EDUCATING ENTREPRENEURS ON ANGEL AND VENTURE CAPITAL FINANCING OPTIONS

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Abstract

Entrepreneurs often lack the knowledge and resources to obtain equity financing for their ventures. In addition, many private investors are unaware of the number of entrepreneurs seeking their capital. Since small business plays a major role in the economy, it is important to establish a market that matches entrepreneurs in need of capital with willing investors. To achieve this match, it is necessary to educate entrepreneurs on the criteria investors use to determine investment. Investors look at ventures to identify "winning" deals that provide exceptional returns. They evaluate ventures to determine the stage of development, product and market demand, expansion strategy, management team, and future growth potential. Improving entrepreneurs' understanding of the investment process will enable them to target the right investors, and in turn, will enable investors to fuel the economy by funding "winning" ventures.

Introduction

Entrepreneurs have several options available when it comes to financing their ventures. Initially, an entrepreneur must understand what pre-initial public offering (pre-IPO) stage (when an organization has not made a public offering) the business represents and what type of expansion strategy will be needed in order to identify the type of investor to seek for additional capital. It is equally important for entrepreneurs to understand the roles investors may play in their firms. To accomplish this, entrepreneurs must make the distinction between business angels and venture capitalists as well as know where to find and how to approach each type of investor.

What are angel investors? What are venture capitalists? Angel investors are those that "save struggling firms with both finance and know-how when no one else will" (Van Osnabrugge and Robinson, 2000, p. 4). Bradley, Benjamin, and Margulis (2002, p. 9) describe venture capitalists as those that create a "highly institutionalized investment process, designed to bring together those with massive amounts of money to invest with those whose ideas are promising enough to warrant its receipt." Historically, it was appropriate to say that angel investors were willing to accept more risk than venture capitalists (Sohl, 2003; Bradley, Benjamin, and Margulis, 2002; Lipper and Sommer, 2002; Amis and Stevenson, 2001; May and Simmons, 2001; Van Osnabrugge and Robinson, 2000; Thompson, 2000; Gutner, 2000). But, is this changing?

Entrepreneurial Ventures and the United States Economy

Matching entrepreneurial ventures with appropriate investors is important to the health of the economy because such ventures make a considerable contribution to the labor force and the country's Gross Domestic Product (GDP). Between 1992 and 1997, 50 percent of GDP was contributed by small and entrepreneurial firms (Popkin and Company, 2001). Additionally, small businesses "represent about 99 percent of employers, employ about half of the private sector workforce, and are responsible for about two-thirds of the net new jobs" in the economy (U.S. Small Business Administration, 2003, p. 3).

The market often presents a problem for those looking for investment capital that will nurture their firms into mature entities. After exhausting their own financing resources, start-up entrepreneurs usually seek additional financing from family, friends, and colleagues. Most entrepreneurs next search for additional financing through lending agencies, the United States Small Business Administration, or venture capital firms, only to be turned away because of the high risk involved in early-stage business ventures.

Angel investors may provide the money that these early-stage businesses need in order to grow. In fact, they "play a critical role in early-stage finance . . . providing 80% of the seed and start-up capital" for small businesses in the United States (Wessner, 2002, p. 353). In addition, Van Osnabrugge and Robinson (2000, p. 5) state, "Business angels fund thirty to forty times more ventures each year than venture capitalists, their better-known counterparts." Interestingly, in 2001, only 400,000 of the two million individuals that have enough net worth to invest in early-stage companies actively participated in the market (Benjamin and Margulis, 2001).

Finding completely accurate numbers for angel investing is difficult. Most angels want to remain anonymous so not to be overwhelmed with too many requests for capital. Lack of documentation along with "the very high number of transactions; the smaller and therefore less visible investments; and the high degree of confidentiality demanded by high-net-worth angels upon engagement" has made angel information hard to find (Bradley, Benjamin, and Margulis, 2002, p. 7). Still, according to Sohl (1999), 400,000 angels are currently investing between $30 billion and $40 billion per year in approximately 50,000 ventures in the United States.

In contrast to angels, venture capitalists prefer investing in ventures that involve later-stage businesses. Efficiency is the main reason for this tendency. It is more efficient for formal investment institutions to make fewer large investments rather than multiple smaller investments (Van Osnabrugge and Robinson, 2000). The costs of having a portfolio manager take care of several small deals would easily outweigh the benefits of making each investment. Therefore, it is more efficient for venture capital firms to make larger investments in fewer business deals in order to maintain the manageability of each portfolio by a single venture capitalist.

Venture capital investments for 2002 were $21.2 billion, almost a 50 percent decline from the $41.3 billion in 2001 (PricewaterhouseCoopers, 2003). With the previous spike in venture capital investment in 2000, it is obvious the "dot-com" bubble and the recent strains on the economy have decreased investments. However, Tracy Lefteroff believes "this level of investing is more realistic and more sustainable" for the market (PricewaterhouseCoopers, 2003). While venture capitalists play an important

role in the economy, they "are funding less than 0.5 percent of the deal flow they receive" (Benjamin and Margulis, 2001, p. 20). Even though the numbers are not outstanding, PricewaterhouseCoopers (2003) reports that if improvement in the public markets and liquidity opportunities occur in 2003, then venture capital investments will stabilize. Still, in the second quarter of 2003, 442 firms received venture funding (Ernst and Young, 2003). Yet, annually, 3.5 million new ventures are launched (Timmons, 1999).

Liquidity events come in the form of initial public offerings (IPOs), major buyouts, and mergers or acquisitions. Since only three IPOs occurred in the second quarter of 2003 (Westenberg and Gallagher, 2003), the current focus is upon mergers and acquisitions. Because the number of exit vehicles has become more limited, it is now even more problematic for venture capitalists to exit an investment. This generally limits the dollar amount one company is willing to pay for another and makes it more difficult for large investors to get out of very large deals. Thus, the playing field has changed significantly over the past few years, making lower dollar angel investment very appealing. But, there is still the need for an exit strategy. Interestingly, angels appear to be focusing on exits coming through mergers or acquisitions rather than venture capital participation and subsequent IPO. Mergers and acquisitions do address some of the issues surrounding restricted stock, making them attractive. However, in a declining economy, the upside valuation of a venture may be limited, since fewer buyers may be vying for the venture.

The high risk avoidance of venture capital firms creates a "capital gap" in the entrepreneurial investment market which represents the investment money of between $250,000 and $2 million (Wessner, 2002). Angel investors are the solution to the gap. Additionally, networks of angel investors have the ability to push toward and beyond the $2 million threshold. In fact, it has been noted that the "angel capital market may account for $100 billion annually" in the U.S. economy (Bradley, Benjamin, and Margulis, 2002, p. 7). This money funds small and entrepreneurial businesses that create "55 percent of all technological innovation…, [which is] twice that of larger corporations" (Benjamin and Margulis, 2001, p. 13).

Angel investors usually follow right behind the venture capitalists in terms of investment intensity. In one report from the first quarter of 2003, 38 angel investor organizations invested $7.1 million in 14 deals ranging from $11,000 to $4 million (EMME Consulting, LLC, 2003). At the same time, venture capital investment increased 14 percent from the prior quarter, reaching $4 billion (Ernst and Young, 2003).

Stages of Development and Growth of Entrepreneurial Ventures

It is obvious that there are stages of development for entrepreneurial ventures. Van Osnabrugge and Robinson (2000) categorize the four stages of a pre-IPO firm as seed, start-up, early-stage, and later-stage. Bradley, Benjamin, and Margulis (2002) identify nine stages of development including seed, research and development, start-up, first stage, expansion stage, mezzanine, bridge, acquisition/merger, and turnaround.

In the seed and research and development stages, the entrepreneur usually utilizes his/her own personal savings and wealth

including lump sum retirement distributions, second mortgages, severance pay, and credit card debt along with money provided by family, friends, and colleagues to fund the firm's development. Once the business becomes operational, leasing, factoring, and accounts payable may be utilized. When the business is past the research and development stage but not quite to the expansion stage, it has usually exhausted all funds from the entrepreneur's savings, family, friends, and colleagues. Now, the entrepreneur is in need of other capital, most likely angel capital. After the angel provides the equity to bridge the gap between the research and development and expansion stages, the entrepreneur will often exit or harvest the business, or the new venture will fail. Should the firm aspire beyond this stage, the entrepreneur will typically seek follow-on money from other angels or even venture capitalists.

Ultimately, businesses have four stages left after reaching the expansion stage of development: mezzanine, bridge, acquisition/merger, and turnaround. Invariably, these directly connect to the management strategy of the entrepreneur. At mezzanine stage, the firm is breaking even or possibly making a small profit but has a need for more capital for expansion, marketing, etc. Businesses in the bridge stage need additional capital to gain or maintain stability with the near-term intension of an IPO. The acquisition/merger and turnaround stages are simply what they imply—capital is needed in order to sell, merge, or change the firm's strategy (Bradley, Benjamin, and Margulis, 2002), or even possibly to survive.

The definition of "entrepreneur" is often based on the type of business the individual enters. Typical classifications include the hobby business, lifestyle business, family business, small business, expansion-minded business, entrepreneurial business, or corporate venturing. These same classifications often overlap with the growth strategy descriptions for firms. The growth strategy describes the entrepreneur's strategy for expansion and can be categorized as lifestyle (low growth), middle-market (modest growth), and high-potential (high growth) ventures (Van Osnabrugge and Robinson, 2000; Sohl, 1999; Hisrich and Peters, 1998).

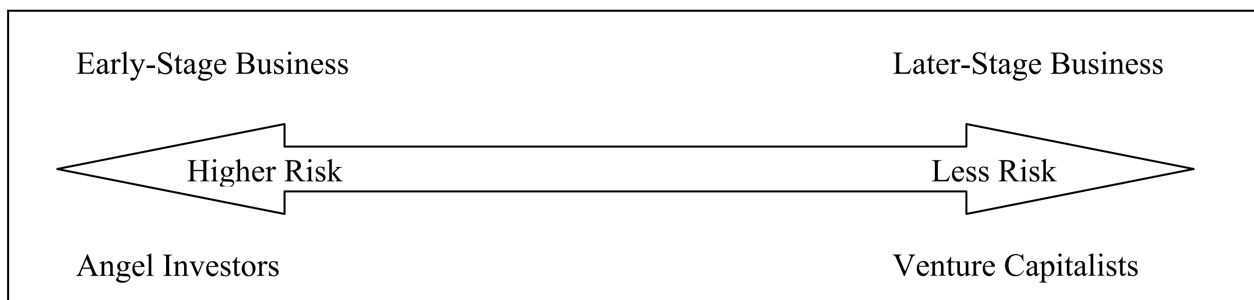
Timmons (1999) contends that there is a significant difference between low-growth potential, or what he terms lifestyle businesses, and modest- and high-growth potential ventures, which are more entrepreneurial in nature. Initially, a business owner looking to operate a business with little risk and make enough profit to suffice his/her desired living standard probably has a hobby, lifestyle, family, or small business with a low-growth strategy. According to Sohl (1999), these firms are classic small businesses, with five-year revenue projections under $10 million. Firms in this category are rarely attractive to investors; thus, the owner must rely on internal rather than external financing. Next are the middle-market firms with a modest-growth strategy that forecast growth of more than 20 percent per year along with expectations of $10 to $50 million in revenues within five years (Van Osnabrugge and Robinson, 2000). Ventures like this are often appealing to angel investors, even though they often depend upon bootstrapping to fund initial growth (Sohl, 1999). Middle-market firms may also be attractive to venture capital investors. Ultimately, high-potential strategy firms are those businesses that have high aspirations of vast growth through remaining innovative, adaptable, and venturesome. In most cases, they project having more than

50 employees in five to 10 years. Unlike the modest growth firms, the high-potential firms foresee a growth rate above 50 percent each year along with a revenue forecast of more than $50 million within five years (Sohl, 1999). Organizations that have a service or product with prospective high market demand in conjunction with a high-potential strategy are “diamonds in the rough” for any investor (Van Osnabrugge and Robinson, 2000).

Business Angels and Venture Capitalists Defined

Making a distinction between investors is one of the most important tasks an entrepreneur must make when searching for capital. Understanding the differences will allow the entrepreneur to use his/her time more efficiently and prepare the appropriate materials required by each type of investor. At one end of the spectrum are unsophisticated angel investors. At the other end of the spectrum are venture investors like venture capitalists or institutional investors (refer to Figure 1). All types of investors provide capital to entrepreneurial firms. However, business angels and venture capitalists usually finance at different stages of the pre-IPO business cycle, although this may be evolving.

FIGURE 1
Business Stage and Investor Preference Risk Continuum



One may speak of an angel investor or venture capitalist, but like the term entrepreneur, that seemingly encompasses hobby venturing through corporate venturing, these two terms are often distorted. Earlier, we defined angel investors as those individuals that “save struggling firms with both finance and know-how when no one else will” (Van Osnabrugge and Robinson, 2000, p. 4). But, how have angel investors evolved to how we know them today?

The term “angel” comes from the practice in the early 1900's of wealthy businessmen investing in Broadway productions (Kautz, 1998-2003). The seed-capital financing system for companies “operates like it was 200 years ago,” contends Vicki Rellas, CEO of the online financing service PriCap (Bunn, 1997). Doctors, lawyers, and high net worth individuals would sit around and talk about “deals” friends and associates were embarking upon. Many times, funding was put together, and an investment was made. Little or no due diligence was performed, and investments were made based upon the trust of the others involved in the deal. Along this line would be the family member or friend that invests in a venture solely on the basis of his/her relationship with the entrepreneur. Undoubtedly, both types of investments still occur today. Collectively, this first category of angel investors is unsophisticated angel

investors. Yet, in order to truly grow a business, an entrepreneur must find a sophisticated investor(s) who can add both money (up to $5 million) and value to the venture (Mitchell, 1998-2003).

In contrast, the second category is made up of sophisticated investors. Traditionally, this term has been applied to the knowledge base of the investor and/or a minimum net worth/income requirement. Though there is extensive discussion that net worth or income alone should not determine sophistication, this along with investor knowledge base establishes an ability to adequately invest minimum amounts of dollars in multiple ventures to make the ventures self-sustaining or built-up to a point of being able to attract additional outside investment (e.g. venture capital). Knowledge base refers to the ability of the investor to understand the financial impact and terms of their investment (Leshchinskii, 2002). Arguably, in the world of angel investing, knowledge base would extend to an understanding of the industry of the venture.

The term "sophisticated investor" differs from the term "accredited investor." Accredited investor is a legal term specifically defined by the federal securities laws (Securities Act, 1933) while sophisticated investor is a term of art that has no legal definition (U.S. Securities and Exchange Commission, 2003). Both terms typically refer to an investor who has such a high degree of financial knowledge and ability that he/she does not need the protections afforded by registration with the Securities and Exchange Commission. Yet, an investor who may be considered "sophisticated" may not meet the definition of an accredited investor (U.S. Securities and Exchange Commission, 2003).

The third category is a hybrid that falls somewhere between sophisticated angel investors and venture capitalists and may be referred to as venture angels. Venture angels usually exhibit one or more of the following characteristics (Cooper, 2003): (1) Comprised of a small number of external investors; the total dollar amount raised is far less than major venture funds, and the source is private money rather than institutional resources; (2) Have an ability to invest greater amounts of money than individual angel investors; they may or may not have the ability to totally fund the venture through exit; and/or (3) Investment portfolio is run by professional management though the staff, if any; tends to be much smaller than a venture fund team.

The final category is angel networks, and there are two types of these (Wainwright and Horvath, 2002). One is the informal network represented by groups like the Rockies Venture Club, a Colorado group where open monthly meetings are held with the intent of trying to introduce individuals with money to individuals in need of money. The second is the formal angel investor network. Formal networks have been founded around entrepreneurial hotbeds around the country. As an example, Band of Angels was formed in Silicon Valley followed by groups in Austin, Boston, North Carolina, and Colorado, just to name a few. In this article, the term "angel networks" refers to formal angel networks.

Formal angel networks may be no cost or fee related (Magids, 2001). On one hand, angels may be required to pay a fee to participate in the network and/or a fee may be assessed to entrepreneurs to submit or present business plans to the angel network.

An angel network brings together diverse backgrounds of investors in order to increase

deal flow quality, reduce risk, and increase the total potential dollar investment amount (May, 2002; Wainwright and Horvath, 2002). The diverse backgrounds of the investor group allow each individual investor to draw upon the trusted expertise of a co-member. By relying on a co-member's expertise, an investor that would not invest in a particular deal due to a lack of individual expertise may now collectively invest with others in the group. In general, investors have numerous deal opportunities, but very few merit investment. By increasing the number of contacts an individual investor has, the pool of quality deals will also increase. By having other investors share in the investment, i.e., putting less individual capital into a deal, the individual investor reduces his/her risk exposure. Ultimately, a network with 75 or more members has the investment capability to eliminate venture capital money (except in extremely high dollar deals) later in the deal. This reduces angel investor dilution in subsequent rounds and makes angel money a one stop shop. This issue will be addressed in greater detail shortly.

Finally, there are venture capitalists. Venture capitalists were defined earlier as those individuals that create a "highly institutionalized investment process, designed to bring together those with massive amounts of money to invest with those whose ideas are promising enough to warrant its receipt" (Bradley, Benjamin, and Margulis, 2002, p. 9). Obviously, there are degrees of venture capitalists. There are those that invest billions of dollars such as SoftBank along with smaller venture funds like Vista Ventures with $60 million dollars in total investment capital in its current fund (Ford, 2003). Here, the term "venture capitalists" will be used broadly, keeping in mind that the investment criteria, amount to invest, and area and stage of investment may vary.

Distinguishing Between Business Angels and Venture Capitalists

Seeing the broader picture that encompasses all pre-IPO investments provides a better understanding of the business cycle and where entrepreneurs should seek capital. Benjamin and Margulis (2001, p. 19) capture this connection by stating that "active business angel investors in the United States provide early-stage companies with 90 percent of all rounds of financing under $1 million and 80 percent of all dollars. Meanwhile, venture capital resources provide later-stage financing in growing companies that *are* originally financed by the founders, family, friends, and angel investors." These facts present the continuum for the pre-IPO business cycle stages and the gradual change in which type of investor an entrepreneur should approach (see Figure 1).

Before hopeful entrepreneurs try approaching an angel, they must have at a minimum an idea with modest-growth potential and the vision to market that idea to the investor(s). Most angels want to participate in deals with a high probability of success—modest-growth or high-potential firms—along with those deals that require operational assistance. If the business deal meets these criteria, then angels are willing to wait for the possible high returns (Wetzel, 2002).

Angel investors' interests often reside in the entrepreneurial experience. Angels are looking for a deal where they can participate by consulting with the entrepreneur or sitting on the board of directors. This is where, if the entrepreneur has found the

right angel, the angel adds value to the early-stage firm. Most often, business angels "have extensive small business experience, and over 80 percent of them…have started a company of their own" (Benjamin and Margulis, 2001, p.22). As might be expected, most angel investors are comfortable in the industry where they have been successful themselves. According to the National Venture Capital Association (2003), high technology investment makes up most of the venture investing in the United States. Regardless, angels are in the venture to make money.

Adding value is an important quality business angels bring to a venture. In the early stages of a firm's existence, there are many obstacles to overcome to succeed. Angels may provide solutions to a number of these problems either through external contacts or their own previous experiences. They may also assist with strategic management issues in operations, marketing, human resources, etc. For angels to provide such operational assistance, they want the deal to be "reasonably close to where they live, within 300 to 500 miles" (Benjamin and Margulis, 2001, p. 23). A survey conducted by Elango, Fried, Hisrich, and Polonchek (1995, p. 161) illustrates investor attitudes toward involvement. The sample population felt that those investors adding value to a deal also placed more importance on being the entrepreneur's confidant than the less active investors. This research indirectly illustrates the value-adding relationship between the entrepreneur and the business angel by presenting the hands-on activity of most angel investors.

Venture capitalists are searching for ventures that require larger amounts of capital with lower levels of risk. Venture capitalists "are looking for later-stage deals in which investment sizes are larger, risk is reduced, and the time frame to harvest is shrinking" (Bradley, Benjamin, and Margulis, 2002, p. 9). Investors in this category are using money they received from larger corporations, pension funds, etc. They are not investing their own money; instead, they are investing someone else's money. Reduced levels of risk, achieved in later stages, are the key factors for venture capitalists. Firms in the later stages of the business cycle are more suited for venture capital investors. With this said, the rule of thumb for venture investing in 10 companies will breakdown as follows: six or seven will tank, two to three will make some money, and one investment results in a home run (10 times the invested amount is returned) (Popper, 1999).

Disproportionate rewards are the key to attracting high-risk money (Frezza, 2002). Venture capitalists have less interest than angels in the true entrepreneurial experience because of the need to secure and maintain a good reputation. In order to finance their own operations, these investors must maintain an impeccable reputation with their financiers. The only way to keep a sharp reputation is to finance ventures with a risk/return assessment that will provide "annual returns of 30 to 40 percent or more and a total return of five to 20 times their original investment" (Arundale, 2002) over the life of the portfolio.

Venture capitalists also lend industry experience and connections. Most venture capitalists specialize in specific industries or even segments within an industry. Many have large teams of highly skilled personnel on staff to assess the venture prior to investment and then track the progress of the venture on an ongoing basis. Venture capitalists often identify or attract professional management to take the venture to the next level. Frequently, venture

capitalists prefer a team that has acquired IPO funding in the past to seek IPO funding for their latest venture. As might be expected, they seek to add value through their experience in investing in hundreds of firms. Some venture firms are successful by creating synergies between the various companies where they have invested. For example, a company that has a great software product but does not have adequate distribution technology may be paired with another organization or its management team in the venture portfolio that has better distribution technology.

Although both angels and venture capitalists participate in entrepreneurial ventures, angels usually spend more face-to-face time with the firm's management team. They spend more time with the company since it is a start-up firm trying to reach the expansion stage of the business cycle. Additionally, investments made by a number of individuals through an angel network are usually connected to the venture through a single lead investor from the group. On the other hand, venture capitalists often fill board of director positions in order to monitor their investments. Still, the involvement of venture capitalists in the business operation is usually not as hands-on as angel investors. Most often, investors "that provide a high level of assistance should invest in early-stage companies and those that provide a low level of assistance should invest in later-stage companies" (Elango, Fried, Hisrich, and Polonchek, 1995, p. 159).

With a greater number of sophisticated angels and rapid growth in the number of angel networks, a similarity between angels and venture capitalists has developed, though their participation level in the business deal and primary reasons for involvement are different. Both types of investors involve themselves in the ventures they select to finance. On the one hand, angel investors are active in their investments in order to help the firm progress through the business cycle stages. On the other hand, venture capitalists participate in order to make sure the company performs well enough to provide the projected returns determined in the business valuation. Angels have their own skin or "money" in the game whereas venture capitalists invest "other people's money" ("OPM") and are driven by return on investment, a slight but significant difference.

There are reasons why angels prefer to invest in early-stage firms and venture capitalists like to invest in later-stage firms. Early-stage firms are in need of consultants with knowledge to help the venture grow and prosper. Not surprisingly, a preliminary study by several of the authors of this paper found that 100 percent of 26 angels polled personally and actively participate in ventures in which they invest. Later-stage firms, in contrast, usually already have personnel with skill levels necessary to maintain their current position or grow. Thus, venture capitalists add value to ventures through participation in later-stage firms, but their primary purpose is still to obtain the forecasted return on investment (Bradley, Benjamin, and Margulis, 2002; Benjamin and Margulis, 2001; Van Osnabrugge and Robinson, 2000; Freear, Sohl, and Wetzel, 1994).

Customarily, it was appropriate to say that angel investors were willing to accept more risk than venture capitalists. But, that may be changing. Today, there is a movement on the part of angels to later-stage investment (Sohl, 2003; Lipper and Sommer, 2002; May, 2002; May and Simmons, 2001). Part of this is, no doubt, a result of the furious investment activity during the dot-boom and

then the impending dot-bomb. This is also driven by the ability of angels to co-invest in networks. As a result, much larger dollar amounts are available, rivaling small venture capital funds. Recently, through personal experience, one of the authors witnessed 20 angels and seven venture capitalists accusing each other of invading their traditional investment spaces. Thus, it appears angels are moving to the right on the venture capital continuum to later-stage deals while venture capitalists are moving to the left in search of quality and complementary deal flow.

Understanding Due Diligence Expectations of Business Angels and Venture Capitalists

The unsophisticated angel investor spends a miniscule amount of time on due diligence, unlike the venture capitalist who spends most of his/her time on due diligence. Due diligence is the time and effort taken by the investor to evaluate the worthiness or potential of an entrepreneur and all aspects of the venture. The different emphasis each type of investor places on due diligence inversely relates to his/her risk characteristics.

Today, sophisticated angel investors perform background checks on all management team members, take months to assess the state of the business prior to investing, and use stepped investments tied to specific milestones. Abrams (2003, p. 226) states, "A milestone list allows you and your financing sources to see what you specifically plan to accomplish, and it sets out clearly delineated objectives." Failure to meet these milestones could harshly impact the ownership interest of the entrepreneur.

Term sheets, the initial agreement between the entrepreneur and angel, are detailed documents that provide the provisions for the investment agreement. Over the years, these documents have evolved in regard to content and complexity. Interestingly, they are sometimes skewed to the interest of the angel. As a result, for protection, the entrepreneur must have legal representation in this process.

The venture capitalist accepts an average return rate for less risk, while the angel will accept more risk in hopes that he/she has found an entrepreneur with a winning idea. This conclusion follows the financial theory that investors "should expect higher returns from higher risk investments" (Elango, Fried, Hisrich, and Polonchek, 1995, p. 159). However, disappointment may arise when the angel realizes the business idea is not a winner, and the return on investment is diminutive.

Although there are differences between the timing and dollar amount preferences of angels and venture capitalists, both look for specific criteria for a potential investment. The basic criteria are: entrepreneur and management team, product and market potential, financials, and the business plan (Van Osnabrugge and Robinson, 2000). The most important criterion is the enthusiasm, trustworthiness, first impression, and expertise of the entrepreneur. Or, simply stated, has he/she been there and done that? In fact, these key attributes are what most encourages business angels and venture capitalists to invest in a deal, even if the management team is incomplete. As might be expected, venture capitalists place more importance than business angels on a complete management team. Not surprising, business angels are hoping to be active in the venture and help the entrepreneur construct an appropriate management team.

Evaluating the product and market are important to both types of investors. The

entrepreneur must know the product and the market completely and realistically before approaching either type of investor. Both angel and venture capital investors want to see a niche product; however, venture capitalists need a modest to high growth potential before considering the deal, which contrasts to the market growth angels typically require. If entrepreneurs know there is no growth potential, then they "should not…consider approaching a venture capitalist" (Van Osnabrugge and Robinson, 2000, p. 128). Angels and venture capitalists want to invest in ventures with a product niche and growth potential, management with knowledge of the industry, and competition protection (Van Osnabrugge and Robinson, 2000).

Providing financials and a business plan are important to investors (Jensen, 2002; Wetzel, 2002; Benjamin and Margulis, 2001; Van Osnabrugge and Robinson, 2000; Seglin, 1998; Freear, Sohl, and Wetzel, 1994). These criteria are important in the due diligence process because they provide the information an investor needs in order to roughly determine the risk involved in the deal. However, business angels are ambiguous with these measures. Some angels are very subjective when evaluating deal flow and may not require a full-blown business plan; even their concern with financial ratios may be lenient.

Consequently, some angels start with the financials of a business plan and value them, while others may also begin there but by literally ripping them out and creating their own. The financials in a business plan tend to be one of the greater points of contention with entrepreneurs and investors, since these numbers play a key role in the valuation of the venture and the resulting amount of ownership the external investor will receive. On the contrary, venture capitalists place strict emphasis on the financials and business plan, and they make sure the financial numbers (like return on investment) are as precise and accurate as possible.

Identifying Business Angels and Venture Capitalists

Angel investors are elusive so it takes some effort on the entrepreneur's part to find them. In general, angels prefer a personal introduction rather than receiving an unsolicited business plan that will probably go unread. Therefore, the best way to contact an angel investor is through personal contacts such as friends, family, bankers, accountants, attorneys, business colleagues, etc. These individuals may provide a personal introduction. Networking with such individuals to find a business angel gives the entrepreneur a little more credibility. Steier and Greenwood (2000) illustrate networking strategy with a story of an entrepreneur who found angel capital by simply networking through people he knew. This triggered an event where those individuals networked through another layer of people until the entrepreneur identified an angel.

If such networking fails, the next best attempt is to search the World Wide Web for angel investors. Usually, multiple links will appear on a meta-crawler like Google.com. Taking this route will lead to many websites matching entrepreneurs with angels, generally for a registration fee. These links also provide additional information on investors and entrepreneurial entities. Such information may lend valuable insights as to what type venture in which they might be interested in investing (e.g., technology) or the type of information they would require to be submitted for investment consideration. Some of the more popular

sites are http://www.ace-net.sr.unh.edu and http://www.investorscircle.net.

Once an angel is identified and expresses an interest in the venture, negotiations will begin. This may be a very difficult process for all involved and may fall apart even at the last moment. Since early-stage ventures have few, if any, sales, many traditional valuation models (e.g., discount cash flow) are speculative at best. Therefore, the valuation of the venture, especially a very early-stage one, will rely almost solely upon the negotiating skills of the parties. With that said, entrepreneurs have a tendency to think their venture is worth more than the perceived value held by the investor. Should an agreed upon valuation not be found, no deal will occur. In the end, should investment terms be agreed upon, other angels may enter the picture through the networking efforts of the initial angel.

A growing, high-potential business in the later stages of the business cycle might seek venture capital to significantly grow the business. The ability of such a venture to attract these additional investment dollars is further enhanced through the prior participation of an angel investor. Much as the referral network works for entrepreneurs in approaching angels, the same is true with ventures as they approach venture capitalists. Many venture capitalists have worked with angel-funded businesses in the past and thus the credibility of the venture increases due to the investment and knowledge contribution of the angel. The angel is a known commodity to the venture capitalist. At this point, its probability of acceptance by additional investors is enhanced. As soon as the entrepreneur attaches to an angel and the business is successful, the credibility of the company in general is noticeable by other investors.

Seeking equity from venture capitalists is not such a mysterious process as finding angels. These institutions are built on their reputations with the public and are looking for deals that will prove themselves in terms of earnings. Thus, using a web-crawler will provide a long list of venture capital websites that have listings of top-rated venture capital firms. An accountant or banker will probably know many notable institutions. Venture capitalists may also be found through the National Venture Capital Association at http://www.nvca.org.

Venture firms that have proven themselves and are in later stages of the business cycle might receive funding from venture capitalists. For example, 3Com, Apple Computer, Cienna, Cisco Systems, Digital Equipment Corporation, Federal Express, Genentech, Hotmail, Intel, Lotus, iVillage.com, Microsoft, Oracle, Vitesse Semiconductor, and Yahoo! are all companies that successfully reached the later stages of the business cycle and received financing from venture capitalists (National Venture Capital Association, 2003; Van Osnabrugge and Robinson, 2000).

Concluding Remarks

Identifying sources for investment capital without clearly understanding the purpose of the business or the preferences and investment criteria of the equity providers is an unnecessary mistake made by many entrepreneurs. Since entrepreneurial activities are significant to the health of the United States economy, further research is needed as well as better methods of documenting activities of angel investors. Entrepreneurs, investors, and researchers need this information in order to educate the populace on investment opportunities and the steps entrepreneurs and financiers must

take to create successful investment transactions. Educating entrepreneurs on the differences of investor types will allow them to better organize their equity searching efforts along with the due diligence criteria that investors use to analyze deal flow. With this in mind, entrepreneurs should first be willing to give 110 percent to their ideas before considering other financing options. Without a doubt, such dedication by entrepreneurs to their business ideas will be quite appealing to angel investors and venture capitalists that are making decisions to finance ventures.

The process to acquire outside investment begins with an outstanding idea that is then reduced to paper in the form of a business plan. That plan will detail the "winning" opportunity and provide for a modest- to high-growth market strategy. Contained within that document are the foundations for an exceptional team to lead the venture forward.

Unfortunately, the reality is that most ventures will not possess the necessary attributes to attract outside investment. Of the 3.5 million businesses begun each year, few will be candidates for either angel or venture capital funding. But, those entrepreneurs in ventures that do fit the profile for external investors and begin the long and arduous growth journey are what legends are made of. The founders of such ventures become subjects of admiration and study--our business heroes, civic leaders, and philanthropists. They create a class unto themselves: entrepreneurs.

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