Angel Investing: INISMO Investing

Angel Investing: How do angel investors gain traction?

Presumably, angel investors get better when their deal flow improves, but how do they increase their deal flow to begin with?

4 Answers

100 **Dave McClure, I've been an angel investor in 13 startups personally, and over 350+ companies as a VC (Founders Fund, fbFund, 500 Startups)**

Votes by **David S. Rose** (Managing Principal of Rose Tech Ventures. Activ...), **Marc Bodnick** (Co-Founder, Elevation Partners), Mike Dudas, Pranay Srinivasan, (more)

actually it's pretty simple.

1) invest alongside other smart / well-known angels & VCs.

this well help you get to know the community, get into good deals, and help you learn deal structure & protect you from your own ignorance when you have little knowledge or ability to negotiate. these days it's much easier to figure out who is in which companies & get quality dealflow by using AngelList & Syndicates.

early in my investing career, I was fortunate to co-invest with Ron Conway / SV Angel & also Josh Kopelman / First Round Capital, as well as with other early PayPal & Facebook folks. later I was working for Founders Fund & co-investing with Mitch Kapor. needless to say these were top investors, and I was lucky to get into deals with them. but surprisingly it's not that hard to do even for unknown and less rich people.

altho I didn't understand legal structures or valuation well at the time, and I was such a small investor I couldn't negotiate much, but because I was in deals led by knowledgeable / frequent investors, I didn't get screwed with very much.

2) invest small amounts in lots of deals (>20 at minimum, ideally ~50-100+).

the best way to have a shot at making money is to diversify across a lot of deals. even for the best investors, it's probably unlikely more than 20-30% of their investments return >1X, and in fact prob <10% return >3-5X or more. typically in 50% or more deals you will lose ALL of your money.

in other words, returns are *highly* asymmetric, and big wins are very infrequent.

in order to maximize the chance of participating in big wins, most people think doing lots of up-front due diligence and evaluation will help them get better returns. personally speaking, I think this is a fallacy, and the ability to detect "greatness" early in either founders or companies is extremely challenging.

the solution to this is simply to try and get access to high-quality dealflow (see #1; invest alongside experienced folks), and diversify into as many deals as possible, and at least aim for a portfolio size of 20+.

in my own experience, I was able to pick winners 1 out of 3 times, and big winners (10X+) 1 out of 5-10 times.

in my personal angel portfolio of ~15 companies, I was fortunate to participate in early investment rounds for Mint.com , Slideshare, and Mashery, which all returned 10-15X or more.

in addition to providing diversification, investing in lots of companies also is a free marketing campaign -- it tells people that you are an active participant in the market, and this in turn will increase access to deals and to other experienced investors.

most folks don't understand this, and the benefits of a large portfolio are not obvious at first. however there are clearly network effects that build after you have established a minimum critical mass of investments (say, 7-10 or more), and have co-invested with other knowledgable people.

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it's unclear whether I have gotten any better at selection after investing for more than 10 years. however, over time larger portfolio size has probably improved my access to deals & returns quite substantially.

lastly, people tend to remember your winners and forget about your losers. this very human psychological factor also benefits a larger portfolio size. ("even a broken clock is right twice a day"... "even a blind squirrel finds a nut now & then" ;)

3) develop an area of focus or expertise, and build your brand & network around this.

in my case, because I had both engineering & marketing background, and because I had worked at PayPal doing developer community work & e-commerce education, I got access to a lot of financial services startups (like Mint.com & Credit Karma), and to a lot of consumer internet startups (Bix & TeachStreet), and developer tools & platforms (Twilio & SendGrid).

the more you can develop an area of focus & expertise, the less it matters about how much money or investjng experience you have... I was fortunate to get into deals when I had only $5-10K to invest because of the other skills & experience I has to offer.

4) develop a bias towards lower-valuation deals, or higher-valuation deals with other proven metrics & investors.

while it's true that some of the very best deals may be priced substantially higher than average, it's also true that some of my best investments were not particularly expensive when I invested (ex: Mashery, SlideShare, Twilio, SendGrid, Lyft, http://Bit.ly , TaskRabbit were all done at valuations of between $1M-$3.5M).

there were also deals that I passed on due to price which were clearly major fuckups on my part, and I should have done (most regrettably, I passed on Uber at $10-12M valuation I think, when Travis asked me... altho he wasn't running the company at the time, I still should have invested... sigh).

while it's difficult to figure out when price matters and when it doesn't, my experience has lead me to bias towards less expensive deals on average, and occasionally I let myself "binge" on a few exceptions here & there where I feel the company has potential and has already proven some specific KPIs.

that said, I am as likely as anyone else to get "FOMO" (Fear Of Missing Out), and can occasionally be enticed into an expensive deal if I see other smart people already investing ("social proof"). while I try to avoid this, it's not always a bad thing, and at the very least having a group if other notable investors along for the ride can help avoid some (but not all) future challenges.

still, I stand by my assertion that a large portfolio of inexpensive deals will likely perform better than a concentrated portfolio of "high-quality" deals at higher average price. then again, other investors may prove me wrong.

5) double-down on winners / traction, but ONLY if you can [afford to] double your ownership and if there's a reasonable chance for an exit.

this last point probably doesn't matter as much as the earlier ones, however it has become clear that when I was able to follow-in at reasonable prices, and increase ownership substantially, this was a winning strategy.

however, I also worry that the desire to "double-down on winners" may have also caused me to deploy more capital than necessary, and in a constrained capital situation (which most of us live in), it may be more prudent to conserve cash for more new investments, rather than deploying capital into companies where I already owned a substantial position at a lower valuation.

some folks like Peter Thiel (my twice former employer, co-founder/ceo of PayPal, early investor in Facebook, and a pretty smart guy) talk about "power law investing", and advocate writing a check as long as the deal is led by an institutional investor (aka a reputable VC).

while I don't disagree with Peter that this is a reasonable strategy, not all of us have as much money to invest as he does... and in a budget scenario where you have access to a finite amount of capital, you will have trade off decisions to make about whether to follow-on in your winners vs. investing in more new deals.

since many of your "winners" may not actually be a lock to get to an exit, note that you may double down on a company with improved KPIs & traction, but still <50% chance of an exit, and perhaps <20% chance of a big win... this raises the bar for when to double down.

my personal philosophy is that if we can double ownership for <3-5X of the previous valuation where we invested, AND we feel the company has proven some level of "product-market fit" & a scaleable path to customer acquisition, AND there is an adequate amount of growth or revenue, AND the company hasn't raised so much capital that it can't be sold for more than the last round valuation, AND there is a logical path to an exit / acquirer, AND we aren't capital-constrained at the time of the investment... THEN yes we will double down.

as you can tell, there are probably more reasons to NOT follow-on to an existing investment than to double down, so ask yourself a LOT of questions before you commit to your "winners".

6) continue to re-evaluate your strategies based on current market conditions and structural changes to environment.

while I don't believe I have changed my investment philosophy much in the past ten years, I still have a healthy amount of doubt about any & all of my strategies, and continue to examine whether market conditions or structural changes to the environment may invalidate my prior logic or expectations.

in other words: I still don't know shit, and I'm scared as hell I'm going to lose my shirt any minute now.

but in the meantime... hey what's trending on AngelList? ;)

hope this has been helpful.

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21 **Harjeet Taggar, Partner, Y Combinator. Holds investments in real estate, public + private stocks.**

Votes by **Terrence Yang** (Ex-Wall St. Value and startup investor.), **Dave McClure** (um, yeah... i've invested in a crap-ton of comp...), Kirill Makharinsky, TJ Murphy, (more)

I've seen a few ways investors who are new to angel investing start building deal flow, since a lot of them come to us at YC as a first step:

- Brand themselves as experts on a particular skill/area and attract founders who would benefit from that expertise. I remember reading this advice from Naval Ravikant a while back (he has used it effectively himself to create deal flow). This generally works well/is more applicable to successful founders starting to angel invest.

- Work hard at networking and meeting the top-tier angels who generally see all the best deals (well the most visible/hyped deals, which doesn't always mean the best deals) in the hope they'll be able to follow on invest in some of them. This seems more applicable to people who don't have a background in tech and are essentially outsourcing the decision making/evaluation process to experienced investors and literally buying themselves deal flow. Y Combinator's AngelConf is an event where you can meet and hear experienced investors speak about angel investing.

- Bring an existing large and valuable network to the table. Ron Conway & SV Angel would be the clear role model to aspire to for this kind of investor but you don't need to have been investing for as long as Ron to do this e.g. Chris Sacca had a large and valuable network before he started angel investing professionally.

- Work your ass off to provide value for any companies you do invest in so they tell other founders how great you are, building a reputation via word of mouth. Nils Johnson is doing a great job of this right now, every YC company he's invested in so far emails me telling me how much he's helped on specific things like finding potential hiring. In a world where a lot of people like to throw around vague terms like 'access to my network' or 'strategy advice' providing tangible value sets you apart.

Ultimately I think the best strategy would be to make investment decisions quickly, on standard terms and work hard for your investments. Even companies who are oversubscribed/hot deals will be inclined to make room for someone they think is going to be a hassle free investor who likes what they're doing and will work hard for them.

Upvote · 1 Comment · Written 20 Jul, 2010

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50 **Keith Rabois, I have invested in some great entrepreneurs, including the founders of yelp, LinkedIn, Xoom, YouTube, yammer, Milo, AirBnB.**

Votes by **Harjeet Taggar** (Partner, Y Combinator. Holds investments in rea...), **Marc Bodnick** (Co-Founder, Elevation Partners), **Dave McClure** (um, yeah... i've invested in a crap-ton of comp...), Taso Du Val, (more)

- To quote Peter Thiel, you need to be contrarian *and* right.

Don't invest in the "hot" deal of the day. Find a different market, unusual entrepreneur and invest in companies **before** other investors decide a company is attractive. If you prove to be proficient at spotting companies and talented entrepreneurs, you are set. Do not expect to employ user growth as your key criteria, as startups that have already demonstrated that will be swarmed by potential investors.

- Develop a competitive advantage *vis a vis* other investors.

Just offering an incremental $50-100k has little value in today's "frothy" environment. Harjeet offers some examples, but you need to develop a brand based upon your own background and expertise.

- Offer to assist entrepreneurs broadly, whether or not you are an investor.

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9 **Lauren Flanagan, Have invested in 30 early stage companies over the last 6 years. Co founder of two funds: Phenomenelle Angels Fund & BELLE Capital**

Votes by **Dave McClure** (um, yeah... i've invested in a crap-ton of comp...), Trevor Fiatal, Lili Balfour, Quora User, (more)

Great comments by Keith and Harjeet. I'd add that a successful contrarian strategy is to seek out underserved markets. There's structural advantage in investing in areas with a lack of available capital, meaning you get lots of deal flow at favorable terms. Although I hail from the Bay Area and started up my all own companies there, it's an overheated, overpriced market right now. There are stellar companies to be found around the country near big research universities and where there are market leading companies to provide management depth.

Another viable strategy is to play "smallball." We look for attractive valuations and terms so that we make can money on a $25-50MM exit--the sweet spot of current M&A action. Of course we'll swing for the fences too on a great pitch by a great team, but a solid portfolio and good returns can be built on a mix of singles, doubles, triples with just a few strikeouts. Of my 30 companies invested over the last 6 years, most are in the greater Midwest so that's an underserved geography filter. About half are led by women, another hugely underserved market. I lost 100% on one, got an 80% return on another, and earned 15x in 16 months on a 3rd. And we've gotten tax credits for most, offered more and more frequently by states in underserved markets. These along with the all the warrants we usually get are nice IRR sweeteners. The other 27 companies are all still kicking, all have raised substantial amounts of follow-on capital and look to be a good mix of doubles and triples and at least 2 potential homeruns. Of course time will tell if these strategies prove out. However, we have more deal flow than we can fund.

In sum, go fishing in waters other boats haven't found yet.

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1 Answer Collapsed

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