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NOTE ON ANGEL FINANCING (2012)

Welcome to the angel investing world! Get your checkbooks out. Let's get it started.

—Ron Conway, super angel, at AngelConf in 2010¹

We can't know how much longer this abundance of capital will last, but I don't want to be a part of it. When I see a massive number of new investors and carpetbaggers coming in, it's time to get out.

—Kevin Hartz, CEO of Eventbrite and angel investor in Pinterest (among others), in 2012²

The world of early-stage financing has undergone many changes over the years. In this note, we will first document the historical roots of early-stage investors, and describe important milestones along the developmental path. We will then describe the types of modern-day angel investors, focusing on their investment preferences and practices. Finally, we'll set up a discussion of salient issues in angel investing for the future.

HISTORY OF EARLY-STAGE INVESTING

Angel investors have existed in spirit for thousands of years. Indeed, examples that detail the commitment of capital by a private investor in a high-risk venture exist even in the Bible. Such investments are also said to have funded Christopher Columbus's inaugural trip to the "New World" as well as Alexander Graham Bell's invention of the telephone.

The earliest *venture capital firms* were created in the 1930s and 1940s on the East Coast of the United States as an effort to professionalize private investment activities. Some members of the Bessemer, Rockefeller, and Whitney families set up these entities, charging professional managers to seek out and invest money in promising ventures.³ These early venture capital firms as a class were not predisposed to early-stage, late-stage, or buy-out investments. They simply sought out good opportunities to make their capital productive, and hence became the roots of what are now called venture capital firms, private equity firms,¹ and certain modern angels.

¹ An example of a modern private equity firm rooted in a family fund is New York City-based American Securities Capital, which was started in 1947 to manage a portion of the Sears, Roebuck, and Co. fortune. See <http://www.american-securities.com/Overview/FirmHeritage>.

Arar Han (MBA '09) and Professor Ilya A. Strebulaev prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The writers gratefully acknowledge the invaluable perspectives contributed by Shayne Fitz-Coy (MBA '10).

The First Venture Capital Firm

Harvard Business School Professor and General Georges F. Doriot is credited as the father of the modern venture capital firm. Together with the heads of the Federal Reserve Bank of Boston, the Massachusetts Institute of Technology, and the Massachusetts Investor Trust, Doriot founded American Research and Development (ARD) in 1946. ARD was a publicly-traded investment firm whose purpose was to help commercialize technologies developed during the Second World War.⁴ While later venture capital firms tended to be privately held, rather than public, they followed at least two key attributes modeled by ARD:

- **Capital and advisement:** Doriot provided not just capital to his portfolio companies, but also management guidance and industry advice. He was known to discourage the pursuit of quick profits, and to encourage investments in research and development.⁵
- **Short head, long tail returns:** Top performers drive principal returns for most high-risk capital portfolios. ARD demonstrated this principle to hold with venture capital investments with its 77 percent stake in Digital Equipment Company, a mini computer start-up.⁶ By 1971, ARD's original investment of \$70,000⁷ in 1957 was worth \$355 million, ultimately representing about half of all ARD returns, ever.⁸ Such success gave rise to the hit-driven mindset of the growing venture capital community.

A less-imitated attribute modeled by ARD was its emphasis on social good. As his student Arthur Rock remembered, Doriot was known to say: "If you're interested in building a business to make money, forget it. You won't. If you're interested in building a business to make a contribution to society, then let's talk."⁹

West Coast Venture Capital

ARD inspired the creation of the modern venture capital industry, which initially grew in Boston and New York City. The first West Coast venture capital firm was founded in 1961. New York investment banker Arthur Rock had visited the Bay Area of California in 1957 to help Eugene Kleiner, and his colleagues from the Shockley Laboratory, finance what would become Fairchild Semiconductor. Four years later, Rock relocated to the West Coast and co-founded Davis & Rock, a firm that would eventually provide funding for start-ups such as Intel (a spinoff of Fairchild). Rock helped formalize the use of venture capital to start-up technology firms, and the use of stock options in addition to salary as employee compensation.¹⁰

Early venture capitalists in what became known as "Silicon Valley" provided many services to early-stage entrepreneurs, including capital, guidance, and access to their networks of bankers, accountants, lawyers, and experts. In 1976, venture capitalist Don Valentine helped Steve Jobs and Stephen Wozniak start Apple Computer by supplying \$91,000 of equity and \$600,000 more through syndicated investors. Apple received a total of \$3.5 million in venture capital financing, which grew to \$271 million when the company went public in December 1980.

Free-Flowing Pension Funds and the Changing Nature of Venture Capital

In the early 1970s, there were less than 15 venture capital funds in the United States, mostly funded by private money.¹¹ By 1979, the total number of venture capital funds increased to 225. By 1989, the number was 674.

What drove this rapid growth was the increased availability of pension funds as venture capital. The “prudent man rule” in the 1974 Employee Retirement Income Security Act (ERISA) had been understood to preclude pension funds from investing in high-risk assets like venture capital. In 1979, however, the Department of Labor issued a clarification allowing pension funds to commit up to 10 percent of their assets in alternative investments. This caused annual contributions to venture capital to increase from between \$100 million and \$200 million throughout the 1970s to over \$4 billion by the end of the 1980s. (**Exhibit 1a** shows the shifting balance of contributions by individuals and pension funds.)

The infusion of pension funds into venture capital led to more funding for companies, which drove a dramatic rise in start-up formation and job creation. There were also some downsides:

- **“Investment bubbles”:** Abundant capital and faddish investing practices could lead to overinvestment in industries. In one example, 43 Winchester disk driveⁱⁱ companies received \$400 million of venture money in the late 1970s and early 1980s, two-thirds of which was invested between 1982 and 1984. By 1983, over \$800 million had been raised by Winchester disk drive companies going public. In the middle of 1983, the top 12 public Winchester disk drive companies were valued at \$5.4 billion, trading at 4x sales and nearly 50x price-to-earnings. As the market flooded and revenues fell, the bubble burst in 1984, and valuation fell to \$1.4 billion by the end of the year.¹²
- **Issues of scale:** Large pools of venture capital created a host of other problems at the company level as well, including premature market entry,ⁱⁱⁱ lax oversight, and a misalignment of capital and entrepreneurial opportunity.
- **Short-term focus:** Finally, pension money fundamentally changed venture capital by introducing a short-term, quarterly focus to fund performance, the timing preferred by institutional money managers. As one venture capital researcher warned in 1984:

[T]he only thing that could destroy this market...is pension funds themselves and their obsession with the short-term relative performance game. Venture investing requires patience as problems are worked through and with all the money that has flowed into venture investments the last few years, the problems are bound to multiply.¹³

ⁱⁱ An early removable disk drive from IBM that put the heads and disks in a sealed unit for greater speed. Introduced in 1973, the drive had one permanent and one removable spindle, each holding 30 megabytes. The “30-30” storage capacities led to the Winchester nickname after the Winchester 30-30 rifle. (Source: PCMag.com.)

ⁱⁱⁱ According to Gompers, there is a 0.7 correlation ($p < 0.05$) between the amount of new money committed to venture capital funds and the number of initial public offerings those funds orchestrate. See Paul A. Gompers, “The Rise and Fall of Venture Capital,” *Business and Economic History*, Volume 23, Number 2, Winter 1994.

An impact of pension money infusion was that venture capital funds redistributed their portfolios to include more lower-risk companies with shorter time to maturity (see **Exhibit 1b: Share of Venture Capital Investments by Stage**). In 1980, all venture funds invested exclusively in seed, early-stage, and later-stage ventures. By 1988, however, leveraged buyouts commanded one-fifth of the capital pool—a much larger one at that.

The influx of public funds into venture capital shows no sign of abatement. From 1991 to 2011, venture capital funds grew over sevenfold in total value from \$26.8 billion to \$196.9 billion, largely fueled by relaxed restrictions at public funds (see **Exhibit 1c: Venture Capital Statistics**). In 2008, a survey of public fund chief investment officers found that the average allocation to alternative investments had risen to 16 percent, with 13 percent of funds at 30 percent or more.¹⁴

MODERN ROOTS OF ANGEL INVESTMENT

The modern use of the term “angel” to denote patrons of entrepreneurial ventures originated on Broadway and was used as early as the mid-1940s.¹⁵ Investors in theatre productions were known as “angels.” William Wetzel, a business professor, re-appropriated the term in a 1978 study, applying it to early investors in technology-based start-up companies who tended to have both a financial and a social motive in participating in the risk capital market. Published in 1983, the study noted:¹⁶

Risk capital investors play an essential role in the growth of the high-tech sector. [T]here is a continuing perception that “gaps” exist in the capital markets for smaller firms, and this raises questions about the vigor of any “age of entrepreneurship.” However, ...capital gaps may be more apparent than real.

The folklore overlooks the investment record of informal risk capital investors—the “business angels.” (Angels do not include founders, friends, or relatives.) Not only do these angels exist, they may represent the largest pool of risk capital in the country, [and] invest in precisely the areas that are cited as gaps in the capital markets for [small, technology-based firms].

In addition, Wetzel noted, business angels were:¹⁷

- Accustomed to sharing investment opportunities with friends and business associates, and making investments together with others.
- Active investors, typically having an informal consulting relationship or service on the board of directors.
- Patient investors who typically held their investments for five to seven years: 44 percent of investments were in start-ups, and 80 percent were in ventures less than 5 years old, while 58 percent of investments were located within 50 miles of the investor.
- Highly influenced by “psychic income,” i.e., the potential to leverage technology for social good: 35-45 percent would accept a lower financial return for “non-financial rewards.”

Wetzel estimated the scope of angel capital in 1987 to be \$20 billion to \$30 billion committed annually by 250,000 angel investors.¹⁸

The 1990s and Beyond

The term “angel investor” as it is used today did not enter the popular financial lexicon until the mid-1990s. At the time, researchers estimated that angel investors funded three times as many seed and early-stage start-ups as did venture capitalists.¹⁹ A then-contemporary estimate put the total amount of annual seed and early-stage investments at \$30 billion for angel investors, versus \$10 billion for venture capital.

Venture and angel investors provided early-stage funding to companies like Au Bon Pain, FedEx, and Staples, not just technology start-ups like Intel, Microsoft, and Apple. However, technology investments have been prominent and consistent along the developmental path of venture capital and angel investing, and will serve as the focus of the remainder of this note.

ANGEL INVESTMENT AS AN ASSET CLASS

In 2011, \$22.5 billion in angel investments provided financing to 66,230 entrepreneurial ventures in the United States, at an average deal size of \$339,725.²⁰ Of this, 42 percent went to early-stage teams and the rest provided expansion capital or follow-on investment. The total pool of angel investments has loosely tracked the growth and decline of venture capital (see **Exhibit 2a for a longitudinal comparison**). However, venture capital firms distributed funds to just 3,673 recipients for a much larger implied average deal of \$7.7 million.²¹

In 2011, 24 percent of angel exits occurred when the start-up company failed, down slightly from 27 percent in 2010. Successful exits tend to be the sale of the start-up company. Mergers and acquisitions accounted for 54 percent of angel exits in 2010 and 66 percent in 2010.²² This data is based on angel investments tracked by the Center for Venture Research, which includes the industries listed in **Exhibit 2b: Angel Investment Industry Mix**.

Owing to the nature of tracking private investments, angel returns are difficult to calculate or substantiate. Anecdotal returns for angels remain in the range of 25 percent to 35 percent IRR. As shown in **Exhibit 2c: Distribution of U.S. Angel Investment Returns (1972-2007)**, about half of all angel investments are expected to fail.

TYPES OF ANGEL INVESTORS

In the mid-1990s and in recent years, the first stop for entrepreneurs seeking pre-seed or seed funding for a technology venture was often their own networks of family and friends. These potential investors might not have domain expertise in the space or any investment experience, but they tended to have a perspective on and a vested interest in the entrepreneur’s success. An entrepreneur might raise between \$25,000 to upwards of \$100,000²³ from this informal capital pool colloquially referred to as “family, friends, and fools,” or “FFFs.” FFFs were not considered angel investors as they were a capital pool available only to personal networks.

Those who used FFF funding to achieve progress toward their idea could then turn to one of three types of angel investors to provide the next stage of financing. (Some might skip the FFF stage altogether and head directly to angels. See **Exhibits 3a and 3b: Staging of Deals**.) A fourth type, “accelerators” and “incubators,” will be discussed at the end of this note.

Individual Angels

In 2011, individual angel investors were estimated to number anywhere from 225,000 to 1 million within the United States and to invest between \$100,000 to upwards of \$500,000 per deal.²⁴ Individual angels invested their own capital and operated as sole practitioners. Deal flow tended to be sporadic or ad hoc unless the angel was well placed, or had a professional reputation that attracted entrepreneurs.

Individual angels tended to have a homegrown decision-making process that favored investments within their own preferences that dovetailed with their market perspectives. They tended to do their own due diligence and legal work, unless they invested with third-parties whose diligence they trusted. For these reasons, individual angels had the ability to make a quick commitment—occasionally even on the spot, without formal diligence.

However, the ‘right’ angel could be difficult for entrepreneurs to find. Many individual angels were, as Wetzel characterized them, “latent”: willing and able to invest but inactive. Nonetheless, individual angels were found in virtually every industry and ran the gamut in terms of industry expertise, involvement in managing their investments, and depth of capital.^{iv}

To address the problem of matching would-be entrepreneurs with would-be angel investors, several public and private groups attempted to create online platforms much like dating sites. On the heels of two failed efforts led by the Small Business Association as well as private groups, the co-founders of entrepreneurial blogging and networking site Venture Hacks started AngelList (angel.co). Launched in 2010, AngelList was alleged to have helped match more than 1,000 start-ups with investors.

Angel Groups

One of the first formal angel groups was formed in 1995 by Hans Severiens, a nuclear physicist turned financier, in the Silicon Valley, California. While the classic individual angel investor was already known to share deals with other angels, Severiens sought to formalize this arrangement through a group of 12 investors who called themselves The Band of Angels. The group would function as a consortium of individual investors, pooling their networks, experiences and expertise to source and vet high-quality deals, while sharing legal and financial duties. By the end of 1997, membership had grown to 100. The Band of Angels of the mid-1990s resembled the small Silicon Valley venture capital community of the early 1970s in that both shared deals among friends and provided advisement as well as capital to their portfolio companies. The key difference was that Band angels invested their own money, while early venture capitalists invested on behalf of their investors.

In 1996, there were 10 angel groups; 10 years later, there were more than 200.²⁵ In 2012, there were approximately 300 angel groups in the United States, with an average of 42 members each.²⁶ Angel groups had a presence in almost every state. The average group invested a total of nearly \$2 million across 7.3 deals in 2007, at an implied average deal size of \$266,000.²⁷ The

^{iv} For an illustrative example of how individual angels work, see Ilya A. Strebulaev and Jocelyn Hornblower, “Wikimart,” Stanford GSB Case E-441.

median round size was \$700,000.²⁸ About 30 percent of all angel group dollars were concentrated in California.²⁹

Modern angel groups comprised accredited investors^v who pooled their time, knowledge, and capital to share deals, due diligence duties, and legal resources. Many individual angels joined groups like Sand Hill Angels for these benefits and others, including taking part in investment activities within a consortium of other investors.^{vi} They did not tend to take board seats, but did provide active advisement upon entrepreneurs' request. Angel groups could be an attractive potential funding option for the entrepreneur because: (1) there was a formal and public application path, (2) that enabled access to many angels at once, (3) who often represented "smart money," i.e., informed industry insiders who could provide sound advisement.

Virtually all angel groups used an online management platform called Gust or operated a proprietary platform to accept applications and manage their vetting process. Angel groups could source anywhere from 50 to 100 deals per month in a number of ways including: direct application through their websites, referral, syndicate investment opportunities, and partnerships with accelerators.

Entrepreneurs submitted their applications through Gust, which notified angel group members to review the funding opportunity. Once the designated group members rated each application, the top deals were invited to present to a subset of the group in a monthly "screening meeting." At the screening meeting, entrepreneurs presented their idea in person and took questions from the group members present. After the screening meeting, the present members voted and sent the top deals to the monthly "dinner meeting," where all members had an opportunity to review the deal and ask questions of the entrepreneurs. At the close of the dinner meeting, group members formed a "soft circle" of funding commitments to their ideas of choice by entering in their pledged amounts to Gust. The funds were released following a successful due diligence process.

Angel groups funded roughly one deal per month. Anecdotally, they expected that out of every 10 deals, one would return in excess of 10x, two or three would return 2x to 3x, and the rest, 0x.³⁰ In choosing what to fund, group members behaved much as individual angels did, according to their own investment theses and industry preferences. As a group, however, they had the benefit of exposure to other reviewers' questions and discussion during the screening and dinner meetings. They could also be influenced by the investment decisions of prominent members of the group, as well as the decisions of "syndicate" investors. Just as independent angels might co-invest with other angels, angel groups co-invested with other angel groups as well as independent angels.

For the entrepreneur, a benefit of obtaining funding through angel groups was access to the angel group members' professional networks and investment syndicates. Successful vetting by one angel group could lead to warm introductions to other investors, facilitating the process of completing a funding round. A downside of working with angel groups was the speed of funding. While an individual angel might be able to fund a deal in as little time as one day, the

^v According to Securities and Exchange Commission, an accredited investor has at least \$1 million or more in net worth not including the primary residence, or \$200,000 or more in stable annual income (\$300,000 if married).

^{vi} Also see Ilya A. Strebulaev and Arar Han, "Sand Hill Angels," Stanford GSB Case E-442.

earliest a typical angel group could fund any deal was one month and as many as several months. By 2012, some angel groups had increased the speed of funding for certain technology deals by eliminating the screening meeting, and for some higher priority deals, by creating a special fund for instant funding by simple majority vote.

Super Angels

In 2000, the mainstream media described a type of angel called a “super angel” as someone who invested \$100,000 per deal, investing only within his or her realm of professional experience.³¹ They were further characterized as “cashed-out CEOs.” The term “super angel” stuck, and evolved in meaning. In 2010, a venture capital industry petition to the United States Senate argued that super angels, defined then as angel investors with a “track record of regularly participating in seed round investments,” ought to qualify for a special “Startup Visa.”³²

By 2012, the definition of super angel was a prominent professional investor who actively participated in early-stage start-up financing with his or her own funds as well as funds from limited partners. Super angels, also called “micro VCs,” could compete for capital with venture capital firms. Because they focused on seed and early-stage investments, they also competed for deals with both venture capital firms and other angels. Super angels were also the source of deal flow for venture capital firms, leading one venture capitalist to wonder aloud, “Are these guys friend or foe?”³³

Compared to other angel types, super angels tended to use their larger capital pools to:

- Place a multitude of smaller bets within a technology space, putting them in competition with other angels and angel groups,
- Make several sizable investments in promising companies, putting them in competition with venture capital firms, or
- Some combination of these two strategies.

A super angel who subscribed to the first strategy was Ron Conway, who by 2010 had invested in approximately one internet or mobile company every six days for 15 years.³⁴ Conway was an experienced technology executive and early investor in Google. He invested in all top 10 firms in a given sector with the assumption that one would “win.” All told, he invested in approximately 1 of every 30 deals he reviewed.

Because of the volume of investments super angels like Conway made, and their prominence in the early-stage funding market, the terms they offered could be precedent setting. Conway made headlines in 2011 when he co-founded the Start Fund to offer every start-up graduating from the accelerator Y Combinator \$150,000 in seed capital as a convertible note. Practices like these posed a disruptive challenge to Silicon Valley’s modus operandi for start-up finance by providing early-stage capital to entrepreneurs under very favorable deal terms but little advisement, and by raising the valuation of start-up companies in advance of a future venture capital round. As reported in *Wired* magazine:

[T]he investment game is about not missing out on the big wins, rather than screening out losers. This is affecting valuations, so smart investors, such as Yuri Milner, are willing to pay more to ensure they're not missing out on hot deals.³⁵

In June 2012, venture capital firm General Catalyst Partners announced that it would join the Start Fund.³⁶

Floodgate's Mike Maples, Jr. was a successful technology executive and former venture capital investor who followed the second strategy above. He sought winners not by making a large volume of small investments, but by providing ample funding to the few companies that he thought would be what he called "thunder lizards":³⁷ one of the 15 top-performing start-up companies each year. He relied most on a network of trusted advocates to refer deal opportunities, rather than the 200 business plans his office received per week.

When evaluating a deal, Maples looked at potential market size and whether there were "unfair" advantages that could be captured by the start-up company. He looked in particular for a visionary founder—not to be confused with 'having a vision,' or an alternate conception of the way a part of the world is. Rather, Maples sought deep, specialized knowledge of the entrepreneur's targeted field of operation, and a point of view that was both contrary to the consensus opinion on the market and likely to be correct. He examined the entrepreneur's market thesis and reasoning, and made a judgment call about whether the entrepreneur seemed "meant to start" the company s/he wanted to start. Maples cited Bill Gates and Mark Zuckerberg as two examples of visionary founders who were "meant to start" their respective companies. His portfolio of previous investments included twitter, ModCloth, Chegg, and Digg.

See **Exhibit 4** for a comparison of angel types, including incubators.

THE START-UP ENVIRONMENT

Much has changed in the world of start-up funding. We discuss four salient trends below.

\$5 Million Then = \$500,000 Today

Ten years ago, starting a software business required no less than \$5 million. Entrepreneur turned venture capital investor Mark Suster remembered:

When I built my first company starting in 1999 it cost \$2.5 million in infrastructure just to get started and another \$2.5 million in team costs to code, launch, manage, market & sell our software. So it's unsurprising that typical "A rounds" of venture capital were \$5 to \$10 million. We had to buy Oracle database licenses, UNIX servers, a Sun Solaris operating system, web servers, load balancers, EMC storage, disk mirrors for redundancy and had to commit to a year-long hosting agreement at places such as Exodus.³⁸

In 2012, the same company required only \$500,000 to start up. The advent of open-source software and open-cloud infrastructure companies like Amazon Web Services had cut start-up costs by 90 percent.³⁹ Other platforms like Facebook, twitter, and iOS and Android operating

systems provided ready-made advertising, marketing, and distribution channels, effectively lowering the cost of acquiring customers.

A Shift in Risk Capital

The crash of the start-up company cost structure naturally favored angel investors, who gained the ability to fully fund a start-up company's seed stage. The median size of angel and angel group syndicate rounds was \$700,000 in 2011, a 40 percent increase from the \$500,000 reported median round size in 2010.⁴⁰ Indeed, 44 percent of angel investments were directed toward internet and mobile software businesses in 2011.

Certain adept venture capital firms^{vii} also seized the opportunity by reducing their commitments to such companies from \$5 million in 2000 to its modern equivalent of \$500,000. The lower capital requirement per company enabled them to make more bets than they otherwise could, so they reshuffled their portfolios to reflect greater numbers of investments, at smaller amounts. Other funds capitalizing on this change were led by super angels, or "micro VCs."^{viii}

For most venture capital firms, however, the dramatically decreased cost of starting up presented a problem. Limited partners of venture capital firms, particularly institutional funds, had billions of dollars in assets. They wanted to make larger commitments so they had fewer general partners to manage, and preferred not to be more than a certain percentage share of any one fund. Moreover, to protect their assets, limited partners placed certain guidelines around venture capital firms' investments. A minimum investment size north of \$1 million was a common requirement, as was unanimous consent of all partners in a venture capital fund. Limited partners effectively restricted venture capital firms' ability to invest in seed-stage software businesses.

Exit opportunities for venture capital firms, traditionally the initial public offering (IPO), were also waning. While 58 percent of venture capital exits were through IPO in the 1990s, the number fell to just 12 percent in the first decade of the 2000s. This suggested that most profitable exits would be through mergers and acquisitions by an existing company.

For venture capital deals and dollar investments by stage over time, see **Exhibits 5a** and **5b**.

The Role of Accelerators and Incubators

The falling cost of creating a software business led to the rapid emergence of accelerators, also known as incubators. These seed funding vehicles functioned as boot camps or academies for start-up teams, with or without a business idea.^{ix} In a best case scenario, they could replace the informal "family and friends" investment round, and carry a business through the seed stage. There were 100 to 200 start-up accelerators in the United States, not counting public or corporate business accelerators.

^{vii} For example, True Ventures and First Round Capital.

^{viii} For example, Dave McClure of 500 Startups, Manu Kumar of K9 Ventures, and Chris Sacca of lowercase capital.

^{ix} While accelerators and incubators arguably constitute a distinct investment class that lies further upstream from angel investors, we include them here because there is not yet a field of study that addresses them separately and because the total asset class is small (we estimate < \$1 billion).

The oldest and best-known accelerator was Y Combinator (YC), which was founded in 2005 and had funded 460 start-ups including Dropbox and Airbnb. At the time of writing, 172 of these companies had been acquired, shut down, or raised a round of funding, for an implied total valuation of \$7.78 billion, and an unrealized return of 7.8x.⁴¹ The venture capital firm Sequoia Capital was an investor in YC.

YC accepted a semiannual class of digital start-up teams by application and provided them a small amount of funding (\$14,000 for one founder, up to \$20,000 for three or more co-founders), and much advisement for three months in exchange for 6-7 percent of equity. As of March 2012, YC also accepted teams without an idea. At the end of each quarter, all YC companies “graduated” on “Demo Day,” an investor roadshow.

Tandem Entrepreneurs was an accelerator established in 2007 that accepted up to six teams per quarter and granted each \$200,000 for six months of in-house advisement in their paths to turning their idea into a viable business. For this, Tandem received a 10 percent equity stake in each company.⁴² Tandem focused exclusively on mobile start-ups.

Having raised \$32 million in its second fund (its first fund was \$12 million), which was backed by venture capital firms as well as angel group Sand Hill Angels, Tandem preferred to keep its funding arrangements flexible, based on the needs of the individual team and business. Its focus was providing “muscle capital” to drive the successful launch and profitability of the businesses it accelerated, rather than graduating a large class of teams. Tandem did not hold a demo day.

For entrepreneurs, an acceptance to a top accelerator program was considered akin to being admitted to a top graduate school. Some went so far as to suggest that participation in YC was “the new MBA.” At the very least, it was considered a better bet than finding a ‘real job.’ As one YC alumnus said, “[W]ithout YC I would have taken the job offer I had and become a consultant, and I’d probably be chained to a desk somewhere in an office park.”⁴³ Top accelerator programs were thought to provide positive signaling to the market, even if the entrepreneur failed.

Please refer back to **Exhibit 4** for a comparison of angel types, including incubators.

Funding Outlook for Entrepreneurs

For entrepreneurs, the funding market in 2012 was welcoming, if not bountiful. However, unlike at ARD in 1946, the money available to modern software start-ups did not always come with advice and governance. Well-known Silicon Valley investors whose blessing could create a groundswell of financial support for a new business did not necessarily provide more than emergency support to young start-ups experiencing growing pains or operational issues.⁴⁴

For advice, entrepreneurs might need to seek out books like *The Lean Startup*, blogs dedicated to start-up advice, or advisors like business professors and Silicon Valley sages. Experienced formal governance could be difficult to come by, with the sheer number of firms that required boards of directors, and with the reported trend of venture capitalists offering seed money without taking a board seat.⁴⁵

Potential sources of seed funding continued to grow. The Jumpstart Our Business Startups (JOBS) Act of 2012 enabled entrepreneurs to raise up to \$1 million of start-up capital in small increments with no more than a business plan and without having to become a public company.⁴⁶ Accelerators and incubators proliferated within industries and geographies, including a South African incubator that launched in Palo Alto, California in August 2012. AngelList continued to grow, providing potential opportunities for early-stage investments, in addition to seed capital.⁴⁷ Online equity sales platforms SecondMarket and SharesPost enabled equity holders of non-public start-up companies to sell their shares online, providing an early exit opportunity for stockholders.

While funding opportunities abound for entrepreneurs, it would behoove aspiring founders to seek advisement and governance in addition to money. By the same token, while funding opportunities abound for investors, it would behoove angels to recall that all high-risk capital portfolios draw a short head and long tail—some longer-tailed than others.

Exhibit 1a
Share of Contributions to Venture Capital Funds by Source in 1978 vs. 1989

	1978 (Before clarification of “prudent man rule”)	1989
Individuals	32%	8%
Pension Funds	15%	46%
Corporations Insurance Companies Endowments Foreign Investors	53%	46%

Source: Paul A. Gompers, “The Rise and Fall of Venture Capital,” *Business and Economic History*, Volume 23, Number 2, Winter 1994.

Exhibit 1b
Share of Venture Capital Investments by Stage (1980, 1988)

	1980	1988
Seed & early-stage investments	25%	12.5%
Later-stage venture investments	75%	67.5%
Leveraged buyouts	0%	20%

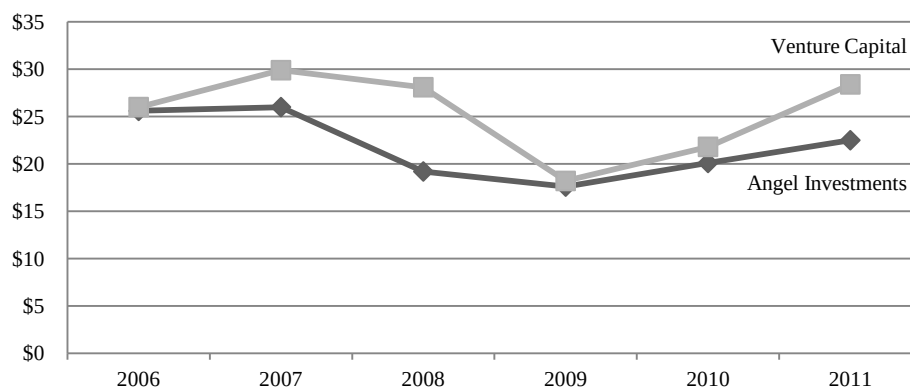
Source: Paul A. Gompers “The Rise and Fall of Venture Capital,” *Business and Economic History*, Volume 23 Number 2, Winter 1994.

Exhibit 1c
Venture Capital Statistics (1991, 2001, 2011)

	1991	2001	2011
All Existing Venture Capital Firms	362	917	842
All Existing Venture Capital Funds	640	1,850	1,274
Total Venture Capital Professionals	3,475	8,620	6,125
Average Capital per Venture Capital Firm	\$74.0 million	\$285.4 million	\$233.8 million

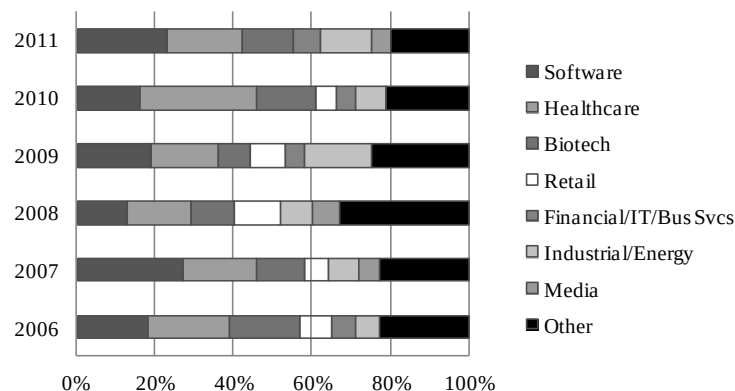
Source: Thomson Reuters, *National Venture Capital Association Yearbook 2011*, 9.

Exhibit 2a
U.S. Angel and Venture Capital Investments in US\$ billion (2006-2011)



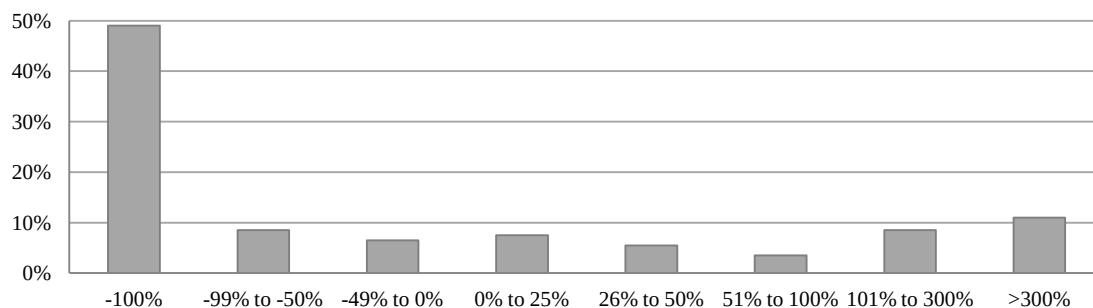
Sources: Jeffrey Sohl, "The Angel Investor Market in 2011: The Recovery Continues," Center for Venture Research. April 3, 2012. "Annual Venture Investment Dollars Increase 22% Over Prior Year," PricewaterhouseCoopers and National Venture Capital Association press release, January 20, 2012, <<https://www.pwcmoneytree.com/MTPublic/ns/moneytree/files/source/exhibits/11Q4MTPressrelease.pdf>> (accessed May 29, 2012).

Exhibit 2b
U.S. Angel Investment Industry Mix (2006-2011)



Source: Jeffrey Sohl, Center for Venture Research annual summaries of angel investments, 2006-2011.

Exhibit 2c
Distribution of U.S. Angel Investment Returns (1972-2007)



Source: Ramon P. DeGennaro and Gerald P. Dwyer, "Expected Returns to Stock Investments by Angel Investors in Groups," Working paper, May 20, 2010, <<http://ssrn.com/abstract=1360817>> (accessed May 28, 2011).

Exhibit 3a

Staging of Start-Up Funding Deals by Investor

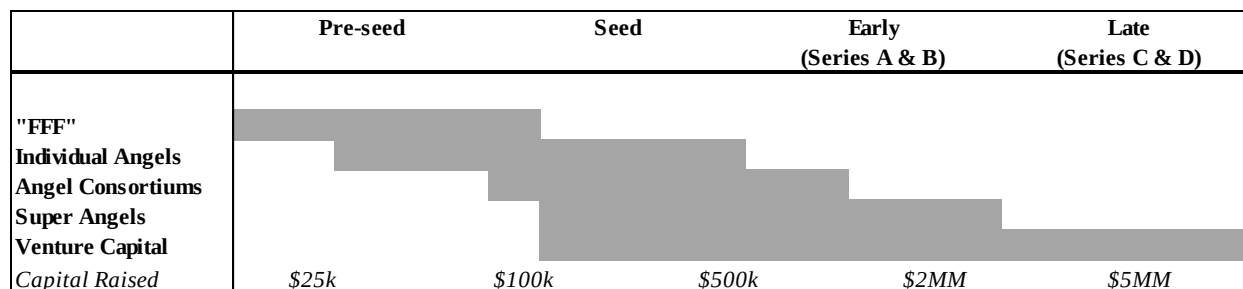
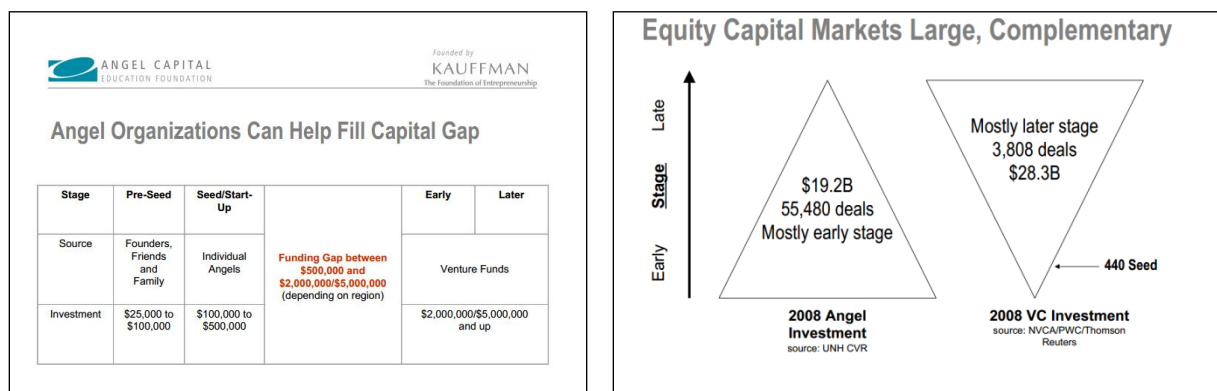


Exhibit 3b

Staging of Deals, Angel Investors vs. Venture Capital Firms



Source: "Important Things for Entrepreneurs to Know About Angel Investors," Angel Capital Education Foundation, <<http://www.angelcapitalassociation.org/data/Documents/Press%20Center/What%20Ents%20Should%20Know%20About%20Angels%202009.pdf>> (accessed July 2, 2012).

Exhibit 4

Comparison of Four Types of Angels

Investment Group	Individual Angels	Seed VC, Super Angels, or Micro VC	Angel Consortiums	Accelerators
Examples	--	Felicis Ventures, Floodgate, Founder Collective, Founder's Fund, Keith Rabois, Harrison Metal, k9 ventures, lowercase capital, SoftTech VC, SV Angel, Quest	Band of Angels, Central Texas Angel Group, Common Angels, Golden Seeds LLC, Hub Angels, Keirestu Forum, Launchpad Venture Group, Sand Hill Angels, Pasadena Angels, Tech Coast Angels	Angel Pad, DreamIt Ventures, LaunchPad LA, Innovation Endeavors Runway, Tandem Entrepreneurs, TechStars, Y Combinator,
Key Benefit Provided to Entrepreneurs	Funding, expertise, and connections	Super Angel participation in a funding round sends strong signals to other investors ⁴⁸	Funding, expertise, and connections of a broader group	Market validation as well as standard, generally friendly funding terms. Follow-on rounds may be larger thanks to signaling effect of participating in incubator
Key Limitations / Critiques	May lack connections for further funding or business needs. Rarely able to make follow-on investments. May be "dumb money"	May be difficult to add expertise, advisement, and governance if following a "spray & pray" strategy	Slower decision-making process. Lack of broader reputation may limit entrepreneur. Lack of ability to make substantial follow-on investments	Could generate lots of "me too" companies unlikely to become the next Facebook or Google
Where are they and where do they invest?	Nationally, some globally	Generally US, predominately in California, usually near San Francisco Bay Area and LA	Nationally - There is an angel group in operation or development in almost every U.S. state, though 30% of dollars are concentrated in California ⁴⁹	Teams and companies can be from any location, but "top programs" are weighted towards major US cities, especially the San Francisco Bay Area ⁵⁰
How many are there?	225,000 – 1mm investors either formally or informally ⁵¹	50-100 ⁵²	10,000 to 15,000 investors belong to 300 angel groups ⁵³	100 to 200 ⁵⁴
Source of funds	Self	Self + Investors	Self	Self + Investors
Idea needed	Yes	Yes	Yes	Depends ^{x 55}

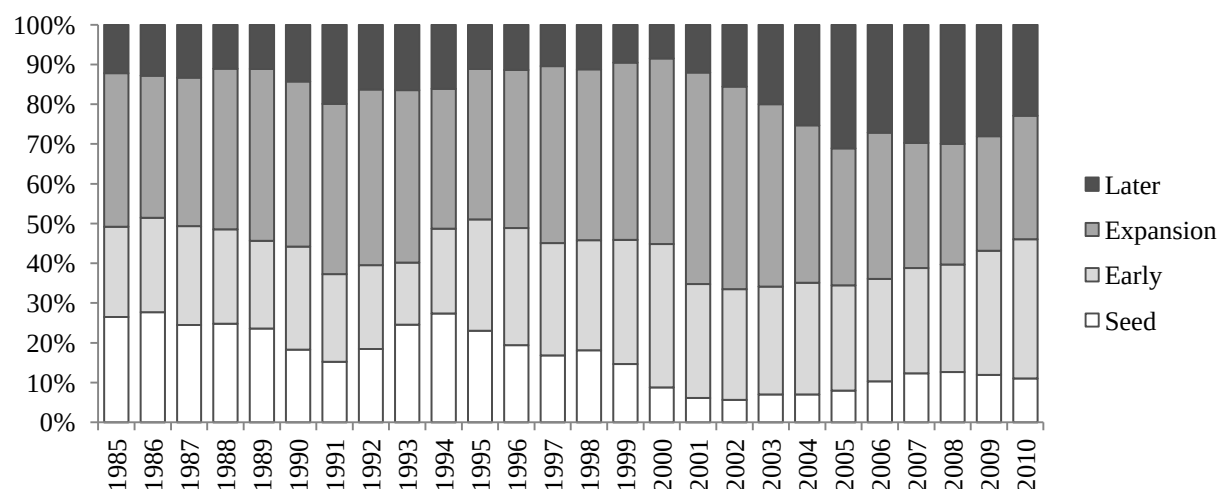
^x While having an idea remains the default, several programs, notably Y Combinator and Innovation Endeavors welcome talented entrepreneurs without specific ideas.

# of investments made annually	55,000 ⁵⁶	Unknown, but varies widely among super angels. Ron Conway of SV Angel averages ~50 investments per year. ⁵⁷ Aydin Senkut of Felicis has averaged about 14 investments annually since 2006. ⁵⁸	Average consortium invested a total of \$1.94 million in 7.3 deals per year in 2007 for an average of \$266k. ⁵⁹ Median round size was \$700k in 2011. ⁶⁰	YC graduated 107 companies in the 2011 Winter and Summer classes. Launchpad LA has graduated 23 companies ⁶¹
Area of focus by number of deals	Unknown	Typically Internet (consumer or business) ⁶²	Internet – 34% Healthcare – 24% Telecom – 10% Industrial – 8% Software – 5% Energy – 4% Other – 15%	Typically Internet (consumer or business) ^{xi}
Area of focus by dollars	Unknown	Typically Internet (consumer or business) ⁶³	Healthcare – 37% Energy – 27% Telecom – 7% Industrial – 6% Internet- 5% Software – 4% Other – 14%	Typically Internet (consumer or business) ⁶⁴
Group size	Individual	Typically 1-3 people	Average Angel Capital Association member group had 42 member angels. ⁶⁵	Varies. Founder group in addition to larger advisory group for start-ups. ^{xii} ⁶⁶
Relationship to VCs	Angels traditionally provided a complement to VCs with angels taking early stage and then moving aside as VCs handled the late stage. This relationship is changing given the entrance of super angels and a reduced need for large amounts of early capital for internet-based ventures.	Super angels add competitive pressure on VCs for early-stage internet deals. May push VCs to either become more agile or exit internet companies and instead focus on heavier capital requirement fields such as biotech, clean energy, and telecom. ⁶⁷	Typically invest in seed or early-stage rounds. Angel groups invest more when co-investing alongside super angels or micro VCs versus other angel investors (\$1.5mm versus \$700k). ⁶⁸	Provide diligence and deal flow for VCs. Demo Days are prime opportunities for investors to scout out new, validated start-ups. ⁶⁹

^{xi} For a list of Y Combinator companies, see:
<https://docs.google.com/spreadsheet/ccc?key=0AkkhSN3vaY4jdF90b111Vnl5NmZjaTBNQWlJYVozMEE&hl=en#gid=0>

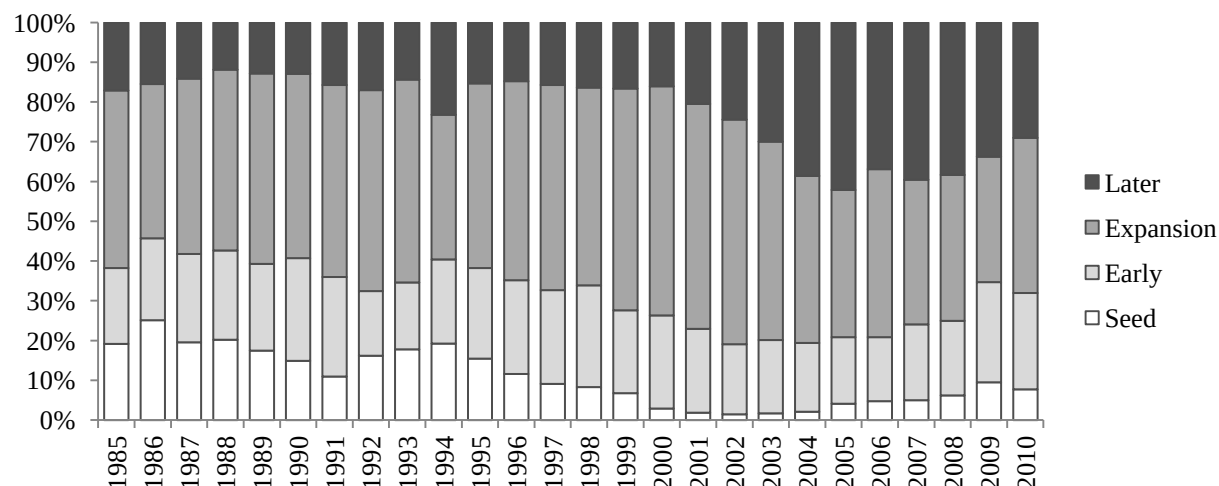
^{xii} For example, Y Combinator lists seven partners, including Paul Graham.

Exhibit 5a
Share of Venture Capital Deals by Stage (1985-2010)



Source: Thomson Reuters, *National Venture Capital Association Yearbook 2011*, 28.

Exhibit 5b
Share of Venture Capital Dollar Investments in by Stage (1985-2010)



Source: Thomson Reuters, *National Venture Capital Association Yearbook 2011*, 28.

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