continues to increase
 - 15 years ago was \$100,000
 - Then moved to \$1,000,000
 - Now is at \$2,000,000
- IPO market froze up
- Strategics walked away from investments and M&A
- Just today, no Fed rate cut

Summary

Angel Investing as an Asset Class

- Angel investments are an actively managed class contrasted with investing in a Venture or PE fund
- Historic returns can be good but hold periods can be long
 - On a pre-tax basis difficult to make the case that returns are sufficient on risk-adjusted basis (deliver alpha with better Sharpe or Sortino ratio)
 - Generally, returns non-correlated at a fundamental level; yet, exit valuations correlated to the market
 - Post-tax, however, angel investing can build wealth without tax drag
- Best analogy is to consider angel investing an unlimited Roth IRA

4 Books to Read and 1 Film to Watch

- **Venture Capital** by A. David Silver
ISBN: 0-471-88029-9
- **The Startup Game** by William Draper III
ISBN: 978-0-230-10486-0
- **The Power Law** by Sebastian Mallaby
ISBN: 9780593491782
- **Dark Side of Valuation** by Aswath Damodran
ISBN-13: 978-0-13-712689-7
- **Something Ventured** (documentary film) ©2011

Best Capital Markets Series

- **Options as an Strategic Investment** by Lawrence McMillan
ISBN: 0-7352-0197-8
Plus several other McMillan books on options and investing in general
- **Financial Modeling of the Equity Market** by Frank Fabozzi, et al
ISBN: 13-978-0471-69900-2
Fabozzi has published more than 10 financial markets titles on several imprints including McGraw Hill, Wiley, Irwin

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ASK

- **Energy Storage startup where I am CFO has need for senior advisors / consultants**
- **Professional engineering disciplines**
 - Civil
 - Structural
 - Electrical (primarily A/C not D/C)
 - Mechanical
- **Manufacturing experience**
 - High welding component including brazing
 - Industrial automation with robotic welding
 - Supply chain