Angel Education Day
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Siding with the Angels
Business angel investing – promising outcomes and effective strategies

Returns to Angel Investors in Groups

Montlake Capital

THE CATALYST
How YOU Can Become an Extraordinary Growth Leader

EFFECTUAL ENTREPRENEURSHIP
**Distribution of Returns by Venture Investment**

**UK:**
- **Overall Multiple:** 2.2X
- **Holding Period:** 3.6 years
- **Approx IRR:** 22%

**US:**
- **Overall Multiple:** 2.6X
- **Holding Period:** 3.5 years
- **Approx IRR:** 27%

Red Bars: U.K. % of exits in that Category
Blue bars: U.S. % of exits in that Category

- **<1X**
  - Hold: 3.0 yrs.
- **1X to 5X**
  - Hold: 3.3 yrs.
- **5X to 10X**
  - Hold: 4.6 yrs.
- **10X to 30X**
  - Hold: 4.9 yrs.
- **>30X**
  - Hold: 6.0+ yrs.
Outcomes Split by Industry Expertise

60% better multiple for deals related to industry expertise

Multiple Category

- <1X
- 1X to 5X
- 5X to 10X
- 10X to 30X
- >30X

Percent of Exits

- No Industry Expertise
- Some Industry Expertise
Outcomes Split by Due Diligence

- <1X
- 1X to 5X
- 5X to 10X
- 10X to 30X
- >30X

Percent of Exits

Multiple Category

Less Than 20 Hours 20+ Hours

2X better multiple for 20+ due diligence
Details in Due Diligence

- **Transaction Economics vs. Macro Economics**
  - Price
  - Cost
  - Contribution Margin
  - T.A.M.
  - Predicted Market shares
  - Historical Data
  - Comparables
  - Cost of Customer Acq
  - Customer ROI
  - Key Target List

- **Cash to Cash cycles & Capital Intensity**
  - Longest lead time supply
  - Production cycle
  - Sales Cycle
  - Order/Shipmet gap
  - Days in AP
Early stage investing perspectives

– Select ventures that appear most capable of influencing critical market elements.
  
  *Create and influence localized markets OR*  
  *Compete in large growing markets*

– Emphasize the current means and capabilities of the venture rather than on plans for acquiring the “best” means to reach their original goals.

  *Adjust goals to use current means OR*  
  *Acquire means critical to insightful goals*

– Encourage the venture to make smaller investments that get to cash flow positive rather than investing in the resources suggested by market research to “hit plan.”

  *Overhead trails growth OR*  
  *Pre-position assets to time great opportunity*

– Avoid prediction as the basis for investment decisions.

  *Emphasize affordable loss OR*  
  *Maximize expected values*
Effectual vs. Predictive Logic

Distinguishing Characteristic Of Predictive Logic:
Selecting various means to achieve pre-determined goals

Given Goals

New means may be generated over time
Effectual vs. Predictive Logic

Distinguishing Characteristic of Effectuation:
Imagining & Selecting various goals using a given set of means

What CAN we do, rather than what SHOULD we do.
Effectuation

Market Definition
Segmentation (using relevant variables such as age, income, etc.)
Targeting (based on evaluation criteria)
Positioning (through mktg strategies)

THE CUSTOMER

Segment Definition (through strategic partnerships & “selling”)
Adding Segments/Strategic Partners
Definition of one of several possible markets

Customer Identification (through Who am I? What do I know? Whom do I know?)

Effectuation as Used by Expert Entrepreneurs

Causation Model from Expert managers
Prediction vs. Control

**Prediction:** To the extent that I can predict the future, I can control my outcomes.

Efforts to insightfully position for success based on expectations/forecasts for the development of important market elements. This often includes modeling event spaces, estimating probabilities and consequences, and forming sophisticated portfolio strategies with multiple options. Assumes that market elements are predominantly independent of the organization.

**Control:** To the extent that I can control the future, I do not need to predict it.

Efforts to deliberately construct/create market elements, such as defined products, articulated demand preferences, and market structures (i.e. channels, technical standards, common practices). Assumes either the non-existence of some key elements, or the organization’s ability to significantly affect the evolution of those elements.

Prediction is uniquely difficult with new ventures, while efforts to directly construct markets may be particularly effective.
# Non-Predictive Control: Effectuation

<table>
<thead>
<tr>
<th>Tactics for Control</th>
<th>Tactics for Prediction</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Where to Start</strong></td>
<td><strong>Set a Goal.</strong> Goals determine actions. For example, the goal of achieving X, will dictate I need person A with skills matched to X.</td>
</tr>
<tr>
<td><strong>Assess Your Means.</strong> Take action based on what you have available:</td>
<td></td>
</tr>
<tr>
<td>* Who I am</td>
<td></td>
</tr>
<tr>
<td>* What I know</td>
<td></td>
</tr>
<tr>
<td>* Whom I know</td>
<td></td>
</tr>
<tr>
<td>Example: I have person A, I can achieve X, Y, or Z</td>
<td></td>
</tr>
<tr>
<td><strong>2. Risk, Return and Resources</strong></td>
<td><strong>Calculate Expected Return.</strong> Pursue the (risk adjusted) largest opportunity and accumulate required resources. Maximize upside potential.</td>
</tr>
<tr>
<td><strong>Set Affordable Loss.</strong> Pursue interesting opportunities without investing more resources than you can afford to lose. Set a limit on downside potential.</td>
<td></td>
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<tr>
<td><strong>3. Attitude Toward Outsiders</strong></td>
<td><strong>Perform Competitive Analysis.</strong> Protect. Strategy is driven by potential competitive threats.</td>
</tr>
<tr>
<td><strong>Form Partnerships.</strong> Grow. Strategy is created jointly through partnerships to create new opportunities.</td>
<td></td>
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<tr>
<td><strong>4. Contingency</strong></td>
<td><strong>Avoid Contingencies.</strong> Surprises are bad. Contingencies are managed by careful planning and focus on targets.</td>
</tr>
<tr>
<td><strong>Leverage Contingencies.</strong> Surprises are good. New developments encourage imaginative re-thinking of possibilities and continual transformations of targets.</td>
<td></td>
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<tr>
<td><strong>5. Approach</strong></td>
<td><strong>Predictive.</strong> The future is a reliable continuation of the past. Accurate prediction is possible and useful.</td>
</tr>
<tr>
<td><strong>Transformative.</strong> The future as shaped (at least partially) by actions of all players. Prediction is neither easy nor useful.</td>
<td></td>
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Selecting ventures for investment

Investors prefer opportunities:
- in large and fast growing markets
- with customers lined up waiting to repeatedly buy a high margin product
- where no powerful competitors exist
- with the potential to ‘keep others out’ of the market
- led by experts in the field who have prior entrepreneurial success

The problem is the sequence; prioritization
- i.e. insightful market research to demonstrate market potential, or win a great beta customer?
- i.e. win a new great team member, or finish the prototype to demonstrate claims?
Staged Decisions in Angel Investing

<table>
<thead>
<tr>
<th>Dependent Variable</th>
<th>DD1</th>
<th>DD3</th>
<th>DDP2</th>
<th>Funded</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-2.16</td>
<td>-3.41</td>
<td>0.10</td>
<td>-4.07</td>
</tr>
<tr>
<td>Inv Entre</td>
<td>0.52</td>
<td>0.42</td>
<td>0.09</td>
<td>0.05</td>
</tr>
<tr>
<td>Inv Angel</td>
<td>0.17</td>
<td>0.21</td>
<td>0.16</td>
<td>0.17</td>
</tr>
<tr>
<td>Eval Prediction</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Eval Control</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prediction Emphasis</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Control Emphasis</td>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

N = 2283, Adj R2 = .455

N = 2383, Adj R2 = .409

N = 2109, Adj R2 = .046

N = 2156, Adj R2 = .040

- Angels use predictive information more than they think
  - Especially early in the process

- This shifts as we approach actual investment decisions

- Investors with more Entre Experience Prefer Non-Predictive Info.
Cognitive Matching between VC’s and Entre’s

Conjoint analysis of VC investment evaluation.

Simultaneous manipulation of preferences

Economics: Hi Potential vs. Moderate
Social Capital: Strong rep and Referrals vs. Moderate
Entre Mindset: Effectual vs. Causal

1. The match between VC’s and Entre’s significantly increased funding

2. Social Capital and Match were jointly as ‘powerful’ as the economics
Returns to Invested Capital

- Smaller venture deals do get to exits
- The returns to those deals are quite attractive

### Acquisitions of Private Ventures by Public Corporations

<table>
<thead>
<tr>
<th>Paid In Capital Range</th>
<th>Deal Count</th>
<th>Median Price</th>
<th>Median Paid in Capital</th>
<th>Median Multiple</th>
<th>Sum of Price</th>
<th>Sum Paid in Capital</th>
<th>Aggregate Multiple</th>
<th>Aggregate Profit</th>
<th>Profit $'s per deal</th>
<th>Hypothetical ROI</th>
</tr>
</thead>
<tbody>
<tr>
<td>$5M-$100M</td>
<td>322</td>
<td>60.2</td>
<td>14.0</td>
<td>3.5</td>
<td>34,914</td>
<td>8,260</td>
<td>4.2</td>
<td>26,654</td>
<td>82.8</td>
<td>20%</td>
</tr>
<tr>
<td>under $5M</td>
<td>1,359</td>
<td>10.3</td>
<td>0.2</td>
<td>53.6</td>
<td>35,741</td>
<td>931</td>
<td>38.4</td>
<td>34,810</td>
<td>25.6</td>
<td>48%</td>
</tr>
<tr>
<td>Whole Sample</td>
<td>1,530</td>
<td>14.8</td>
<td>0.5</td>
<td>24.5</td>
<td>70,655</td>
<td>9,192</td>
<td>7.7</td>
<td>61,463</td>
<td>40.2</td>
<td>29%</td>
</tr>
</tbody>
</table>

Includes ONLY deals with a MULTIPLE OF AT LEAST 1
Includes ONLY deals with complete data (70% of transactions)

ROI equates if 3 and 7 year holding periods
ROI equates if smaller deals fail 91% of the time
VERY Active Angels

- Interviewed 30 “Super” Angels
- Average of about 30 angel investments.
- Min $8M invested (max of $100M)
- Amgen, Autocad, Google, Intel, Apple, Twitter, National Semiconductor, Sun Micro, Plaxo, Guidant, Silicon Valley Bank, Teledyne
Searching For Something

• What role does their network play in their investing?

• What is their approach to angel investing?
  Criteria, Strategy, Process, “Rules” etc.

• How do they manage investments after the fact?

• What have they learned along the way?
3 key findings to date

• **From experience: Better at reading people**
  – No quitters, no liars, no jerks, big passion
  – real FIT between the person and the opportunity.
  – Some love “coachability” but not all.

• **Major Sector Focus**
  – Med Devices is not Bio Tech
  – Consumer Internet is not Network Technology
  – Software is not hardware.
  – Software isn’t even software

• **Strategies: Equifinality**
Equifinality: Many paths ➔ same end

• **Broad and Thin**, support in “key moments,” team interaction is critical, no follow unless “no-brainer”

• **Co-Founder**: start with 100% ownership, use it to build team and opportunity

• **Wealthy Sector Expert**: go deep on funding as needed, forget co-investors, work with experts you know

Strategic Coherence, Yes (though not always consistent)
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