Stop the Merry-Go-Round, I Want to Get Off: An Introduction to Angels and Exits

By Hambleton Lord and Christopher Mirabile

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My heart skipped a beat when I glanced at my iPhone and noticed an email with the subject line of “URGENT: Shareholder Consent Needed.” More often than not, these emails are an indicator of bad news. After reading the email, my anxiety turned into elation. The company was about to announce that their board had accepted an acquisition offer from a public company. I was weeks away from collecting a very large check for an 11X return on one of my first angel investments. This time, the investing gods were smiling down on me.

When I started angel investing nearly 15 years ago, I had no concept of what I was getting into from an investment returns perspective. We all hope to do better than the public stock market… but how much better? At the time, the dotcom bubble was yet to burst. VCs were making money hand over fist. It was the glory days. So naturally, I was a bit starry eyed and my expectations were a bit high. Easy 10x returns didn’t seem so far fetched.

Fast forward to today and I’ve had the opportunity to witness two major stock market crashes in less than 10 years with the bursting of the dotcom
and real estate bubbles. Expectations for investment returns in both the public and private markets were tempered by harsh reality. Did my expectations around angel returns suffer proportionately? Well, not exactly. I’ve learned many important lessons about exits, but perhaps the most surprising lesson is the realization that making money in the angel investing asset class is not directly tied to what’s going on in the rest of the roller coaster investing world.

The way you make money as an angel investor is quite different than in the public markets. And to really get your head around what it takes to be a successful angel investor from a purely financial perspective, you have to understand how the exits work in this world.

What do I mean by “Exits”? Simply put, it’s the sale of the company you invested in to some other entity, be it a public company, private company, private equity firm or directly to new investors through an IPO. You don’t just sell your shares in a liquid market, you need to find a buyer to take the entire company. Not surprisingly, these exits don’t occur overnight; they typically require years of market positioning work and a year or more of deal planning. As investment bankers are fond of saying, “Successful companies are bought, not sold!”

This article is the first in a series of pieces that will focus on helping you understand what it takes to turn an investment in a startup company into a successful financial return for your portfolio. The series will cover a broad range of topics, including:

1. Expectations for returns in an angel portfolio

2. Why early exits are so critical to an angel portfolio

3. The importance of alignment between investors and the management
We’ll start with the first item on the list: Expectations for returns in an angel portfolio.

**What is a reasonable return for an angel investor?**

When you make angel investments, you are putting money into a very high risk (and labor-intensive) asset class, so if you are to be paid to take on that risk (and work), you need to get better overall returns than publicly-traded companies. There’s not a lot of rigorous data on angel returns, but most of the studies done to date converge around the idea that a diverse and professionally constructed angel portfolio can return 27%+ on an annual basis.¹

If you dig one level deeper into these studies, you find that a high percentage of angel investing "exits" result in little if any capital returned to the investor. A long standing myth with investors is that up to 90% of new companies fail and go out of business. If you had that kind of failure rate with your exits, it’s next to impossible to achieve a 27% annual rate of return. However, research studies indicate a more optimistic 60% failure rate after 6 years.² And, investors with a solid process for due diligence and post-investment support of their companies can lower the failure rate from 60% to under 50%.
That’s still a lot of lost capital. To make up for the major losses, some or all of the deals in the remaining half of your portfolio have to significantly outperform. Which is precisely what a well-constructed portfolio is designed to do. For example, assuming you invest identical amounts of capital (say, $25K) in a portfolio of 10 companies ($250K total invested), the math needed to achieve a 27% IRR can be modeled as follows:

- 5 companies are total losses and return $0 to the investor. However, you are able to get 20% of your investment back through an offset vs. any capital gains you have. This means each company will return $5K in tax writeoffs for a total of $25K.

- 3 companies average out to 3X on invested capital, so each company returns on average $75K for a total of $225K.

- 1 company produces a 5X return, not a bad exit, but nothing to set the world on fire. This company returns $125K.

- 1 company is the real winner in the portfolio (15X) and does the heavy lifting you need to achieve a high rate of return. Without this exit, it’s hard to justify the risk that an angel investor takes with their capital. This company returns $375K.

- So the combined return on all 10 companies is $750K. That’s a 3X return on your original investment of $250K.

That sounds great, but it hinges on two very important points. First, it only works from an IRR perspective if you get all that liquidity within an approximate 5 year timeframe (which is a timeframe we consider to be an “early exit” - many companies take much longer). Additional time until exit eats away at your IRR. Whether you achieve a 27% IRR depends on how quickly these exits occur. And second, it assumes one extreme winner delivering 15X - without that anchor deal to “return the fund” the same IRR would require a portfolio where every single company delivered a 3X (not
going to happen) or half the companies delivered a 1X and half a 6X (also not going to happen).

The above models are very simple examples. The reliability of results will be much greater across a larger and more diverse portfolio than just ten companies. We will examine more complex portfolios in future posts. But these quick examples bring home the importance of achieving not only exits, but early exits, in your portfolio. Without good advice and guidance, most startup CEOs don’t understand the urgency of driving towards an exit at a very early stage. Part of your role as investor will be to provide this guidance. More on this topic in our next Exits post.

Want to learn more about how to plan for exits and maximize returns? Download our free eBook today Angel Exits: Perspectives and Techniques for Maximizing Investment Returns or purchase our books at Amazon.com

Footnotes:

1 For more detail on angel investor returns check out the following:
   - Returns to Angel Investors in Groups - Wiltbank and Boeker
   - Angel Investor Performance Project

2 For more detail on survival rates of startup companies check out the following:
   - Formation, Growth and Survival - Phillips and Kirchhoff