PITFALLS OF FRIENDS & FAMILY, ANGEL AND VC FUNDING

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There is money, and then there is *money*.

If you are an entrepreneur, you probably know how much money you want for your new or growing venture, but do you know whose money you want? Tony Soprano's money might come with some expectations and risks that you might not want to take. And so might money from your family and friends, a group of angel investors, or from venture capitalists (VCs).

Whose Money Is Best For Entrepreneurs?
At the risk of beating a dead horse(head), the nature and number of your investors are the main reasons one dollar is not the same as another dollar. It is very important for you, the entrepreneur, to understand not just how much money you want, but also the expectations of the people who invest their money with you.

Friends And Family Investors
For everything that is easy and quick about friends and family money, there is a downside that makes it less than optimal. Can your friends and family afford to put money into a risky venture? Inviting investment from people who may not have the wherewithal to understand or afford the investment they are making is not just troubling to you as the entrepreneur -- some friends and family investors may demand their money back or cause major personal trauma for you, if not a lawsuit or two.

Beyond the possibility of family strife and the loss of valued friendships, friends and family investors can eat up your time by trying to help, get involved with, visit or better understand your company, or by demanding that you meet with their family and business introductions, many or all of whom may be inappropriate for your company. Do you really want to hire Uncle Jimmy's son to build your website or be your CFO?

Another difficult issue with friends and family money may arise if your initial capital raise was done at a very optimistic valuation set by you, and your second round of financing turns out to be a "down round" – meaning that your new investors do not value your company as highly as you did when you first sold shares to friends and family. In addition, if your second round of financing is with angel investors or VCs, it is likely they will insist on Preferred Stock, while you probably sold lower ranking Common Stock to your friends and family. If you overvalued your company at the outset, your friends and family will be diluted (as will your management team), and they all will be ranked "behind" any newly issued Preferred Stock. As a result, you may have to make it up to friends and family investors somehow – by offering them more of your founder shares, e.g., or by offering your friends and family an opportunity to invest in the new round, assuming the new money will permit that.

Angel Investors And Organized Angel Investor Groups
Angel investors can often be a big step up from friends and family investors. Angel investors are likely to invest a larger amount of capital and are more likely to have the relationships, expertise, management and domain experience that you will want and need to assist your company's growth and success.

One of the risks of taking money from angel investors, however, is that they may not be real angel investors at all! Some "angels" are actually better described as casual business friends who come with friends-and-family-style burdens. You will want to identify the backgrounds and track records of potential angel investors and ensure that they come with the relationships and experience that can help your company grow.

Assuming you do attract the attention of well-regarded angel investors (whether independently or via an organized group of angel investors), they will require you to produce a better business plan, build a management team that includes impressive professional managers in addition to yourself, and complete a due diligence review process. All of this may take a couple of months. Angel investors will most likely ask you for a seat (or two) on your company's board of directors, and require you to hold regular board meetings. They are likely to urge you to use law firms, accounting firms and other advisors they recommend, and may require that you spend some money on audited financial statements. In addition, angels will likely put some controls on you and your company with respect to how you operate the business. As mentioned previously, angel investors are also likely to request Preferred Stock in your company, while you and your management team only get Common Stock. Angel investors will also ask you to keep good records and make financial reports.

One possible downside of taking money from angel investors is that your particular angels may not be able to invest the total amount of money you need. Independent angel investors have their limits (just like friends and family). But while individual angels will invest only so much in any one venture, some angel investor groups have hundreds of members and the ability to provide larger amounts of investment capital. Tech Coast Angels, for example, has invested in excess of $2 million into young companies, though its more common investment range is from $350,000 to $1.5 million in any one investment round. But if you need to raise much more than $2 million, you may need to look for VC funding.

If you don't expect or want to sell or "exit" from your company in 3-6 years (meaning, you think you will want to keep it private and run it for a long, long time), you may not want angel investor money. Angels and VCs both want a profitable exit as soon as reasonably possible. Angel investors generally seek returns between 3-10x and above, and may invest in companies that they expect to reach a 3x or 5x exit in a shorter period of time. VC funds, on the other hand, traditionally have a higher minimum goal of returns of 10x and above, will be more likely to take specific action with you and your company (and with attendant benefits and risks) to achieve that goal, and will not be interested in companies that are not expected to reach those multiples.

Venture Capital Funds
Many entrepreneurs see VC funding as a "gold seal of approval." The upsides include a larger amount of money invested (typically, VCs are looking to invest $5 million or more over the life of each investment), and the possibility of significant follow-on capital and relationships that will help the company grow quickly. Especially if you need a significant amount of capital or believe you need to move fast to "win the race" in your particular business, these benefits are real, and VC firms are an excellent source of money and relationships.

Of course, some of the benefits of VC funding can also burden you and your company. If your company is not worth at least $5 million on a pre-money basis, you may have to give up 50% or more of the shares of your company in exchange for the approximately $5 million capital infusion a VC firm will want to make. Like angels, VCs are likely to urge you to use their favorite law firms, accounting firms and other advisors. Moreover, VCs are also likely to require audited financial statements and other controls on you and your company, some of which angel investors might not require. For example, VCs often deliver investment capital to companies in chunks based on achievement of certain operational or revenue milestones. In order to ensure you get the funding you are expecting, you need to agree in great detail to what those milestones are and be certain that they are reachable. A member of the VC firm will most likely oversee your investment and visit your offices on a relatively frequent basis. Depending on your relationship with the VC representative, this can be a great benefit to you or a burden on your time, especially if you are not in basic agreement about how to grow your business. For all of the foregoing reasons, you should make a real effort to ensure that you and your potential VC investors agree on the details of your business plan and how it will be implemented once you are funded.

As noted above, traditionally, venture capital funds approach each investment with the idea that it must return at least 10x on the post-money valuation of the company. This approach may affect the business and timetable of the company, and you should consider whether or not you believe your company can grow to a valuation exceeding at least $100-$200 million. If your business plan is to grow slowly and preserve some of the company's funds until you hit profitability, you may find that you and your VC funding sources have different agendas for how much risk to take. It is up to you to discuss this in advance and to choose VC investors that are most closely aligned with your business objectives.

Conclusion

It is very important for you, the entrepreneur, to decide not only how much money you need and when, but from whom to take that investment capital. Each investor has goals and expectations, and each investor's capital comes with its own burdens. You must consider those goals and be sure when you accept investment capital that your investors' interests and expectations are aligned with yours and that your company can grow and succeed given the mix of benefits and challenges your investors are likely to present.

Armed with this basic advice, you should be able to find the investors and the capital that offer you and your investors the greatest overall opportunity for success.