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#AngelGuide

# NORDIC GUIDE TO FINDING AN ANGEL INVESTMENT

**SAMI ETULA**

*"This guide is indispensable for all wanna-be Business Angels and those entrepreneurs seeking Angel Investment! It contains best practices and practical tips culled from Business Angels around the world. It is a must-read, easy-to-read, and great-read for all those private investors interested in playing a major role in the early-stage investment ecosystem and those entrepreneurs interested in attracting Business Angel Investment."*

- [Candace Johnson](#), President, [EBAN](#) (Europe)

*"Angel Investing is the corner stone for building a vibrant entrepreneurship Eco-system, specially in the MENA region. Sami did an amazing job through sharing his experience and giving live examples. This is a wonderful guide and will have a great impact. We will have his work in Arabic and make it valuable to Arab Entrepreneurs"*

- Dr [Abdul Malik Al Jaber](#), President, [MBAN](#) (Middle-East)

*"We at ABAN see this guide as the reference point for the birth of Angel investors and creation of Angel networks across the continent. Its utility value to entrepreneurs and Angels alike as we accelerate the building of Africa's startup ecosystem cannot be overstated. The standards and pragmatic advice Sami has managed to glean from Angel investors and entrepreneurs from across the globe makes this the go-to guide for any serious minded early-stage investor"*

- [H. Tomi Davies](#), President, [ABAN](#) (Africa)

*"In spite of pretty long history of angel investment phenomena there are still lots of myths around the subject. Armies of people waste days and weeks of their precious time going in the wrong direction with all possible might. We really can be a bit smarter ... I am sure that this professional guide will be of very practical help to many novice (and serial!) investors and entrepreneurs. It can help us save our time and money! Great job Sami!"*

- [Konstantin Fokin](#), President, [NBAA](#) (Russian)

"Sami has done an excellent job in compiling the guide to finding an angel investment. The Guide is pragmatic, easy-to-read and full of excellent examples. All entrepreneurs seeking financing will benefit from the guide and increase their probability of succeeding by reading and following Sami's guidelines."

- [Riku Asikainen](#), business angel, Chairman Emeritus, [FiBAN](#).

"There is excellent advice here on how and with what emphasis startups should communicate about themselves to investors, whether it be in respect of pitch, registration in Slush, filling out a matchmaking form or something or something quite other."

- [Riku Mäkelä](#), CEO, [Slush](#)

"Sami's Guide to Finding an Angel Investment is a book of note worthy of praise. The Guide is absolutely brilliant! It is comprehensive, educational, down-to-earth in language accessible to everyone. It is a must read both for entrepreneurs, investors and legislators. It will create a standard for the sector and facilitate the work of both entrepreneurs and investors. Let's make sure that the Guide receives the credit and distribution it deserves."

- [Tero Luoma](#), Investment Director, [Taaleritehtaan Pääomarahastot Oy](#)

"In the light of 17 years of experience as an entrepreneur, seven companies established and well over 10 rounds of financing raised, I wish that I had read this earlier."

- [Lennu Keinänen](#), serial entrepreneur, business angel, [Paytrail](#) founder.

"Sami's Guide to finding Angel Investment is absolutely brilliant! It is a high level showcase, worthy of praise with easy-to-read examples. His Guide is of great service not only to Finland's community of capital but to our Belgian community as well. And a real must to read for our entrepreneurs, our Angel investors and our legislators. Thank you Sami for this excellent job!"

- [Reginald Vossen](#), General Manager, [BAN Vlaanderen](#)





# SWEAT, NETWORKS AND EQUITY

GUIDE TO FINDING AN ANGEL  
INVESTMENT

#AngelGuide

[Sami Etula](#)

FiBAN – Finnish Business Angels Network  
Helsinki, Finland



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# Working for Angels, helping Entrepreneurs

**Finnish Business Angels Network** is a national organization of private angel investors. We work for the benefit and profit of our 500 investor members by managing Finland's most comprehensive deal flow of startups and growth companies, and representing them in public. We organize over 100 events annually, most of which are pitching and matchmaking, and many related to educating our investor members.

Although we put investors' interests first, we recognize it is in our own interest to help entrepreneurs as well. The quality of company presentations in our deal flow depends greatly on how well we educate founders on what angels look for in a startup. Many entrepreneurs don't understand how to attract angel money well enough, and there has been a lack of literature on that subject. Mr. Sami Etula took up the challenge and wrote this guide to help business angels as well as entrepreneurs, and the whole community of angel investing – both domestic and international.

We at FiBAN are proud to distribute this guide under our brand. We have been happy to support Mr Etula in this work, and want to sincerely thank him for his efforts. In addition to Mr Etula, we want to thank the Regional Council of Central Finland as well as the Centre for Economic Development, Transport and the Environment in Finland for supporting this work. We want to also thank all those who contributed to this publication by providing and revising its content and setting.

Jan D. Oker-Blom  
Managing Director

Jaakko Salminen  
Chairman of Board



# Preface

We are currently living in the golden age of angel investment. There are numerous investors and even more applicants. I have even invested myself. We have a problem, however. The majority of companies seeking investment are not in a condition or sufficiently mature to accept the investment.

The Guide you are currently holding is not the final word or omniscient, although an attempt has been made to include the know-how of years of experience and a mishmash of international studies. I hope, nevertheless, that it will contribute to opening up the world of angel investing to everyone interested – starting initially from a large-scale perspective and then gradually in more detail.

The process of writing the Guide has not been completely straightforward. I have found it particularly challenging to make foreign terminology and concepts understandable to everyone. If, therefore, you come across a section of text that is unclear, you can blame me. It is due to the limitations of the author, not lack of understanding on the part of the reader.

I believe that only together can we achieve results. So, a HUGE thank you to everyone who has contributed to this story. I would like to extend special thanks to Jan Oker-Blom, Claes Mikko Nielsen, Ilkka Vuorenmaa, Candade Johnsson and Marjaana for reading through the Guide and acting as sounding boards for me even in the smallest details.

This is my example of sweat equity impact investment. But it is unlikely that the journey will end here, though. I hope, rather, that it will serve as a springboard for future years and knowledge. Let's pay it forward and allow both the printed and online version to be distributed freely.

Wishing you all success, failure, learning and growth!

Sami Etula  
Jyväskylä, Finland, 20th April 2015



1

# **Business angel investing**

## Angels always invest their own money and are minority shareholders

Business angel investing refers to the investment made by a private individual in an unlisted potential growth company to which he or she does not have any family ties. As there is no scientific definition as to who is considered a business angel, Lahti (2008) defines in his doctoral study a business angel by means of three characteristics:

- They perceive themselves as business angels.
- The aim of investment is to make a profit.
- The value of the investment exceeds €10,000.

A typical business angel is a 35-to-65-year-old person. He or she has served either in management positions in a large company or as an entrepreneur for a significant part of his or her career. He or she is able to devote at least one day a week to angel activities. A key characteristic of angels is that they feel that they have something still to offer – to startup companies.

A business angel investment is always a minority investment (usually 10–30%), and it is directed at the pre-seed, early or later growth stage (Figure 1). Correspondingly, Venture capitalists mainly make later stage minority investments (venture investments) or expansion majority investments (buy-outs). Joint global definitions of the various stages of a company do not exist, but they could describe as follows:

**Pre-seed** is the stage at which there may be a team and an idea, but not necessarily even a company. Investment enables the first stages of product and idea development. Increasingly, incubators are taking over this investment phase that allows the business angel to focus on the other stages below.

In the **seed stage**, the team has acquired the tools and produced their first version of the product/service in their garage. The investment is

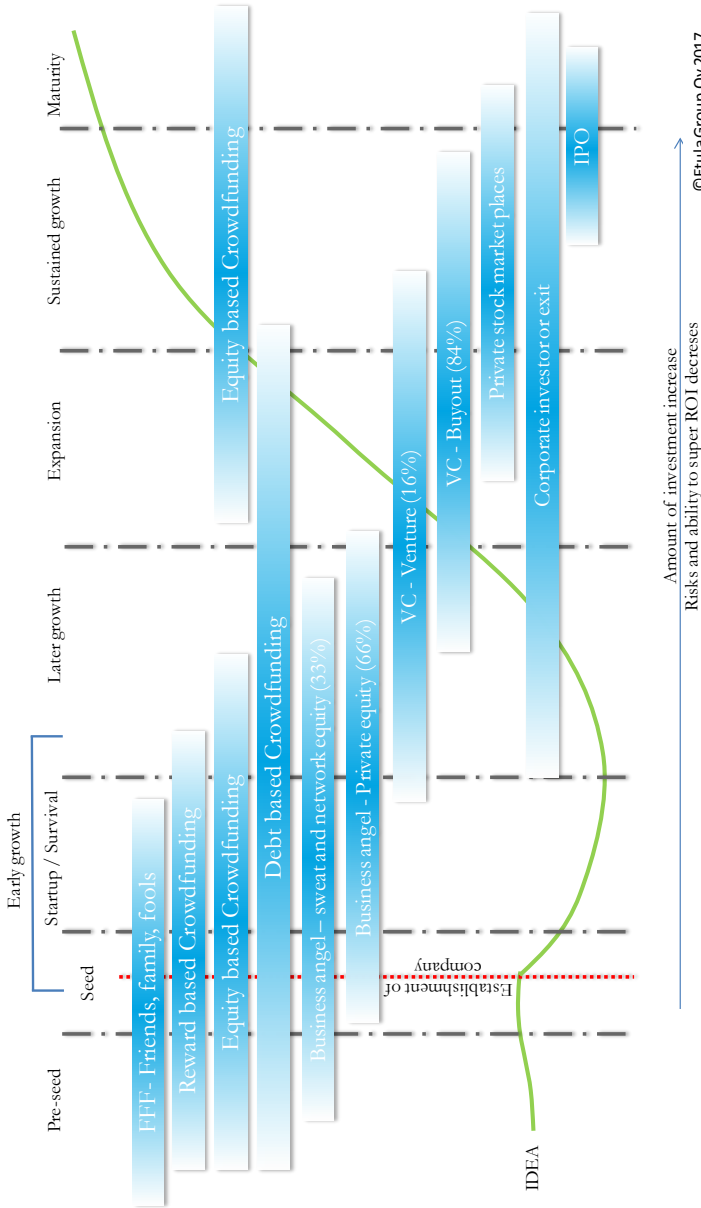


Figure 1. Investor options at various stages of a company's lifecycle.



used in verifying and starting up product development or a business model.

**Start-up/survival** is the stage where the existing team has grown, moved out of the garage into its own premises and launched the first version of the product. Turnover is generated but it is not yet sufficient to cover expenses. An angel investment is usually used for product and market development or working capital, in other words, to get over the "valley of death".

In the **later growth stage**, business expands from the company's home town to the international market and trade booms. Incoming cash flow exceeds outgoing payments and the business begins to accumulate cash. The investment is used to accelerate growth. Here again and thanks to smart phones and broadband network proliferation, many companies are "Born Global" from day one.

In the **expansion stage**, the company already has considerable turnover and aims to expand to ever-new markets, product groups or industries.

Although different types of investors invest in companies at different stages of their lifecycle they do, however, have some features in common. The most important shared feature is willingness to make syndicated investments. Syndication refers to co-investment by several investors where the group is represented by one person. Syndicated investments enable better management of risks and a more diversified portfolio with same investment amount in euros. Syndicates are also an excellent way of acquiring larger investments. Business angels and private equity investors typically also make cross-syndication investments.

The number of business angels throughout Europe is estimated to be approximately 303,650. According to the most recent studies (EBAN), approximately 8.6 billion euros were invested in early stage companies throughout Europe in 2015. Of this sum, 6.1 billion came from busi-

ness angels, 2.1 billion from the early stage VCs and 0.4 billion euros through crowdfunding.

## Angel investment boosts growth

Angel investing differs significantly from other forms of investment in that business angels usually endeavour to actively influence the success of their investment (compare stock market investing). The investment may be in a form other than money. In fact, according to studies, substantially better results are achieved in a company by investing in sweat equity and network equity rather than simply private equity.



**Sweat**



**Networks**



**Equity**

← More time spent  
and greater participation

Less time spent  
and smaller participation →

Source: FIBAN 2014

**Mentoring and contacts are frequently far more important to a company than money.** Target companies list strategic planning, internationalisation of the company, acquisition of business contacts and procurement of additional funding as their most important sweat equity needs.

When considering an investment decision, the business angel considers the following: sweat equity that can be provided; available networks for potential customers or partners and amount of capital needed for the investment to succeed. In short, one could say that one third of angel

Why do the investors seek an 80% annual increase in value?

Investors decide to invest only in good companies. In reality, however, only one in ten investments are successful, four in ten yield a return on the capital invested and with respect to the rest, everything is lost.

If an investor's annual target rate of return for a portfolio is 20%, the estimated duration of the investment five years and the probability of success 10%, a single investment must produce an annual return of 80% to enable the investor to have the resources to make new investment decisions in the future, too. In other words the expected return on investment (EROI) must be 20-fold at the time of the decision.

investing consists of monetary investment, one third of utilisation of networks and one third of making the investor's sweat equity available to the growth company in question. The role of an angel in a target company is determined by the investment portfolio situation and the investment strategy.

There is no standard, universal way of making a investment decision; instead every investor acts according to his or her own principles. The more an investor invests sweat equity and network equity, the more active and committed is the role he or she takes and the more he or she can influence the success of his or her investment. At their most active, investors may be in touch with the several times a week and at their most passive only a few times a year. Angels typically

invest in different companies in different ways: in a passive role in one and in an active role in another. Business angels invest their own personal wealth and their "do not have to invest" attitude, which means that the entrepreneur's personal chemistry and possibility to influence something are regarded as important increase in significance.

Angel investing is always temporary and can last only for a specific stage in the company's lifecycle. The target duration for investments is approximately five years, but investors can be involved for as long as 10

years. Angels frequently seek investments which are close to their knowledge and contact networks, also in terms of geographical location. Few angels invest in companies located further than 200 km from them, other than through syndicates. Increasingly, however, business angels are investing in global syndicates. In such a case, the closest angel usually takes care of the investment and represents the investor group.

Business angels are usually motivated by factors other than money. Underlying reasons may be a desire to influence global development (impact investment) or a wish to help their community. Other motivation factors may be, among others, a desire to stay at the forefront of development and a need for variation. Even though the primary motivational factors are other than money-related, a high return expectation also encourages investment. Money is a fuel without which investments cannot continue.

## **Angels investment in all kinds of companies with growth potential**

Despite the fact that businesses relating to the internet or apps are more easily scalable than traditional sectors, analysis of investment decisions (Figure 2) show that business angels invest in all sectors as long as the investment criteria are met.

### ANGEL INVESTING

1. The average investment period is over eight years.
2. Half of investments fail, one in ten covers other investments made.
3. A typical investment amount is between €10, 000 and €50,000 per investor per round; maximum €1 million.
4. The valuation of a company being invested in is typically below €1.2 million.
5. The stake held by investors usually varies between 10 and 30 per cent.
6. Emotional factors affect an investment.

SECTOR	2012	2013	2014	2015	2016
ICT	47%	32% ↓	13% ↓	26% ↑	-
Creative Industries	4%	3%	3%	5%	-
Mobile	10%	10%	21% ↑	9% ↓	-
Energy	2%	6% ↑	1%	2%	-
Biotech and Life Sciences	1%	10% ↑	3%	2%	3%
Manufacturing	5%	9% ↑	3% ↓	4%	9% ↑
Health Care/Med Tech	8%	8%	5%	9%	9%
Environment and Clean Tech	6%	6%	14% ↑	9% ↓	10%
Retail and Distribution	5%	4%	5%	5%	6%
Logistics and Transport	3%	3%	1%	2%	3%
Biotech and Life Sciences	1%	10% ↑	3%	2%	3%
Finance and Business Services	6%	2% ↓	4%	9%	21% ↑
Impact Investing	-	0.5%	-	-	1%
Gaming and Entertainment	-	-	-	-	5%
Media and Marketing	-	-	-	-	12%
Education technology	-	-	-	-	4%
Lifestyle and Consumer goods	-	-	-	-	13%
Other / Unknown	5%	8%	27% ↑	11%	4%

Table 1. Sector distribution of business angel investments (EBAN, FiBAN)

A target company does not need to be a new business; rather existing companies and companies seeking new growth (restart or start-again) are also generating more and more interest. A company of this kind which is attractive to investors is typically one in a situation where business has stagnated for years until a spark of growth has arisen in the company. The spark can have been ignited by a multitude of causes: a new product, demand on the international market, a generation or ownership change. The turnover of a company seeking investment is

typically below one million euros, but the company aims at aggressive growth.

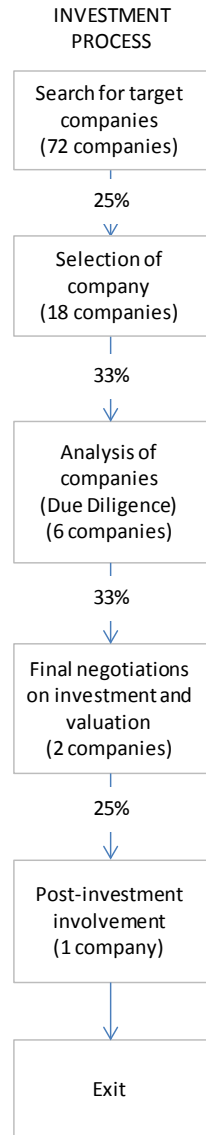
## Business angel investment process

Business angels are persons each of whom has developed their own "best" investment process model. In general, the investment process can be considered starting from when the investor identifies an investment opportunity and ending when he or she exits the company. The main stages of the investment process can be divided into seven steps.

When *looking for companies* investors visit various events where they are able to familiarise themselves with potential target companies. Existing contact networks are also used in this step of the process.

When *selecting companies* investors examine options in the market and select the best for analysis based on their own investment criteria. The investment criteria are investor specific. They are analysed in more detail in section 3. After selecting the investment and before the analysis, a preliminary investment agreement (Term Sheet) which ensures mutual alignment for the duration of the process may be signed. The Term Sheet also specifies the main terms and conditions of the investment. It may be difficult to change the terms afterwards. An example of a Term Sheet can be found here: [se-riisseed.fi](https://riisseed.fi) or [eban.org/about/member-area](https://eban.org/about/member-area).

When *analysing companies* investors analyse the investment target and its valuation in the light of uncertain information. The analysis criteria are in part the same as those for the selection of





companies, but the information is deepened and expanded on as much as possible (chapter 3).

In the *final negotiations on an investment* the investment is either rejected or the investment agreement initially made is clarified further to form a shareholder agreement. The most important section of the final negotiations consists of determining the valuation of the target correctly. A positive decision is made in respect of 1–6% of all companies screened.

Specific issues in the closing negotiations may put a stop to the investment. Issues such as this can include, for example, the willingness of the founder shareholders to accept suggestions and/or criticism or the unwillingness of a founder shareholder to step down from the post of CEO. According to Acland (2011) statistics, 65 per cent of companies that changed their CEO survived and only 9 per cent of companies that did not change their CEO survived. It is no wonder, then, that this section has become one of the key investment criteria.

Where venture capital companies may make a large single investment, business angels tend to make investment in stages, which means that the amounts invested and the risks are more manageable. The size of investments varies from 10,000 euros to 250,000 euros per investor. A typical amount in Europe (and worldwide) is approximately 25,000 euros per investor and investment. When comparing averages from around the world, it is rather amusing that the average has not changed at all during the past 10 years and the currency used is irrelevant. The average is the same whether using dollars, pounds or euros.

# 2

## **Application, valuation and pitching**



## Before applying

Angel investment as a financing form differs from traditional financing options in terms of the search process, securities, and capital and interest expectations. The assessment conducted by an angel investor goes deeper than the assessments of traditional financing providers. Instead of financial situation and solvency, growth potential and prospects are examined. Angel investment also differs in that angels often wish to bring added value and to act in an expert capacity in the company (influence earnings on their investment), which a bank or other financial institution usually has no wish to do.

**Before applying, entrepreneurs should realise that a decision to seek investment is also a commitment to sell the company provided that a potential buyer is found** (sufficiently high price). The company should not, therefore, be a life mission for an entrepreneur, but instead it should be just one phase of their professional life. There is a considerable difference in the philosophies.

Before searching, it is a good idea to consider a few issues:

- 1) A company should be financed, as far as possible, with personal assets and those of family or friends and above all, sales.
- 2) If a company does decide to seek an investor, entrepreneurs must decide on how large a share of the company they are psychologically willing to relinquish.
- 3) The advantages and disadvantages brought by investors to the company in its present situation should be assessed in advance.
- 4) Entrepreneurs should realistically determine their financing needs and the basis for these.
- 5) Entrepreneurs should learn the way and the principles under which business angels invest.
- 6) After taking care of the above, it is easy to determine the ideal profile: What kind of investor is desired for the company? What know-how and networks are needed? How much of the investor's time is required?

- 7) ... and only after all the above, should the entrepreneur make the first contact with investors.

Before applying, it also good to make sure that the company is in a limited liability form and that all the necessary documentation is ready so that an investment process which has started off well will not founder. A list of the most commonly requested documents is provided at [etula.fi/documents](http://etula.fi/documents).

**If it seems that resolve exists but you are bothered by uncertainty, do not be discouraged; instead get in touch with an expert who can help you move forward.**

## **Applying for investment and required documentation**

The first meeting with investors usually takes place 6–12 months before an investment decision, and during this time the investor monitors the company's development and increases his or her knowledge of the company and its operating environment. It is not worth offering an investor a non-disclosure agreement (NDA) to sign before starting the DD (Due Diligence) process, as you will not get a signature. An NDA is also usually unnecessary at the acquaintance stage, as the investor is not interested in technical details or in business secrets which the entrepreneur wishes to protect. The idea itself is not a secret and its value without the right team is non-existent, although people frequently imagine otherwise. In other words, if an idea is so good that it can be implemented by anyone, it will be unlikely to be suitable as an investment, as it has undoubtedly been invented by someone else.

It always makes sense to utilise both your own networks and to seek the attention of angel investors through various events or country-specific angel networks. See: [eban.org/about/find-a-member/](http://eban.org/about/find-a-member/).

Contact with an investor through the **EBAN network** is established most effectively by getting in touch with the contact person for the nearest angel network or by submitting an application through the website of the network in question. After the application has been submitted, the information provided is checked and the merit of the data is ascertained. After checking the information, the investors select the best of the applicants to appear before a bigger investor group.

The applicant is usually informed within a week of submitting their application of any shortcomings in the application, and within one month of why the company was selected/not selected for inclusion in the group of pitching companies. **You should not contact the angel network, but instead wait to be contacted.** Screening and selection of the target enterprises is usually handled by the members, not by the secretariat.

## Valuation: Criteria for determining the value of a company

Valuation refers to the value of a company. The commonly used term usually refers to valuation prior to an investment (pre-money valuation). This differs significantly from another valuation concept (post-money valuation), which means valuation after an investment and which also determines the share in the company received by the investor.

Post-money valuation of a target company is NOT therefore universal and shared by all companies; instead it is investor-specific and also determined in a large part by the added value an investor is able to offer the target company. The more an investor has to offer a target company, the higher the company's post-money valuation can become from the investor's perspective. The value of sweat equity investment might reduce the amount of money that needs to be invested and functions in a considerably larger role as leverage and as an incentive to invest (a surer feeling of success).

$$\begin{array}{l}
 \text{Pre-money valuation} \\
 + \text{ Private equity investment} \\
 + \text{ Sweat equity investment} \\
 + \text{ Network equity investment} \\
 \hline
 = \text{ Post-money valuation}
 \end{array}$$

In addition to valuation, the discussions on valuation determination serve as an excellent opportunity to deepen relations between an investor and entrepreneurs. When both parties share a common view of the net worth of a company, many conflict situations will be eliminated.

The purpose of valuation at the time of investment is complex, too. Firstly and most importantly, it determines the investor's share in the company but at the same time it indirectly decides:

- price per share of shares
- commitment of founder shareholders to company
- purpose of investment
- shareholder risks
- adequacy of financing (time span)
- expected return on investment

So the right valuation is important for both sides. If first round valuation is too high. Investors have no change to get returns on their investments, which means less sweat and networks equity effort. And more important, too high valuation at first round blocks future funding possibilities. Vice Versa. If valuation is too low, founders should blow out too high part of their shares. Golden rule is that founder team should have more than 50 percent of shares after two or three rounds.

You should not start to undertake valuation yourself. Use the rule of thumb below: Or use a reliable [angeltool.org](http://angeltool.org) software for this. Free **Angel Tool (#AngelTool) software enables you to calculate the valuation of your company in 17 different ways in just a few minutes.**

1. Excellent idea – PowerPoint presentation EUR 100,000
2. Product works – prototype ready EUR 250,000
3. Market functions – customers purchased EUR 500,000
4. Business established – some purchases EUR 1,200,000
5. Business running – steady purchases EUR 1,500,000

**If a company's pre-money valuation exceeds EUR 1.5 million, it has an excellent basis and strong track record of successful operations.**

## Valuation gap and its elimination

A valuation gap refers to a situation where the views of the investor and the entrepreneur on the value of a company differ from each other. This is usually due to a situation where the investor optimises returns and wishes to minimise the valuation, whereas the entrepreneur wishes to maximise the valuation and through this his or her holding. **The difference in view on the valuation of the company is one of the most common factors responsible for investment negotiations being discontinued.** A valuation done incorrectly may also prevent follow-on rounds and hence drive the company into a financial impasse.

A company seeking angel investment must form a reasonable, justifiable view of the company's valuation. It is simply ludicrous that a similar company may be available for EUR 100,000, but the valuation presented to the investor is EUR 1 million.

In situations where the investment target is especially interesting, an incorrect valuation not only interrupts negotiations immediately but hinders and complicates them. Understandably, poor investor terms reduce the valuation and good ones increase it. Factors with a positive impact on the decision-making (and valuation) of investors include (see explanations, chapter 4)

- salaries and remuneration of founder shareholders, vesting terms
- allocation of board of director seats
- provisions limiting share dilution
- veto rights in issues
- rights to receive information
- later registration and pre-emptive subscription rights (warrants) as well as drag-along obligations (and tag-along rights)
- redemption obligation of shareholders (e.g. an investment as a loan, which an entrepreneur is obliged to pay 0.5X back to the investor if the plan is not realised)
- various series of shares and conversion and other terms between share series (e.g. dividend, voting rights)
- reputation, name and experience of investor as well as added value for the company
- other special conditions, such as a liquidation preference, a full ratchet provision

Ultimately the valuation of a company is the price accepted by both parties, which in addition to the above, is influenced, by among other things, the general market situation and negotiation position at the time (which party must obtain an agreement and which can refrain from it).

## **Investor presentation – pitch**

Investors usually see several hundred pitches a year, so it is important for entrepreneurs to be able to summarise their growth target briefly and in a manner tempting to investors. Whether open or closed (intended for the investors only), a pitch event is usually an entrepreneur's first contact with investors. A pitch may not ensure an investment, but it can buy time from investors to continue discussions. Under no circumstances should you attend a pitch without preparing – you can give a first impression only once. The basic story should run something like this:

1. The market has a problem
2. We have the solution
3. There is a large market for this solution
4. and we can build a profitable business with the right model
5. There are competitors, but we are better and stand out
6. We are contending with a good team that
7. has brought us thus far
8. We want more, however, and that is why we are looking for private, networks and sweat equity in these areas... And contacts with companies...

A PowerPoint framework for a pitch is available at [etula.fi/documents](http://etula.fi/documents)

Presentations at pitch events are generally in the language of the country concerned, but materials are in English. Entrepreneurs should, however, be prepared to present their pitch in English, as international investors may be present. The language to be used is announced at the beginning of the event.

Pitches can vary in length. They are often presented, for example, in a 3+6 format, which means a three minute pitch followed by 6 minutes for questions. Pitch presentations generally last for 90 seconds, 3, 4, 5 or 7 minutes. Presentation materials are not used in 90-second pitches nor are questions asked. In longer presentations materials can be used as support. When the time allocated for the pitch ends, the presentation must also be brought to a close, regardless of how much you still have to say. Materials should ALWAYS be submitted to the organiser in advance.

After the public pitching, entrepreneurs typically go to their stand, where they have time to continue discussions with potential investors. Entrepreneurs can bring a prototype, brochures, a laptop and business cards to the stand. It is a good idea to charge batteries in advance, as there may be a shortage of sockets. The number of participants at a pitch event is frequently restricted, so that only one or two persons from a company may participate.

# 3

## **Assessment of investment (Due Diligence /DD process)**



## Assessment is uncertain

Analysis of early stage companies is made more difficult by the fact that the information in the business plan cannot be confirmed by customers, personnel, banks, suppliers or an accounting firm because of the lack of a history. The problem does not disappear in the DD process, even if the investor uses outside experts such as consultants, lawyers or auditors. Outside experts are not able to analyse the company any better than the investor other than in a "technical" capacity.



In the DD process, the investor makes a "deeper analysis" of the company's internal affairs and checks the accuracy of the information from various sources. Approximately 40–60 hours are usually spent in conducting a deeper analysis. A significant focus in the analysis is the team, customers, IPR, finances and other aspects relating to the administration of the company. One model of investment target assessment is shown in Appendix 1.

## Level of perfection of team 30–50%

An A-class team can successfully realise a B-class idea, but a B-class team cannot get an A-class idea off the ground. According to studies conducted by FiBAN, business plans have to be changed more than six times after a financing decision before the right model is found. If the company does not have a good team carrying out the new plans, the investor has invested in "vaporware".

One person does not constitute a team. It is exceptional for an investor to invest in a company where there is only one person. Entrepreneurs must therefore surround themselves with people who are smarter than

them. When several people own a company, they need to realise that equal distribution is not a tactic, but rather indicates that the company has failed to discuss the mutual roles of the owners. It also is important to understand that the inception of a limited company is the only time that the ownership of the company can be divided between the owners in a totally arbitrary and preferred ratio without any third party taking interest in the matter. For this reason, a business angel is occasionally sought even before a company actually exists.

*"There is no question that irrespective of the horse (product), horse race (market), or odds (financial criteria), it is the jockey (entrepreneur) who fundamentally determines whether the venture capitalist will place a bet at all."*

*- Mac Millan et al. 1985*

Angels seek people equipped with high motivation, will and business know-how with the ability to make impressive pitches to investors, partners and customers. Previous failures, such as bankruptcy, do not necessarily have a negative effect; instead they may be seen as positive learning experiences.

The level of perfection of a team can be assessed on the basis of eight different areas: Will, Know-how, Courage, Relationship Network, Marketing Spirit, "Coachability"/Learning Ability, Reliability and Heterogeneity/Complementarity.



**Will** indicates most clearly the time span of a team – how long and how intensively they have worked to take the company forward. **Know-how** is indicated by the team's tangible achievements and **courage** is indicated by the willingness of the people involved to "throw themselves" into the company through, among other things, voluntary hours of work,

monetary investments and loans. If an entrepreneur is not ready to finance/take out a loan for a company him- or herself, why would anyone else?

The **extent of the relationship network** reflects for its part the team's previous work history and experience. The more extensive the network, the wider the experience accrued and range of things that have been learned. **Marketing spirit** is, especially nowadays, one of the key features and attributes of a team. This mainly involves the attitude and approach of entrepreneurs towards sales activities. The **“coachability” or learning ability of a company team** reflects the team's potential to develop and grow with the company. A team that is unable to learn or that cannot be coached is an impediment to the realisation of an investment, as pointed out previously.

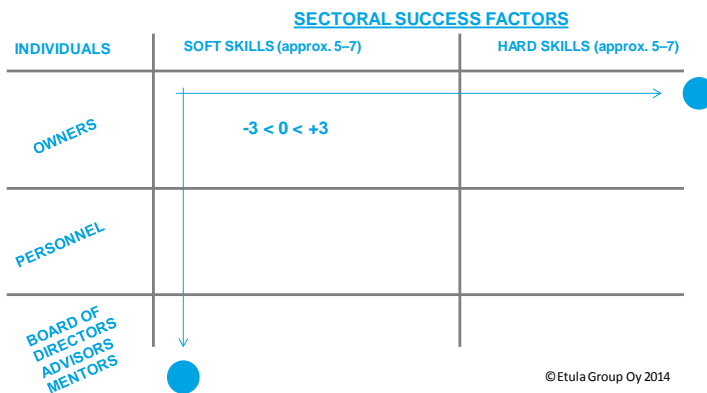


Figure 5. A success matrix assists in putting together a dream team.

The **reliability** of a team is a matter of course for operations. Reliability also measures for its part loyalty to the group and to the idea – whether the interest of an individual or the company is the priority in operations. The **heterogeneity and complementarity** of the entrepreneurial team ensures that each shareholder has something to give and that he or she has a reason to be and a clear role in the company. Heterogeneity

ty is at its best when all the areas are filled, but there is always a "back up" person in the team who is able to perform the duties required in another competence area at an average level, at minimum. You can analyse the heterogeneity of your own group and know-how using the tool above. Instructions on how to use the tool are available at [etu-la.fi/successmatrix](http://etu-la.fi/successmatrix).

Exaggerating or falsifying your abilities easily leads to the curtailment of investment discussions at the DD stage. A company's own awareness of insufficient know-how and its recruiting needs gives the investor a positive image that the company is sufficiently mature to implement the business idea. A person needed to fill a specific key position may be found through an angel's networks and this may positively influence the investment decision – trust between the individuals already exists.

One task to be addressed in the early stage of a company is the setting up of an advisory board or a board of directors. Some of the best advisers are individuals who have a restless and sceptical mind, the courage to express themselves, a forward-looking perspective, the ability to question and inspire and the willingness to commit (Dayton 1984). Before accepting a person on a company's advisory board, you must make absolutely sure that he or she has agreed and is committed to working on the board.

## Market opportunity 20–40%

Market opportunity describes a company's potential for growth and significant increase in value, which is one of the investor's key requirements.

*"When you focus on problems, you'll have more problems. When you focus on possibilities, you'll have more opportunities."*

*- Anonymous*

Market opportunity can be divided into five areas: market size, market niche, turnover potential in five years, the competition situation and momentum.



**Market size** provides the best insight into a company's theoretical growth potential. Market size can be estimated by means of three segments: total market, applicable market and target market. (Figure 4) The size of the total market must be big enough to enable a 1–5% market share to provide the prerequisites to obtain significant turnover. The applicable market provides prospects for the medium term and the total market for the long term, You should not attempt to present a market share exceeding 50%, as this is seldom credible. The majority of companies never exceed a 10% market share.

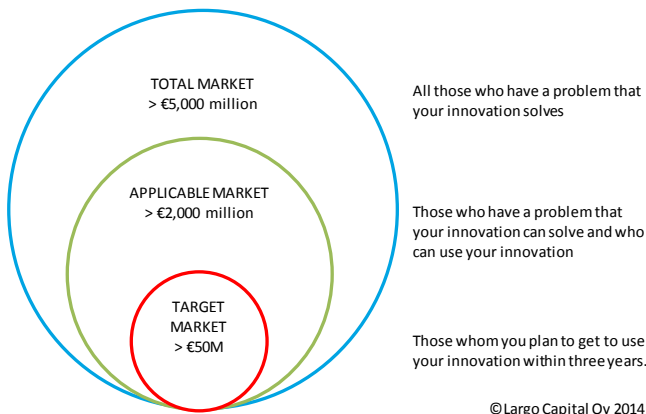


Figure 6. Sizes and definitions of various types of markets

A **market niche** opens up potential growth for a company. Sometimes even large markets lack a market niche on account of legislation or other sectoral "regulations" (e.g. Finland's railway transport – operators are needed but the access to the market is prevented).

The **competition situation** reflects the degree of fragmentation of current and future markets and barriers to entering a sector. The less competition there is in a sector and the more fragmented it is, the more attractive the situation is.

**Turnover potential in five years** assists in understanding sales, strategy and the operating model. In other words, a company must give some thought as to whether its "overall package" is ready from a market point of view to operate in a growth market.

**Momentum** or Market Traction determines the moment a company is on the move. Sometimes even a good idea fails to produce results if the time is wrong (compare Navigators: Benefon ESC 10 years too early vs. Nokia at the right time). Determining momentum and market traction is one of the most difficult things for an investor, as the aim of the company may be to break down existing operating models that are based on people's accustomed models of behaviour.

## Competitive advantage in market 10–20%

Whereas market opportunities approach anticipated success through the market and its dynamics, competitive advantage is based on a company's internal factors. What is a better indication of a company's ability to function in the market than those companies that are already there?

*"A startup is an organization formed to search for a repeatable and scalable business model."*

*- Steve Blank 2010*

A market competitive advantage can be divided into IPR protection, traceability of the solution, sales channels, operating model and earnings model.



**IPR protection** provides, especially in technology-based innovations, a competitive advantage if the protection has been carried out correctly. A patent in itself does not necessarily have any value simply because it exists. A country-specific patent or a trademark alone does not have any value to speak of either. Frequently, a confirmed freedom to operate is sufficient to show that the entrepreneur has familiarised him- or herself with IPR issues and at least does not infringe the patents of others. It should also be taken into account that names and domains may constitute an essential part of a company's IPR property. Simple IPR test is located at: [tuotevayla.fi/en/inventors-tools/ipr](https://tuotevayla.fi/en/inventors-tools/ipr)

In many cases, it is not possible to protect a product with patents or design rights (e.g. services); instead successful realisation of a unit is based on small details and solutions that a company has been able to execute more effectively than competitors. This is called **traceability of the solution**. In other words, although other actors see from the outside what a company is doing, it is difficult to imitate the achievement and the company in question retains its competitive advantage (e.g. Coca-Cola).

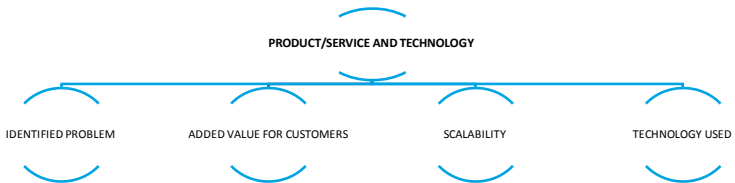
**Sales channels** and related agreements in particular (key distribution channels, waiting periods, exclusive rights, etc.) can create a considerable competitive advantage. Likewise an exceptional **operating or earnings model** can strip away the traditional ground rules in a sector to the extent that it forces other actors to withdraw in fear of losses.

## Product/service and technology 30–40%

The product or service and technology section examines the issues of identifying customers' problems, added value provided to customers, the scalability of a product/service and technology used.

*"If I had asked people what they wanted, they would have said faster horses."*

*- Henry Ford*



The most important aspect in analysing a product or service is to understand **which problem** it solves for the market/customer. In identifying a problem, it is important to know whether a customer must have the problem solved or whether the customer just thinks it would be nice if it was solved. In addition to defining the problem, it is just as important to understand what constitutes **added value provided to customers** (costs are halved, sales increase by 20%, time is saved by 30%). Occasionally, added value for customers consists of the unique properties of the product.

The **scalability** of a product or service is a basic prerequisite. A good test on scaling can be done by considering, for example, a potential order placed with a company: if an order for 100, 1,000, 10,000 or one million items were to be placed tomorrow, how long would the delivery take and where would potential bottlenecks form in the production chain?

An essential aspect to identify is the **stage of the technology**. The earlier the stage at which a product or technology is, the higher will be



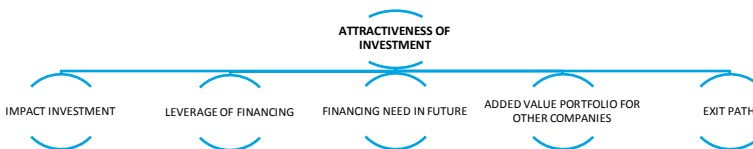
the costs incurred before it can be brought onto the market. As new technology products comprise a significant risk, the added value received by customers must be greater than the value of other products on the market. In the case of product or technology-based companies, it is therefore not enough that the technology is new if the solution is only slightly cheaper, better and more comprehensive than competing alternatives on the market. The difference must be significant.

## Attractiveness of investment 10–20%

The attractiveness of an investment (What can I achieve by investing in this company?) comprises five areas: impact investment, leverage of financing, financing need in the future, added value portfolio for other companies and exit potential.

*"The four most dangerous words in investing are: 'this time it's different.'"*

*- Sir John Templeton*



**Impact investment** is a key decision-making criterion for a surprisingly large number of investors in an investment situation. Even though a company might be excellent otherwise but does not, for example, help the community, make the world more ecological or increase well-being, an investment deal might not necessarily be made. There is a simple explanation for the above, which has already been pointed out previously: business angels are primarily motivated by factors other than money.

**Leverage of financing** means a situation where the entrepreneurial team has already prepared other forms of funding, in which case the equity provided by an investor constitutes only part of the total funding required.

**Follow-on financing need/capital intensity** raises a number of questions for investors. The first question concerns resources: the stage at which it is necessary to commit key persons to the process of seeking a new round of financing. Another question is the holding of an investor in potential dilution: the amount by which a holding changes. The third question concerns the terms brought by new investors: the terms under which the next investment will be obtained. The further a company gets with the funding being sought and the lower the needs for follow-on financing, the better and more attractive the investment is in the eyes of a business angel.

For some investors, the **added value portfolio for other companies** is even a prerequisite. It is easier to keep up with development and manage a group of companies whose activities support each other, rather than rush off in every direction. In an optimum situation, the new investment can purchase products or services from other portfolio companies or vice versa. It is therefore good to know the investor's background.

For the investor, the **exit potential** is the alpha and omega of all activities. It is only when exiting a company that investors receive their reward (or liquidate losses) for the risks borne by them. If an investment target does not have an exit potential on the horizon (also for the next investor), an investment will not be made. Occasionally, so-called cash machine investments are made whose sole purpose is to generate a steady cash flow for the investor, without exit goals.

## Current situation/achievements 0–20%

Excessive planning does not work in a startup company; instead actions must be allowed to "speak". Current situation and achievements describe the moment in time which a company is currently going through. Have results been achieved, do the customers believe in the product as much as an entrepreneurial team and is the company moving forward or has it already been marking time for a year?

*"The pain you feel today will be the strength you feel tomorrow.  
For every challenge encountered there is opportunity for growth."*

*- Ritu Ghatourey*

The current situation and achievements of a company can be analysed in terms of marketing, sales, product readiness level, agreements and cash.



The results of **marketing** are assessed in accordance with the degree of recognition the company has achieved a) generally and b) in the target market in which company operates. The quality and amount of marketing and communication material as well as newspaper articles also serve as an indication of the results achieved in marketing.

The results of future **sales** are indicated by the company's a) tender book and b) order book and history, and c) turnover. The value of the tender book and order book as well as the contagion rate are the most important aspects, as they indicate the future prospects of the company. Paying and satisfied customers and growth in customer numbers are the best indication that the business idea and product work. It is for this reasons that sales work must be started at as early a stage as possi-

ble (well before the product itself is even ready). The selected' business ideas only work with the right customers.

The **product's level of readiness** predicts the necessary time required and resulting costs: how long will it take before the product is ready to be sold and what it will cost. It is self-evident that a finished product is better than a plan and that a piloted product is better than one that is only finished. If a company has a finished product but lacks sales, thought needs to be devoted to considering where things went wrong. Does the product actually solve the market's problem and bring added value to customers or is this simply the manufacturers' imagination. If this is the case, should the team be strengthened?

**Contract management** is frequently neglected in startups. Well drafted agreement, however, are the best indication that the company has committed partners, employees and customers. So committed that they are ready to put things on paper and sign their name to it. There is no point in trying to persuade investors with oral agreements – it will not work.

**The cash situation** increases understanding of a company's condition. Is the company a) on the brink of bankruptcy or b) is investment needed to get over the valley of death/a crisis or c) is investment being sought to expedite more aggressive growth? On the other hand, it also gives an indirect message regarding the condition of the company's processes and whether the company is able run profitable business operations not only in the plans on paper but in the real world.



# 4

## **Typical terms and conditions of investments (Shareholder Agreement)**

## Backbone and binding on all parties

Almost without exception, when an investor becomes involved in a company a shareholder agreement is drafted. A shareholder agreement is a long-term co-operation agreement that is binding on the parties involved – it is the support structure and basis of the entire collaboration. Every investment is unique and therefore there is no such thing as a universal, comprehensive shareholder agreement. It should be taken into account, however, that a shareholder agreement must NOT conflict with the laws on limited liability companies, employment, tax or competition. In the event of any conflict, it is the law that is complied with – not the agreement.

Issues which should be part of a company's articles of association, but which the parties wish to remain confidential, may also be agreed on in a share agreement – unlike a share agreement, articles of association are a public document. A shareholder agreement usually applies to the shareholders and the company. Articles of association are also always binding on others besides the contracting parties. For example, a redemption clause in the articles of association is also binding on the heirs of a former shareholder, whereas an order of redemption agreed in the shareholder agreement is binding only on the signatories to the shareholder agreement. A shareholder agreement can, nevertheless, be expanded to apply also to external members (e.g. a party granting a capital loan), but only in a limited way. An example of a shareholder agreement can be found at [seriesseed.fi](http://seriesseed.fi) or at: [eban.org/about/member-area/](http://eban.org/about/member-area/)

## Entrepreneurial assurances or guarantees

Entrepreneurs are often required to provide assurances or guarantees in the agreement documents of the accuracy of information.

It is difficult, if not impossible, in practice, to rescind an investment decision, the responsibility arising for providing adequate information

to the company's shareholders and management. In this context, a sanction clause may be included in the shareholder agreement specifying a penalty and a rectification period during which a shareholder has the opportunity to rectify or compensate loss or damage incurred. Sanctions included in entrepreneurial assurances or guarantees are more preventive than anything else. Their main aim is to encourage entrepreneurs to inform investors also about any risks associated with the company.

## **Intellectual property rights (IPR) and know-how**

At the latest in connection with signing the shareholder agreement, partners undertake to transfer to the company their know-how and intellectual property rights pertaining to the company's sector (including transfer deeds), without separate compensation, and to attest that they have not retained any intellectual property rights pertaining to the company's sector.

The shareholder agreement also specifies that should any material, such as trademarks, patents, utility models, receiving copyright protection or other intellectual property rights arise later on in the company's business, all such rights shall belong to the company, even if they had arisen as a result of the shareholders' activities.

Endeavours are made to protect the intellectual property rights of the company in general in the best way possible, but at a moderate cost, also in respect of employees and other co-operation partner. Statutory compensation for inventions made during an employment relationship are always paid to an employee in an employment relationship.



## Partner obligation to work (key man) and exiting a company (good leaver/bad leaver)

Partners usually undertake to work full-time for the company and to seek the consent of the investors if they wish to engage in some other business besides working for the company. The roles of each partner are typically specified in a shareholder agreement.

The employment and termination of employment of a partner is usually agreed by means of good leaver and bad leaver clauses. A partner leaving the company is leaving for a good reason (good leaver) if

- a) the death of the partner's spouse, child or close family member or long-term illness prevents the partner from carrying out his or her obligations in accordance with the employment or service contract;
- b) the employment or service agreement of the partner is terminated or cancelled on any other grounds other than under the Employment Contracts Act;
- c) the partner terminates or cancels his or her employment or service contract under circumstances where an employee is entitled to terminate an employment or service contract for employer-related reasons under the Employment Contracts Act.

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<b>Good leaver</b>	Leaves the company for an acceptable reason (Employment Contracts Act, serious illness, etc.)
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<b>Bad leaver</b>	Leaves the company for any other reason ("not interested" attitude).
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A bad leaver has to sell his or her share usually at the purchase price or at a mathematical value, depending on which is lower, and a good leaver at the market rate or the subscription price, depending on which is

higher. The obligation to work and selling commitments are usually tied to a vesting clause.

## Vesting clause

Vesting refers to a condition by which investors bind entrepreneurs to work for the company in the manner the investors wish. This usually means that the number of "free shares" of the entrepreneurs grows either 1) within a specific time and/or 2) on the basis of specific achievements. A table could look as follows:

Time	or Target/ achievement	Free shares
6 months from investment	Prototype ready	20%
12 months from investment	First delivery	40%
24 months from investment	Cash flow in > cash flow out	75%
30 months	Turnover over EUR 1 million	100%

Free shares refer to those shares which entrepreneurs do not need to relinquish should they have to (voluntarily or involuntarily) discontinue day-to-day work for the company. Vesting arrangements secure primarily the company's possibilities to continue operations, as the shares of a shareholder who has exited can be transferred to a potential successor or to other shareholders who want to continue to fully participate in taking the company forward.

## **Non-competition**

Non-competition applies in general to all key personnel. Before drafting a non-competition clause, it is frequently necessary to go through the key personnel's contacts and commitments so that they can, as needed, be included in the shareholder agreement. Shareholder non-competition typically continues for two years after the termination of the agreement (bad leaver) and ends immediately in the case of an acceptable reason for leaving (good leaver).

With regard to non-competition of investors, the only acceptable condition is that an investor may not sit on the board of directors of a competing company. Non-competition clauses restricting the investments or other activities of an investor should not even be suggested – these will not be accepted.

## **Tag-along right, drag-along obligation and anti-lockout clause**

A tag-along right means that if one of the other shareholders sells shares to a third party, the other shareholders have the right to sell the same share of their holding as the original seller. A drag-along obligation, on the other hand, obliges (e.g. founder shareholders) to sell their holding to a third party if an investor has made decisions to sell and the buyer requires this. The aim of the clause is, above all, to secure a business angel's possibilities to withdraw from his or her investment in an industrial exit, in other words, by selling the shares to an industrial buyer. In practice, however, there are limits to invoking the clause, as an industrial buyer often wants to acquire, besides the company's know-how or technology, the management as well.

Other conditions (time interval, turnover, etc.) may also be agreed for a tag-along provision on the basis of which they are valid.

The aim of an anti-lockout clause is to provide the founder shareholders in an acquisition situation with an opportunity to purchase all the shares for themselves under the same terms and conditions as a third party would have purchased them if the founder shareholders do not want to relinquish their holding.

Frequently, a **redemption clause**, which is more detailed and stringent than articles of association, is specified for shareholders. This ensures that the company's shares do not end up in the hands of undesirable persons or investors. Occasionally, a provision securing the exit of investors too (compulsory purchases of investors' shares) is specified. It is triggered if someone purchases alone or together with fellow investors over half the company's shares and thus obtains control of the company.

## **Additional financing needs and other subsequent registration rights (warrants)**

Frequently, investors do not commit themselves to subsequent additional rounds but wish to have the right under a special clause to participate in new rounds in addition to ordinary shareholder rights. In some cases it is possible to agree on, for example, the right of current investors to participate in the next round with a pre-agreed valuation or with their desired share before other investors. There are numerous different variations.

## **New shareholders (partners or investors)**

A separate clause on the inclusion of new shareholders and terms and conditions thereof is often written into a shareholder agreement, as the inclusion of new shareholders always dilutes the holding of previous owners (i.e. the holding of the old owners decreases by same order of magnitude as the percentage of shares given to the new shareholders).

**EXAMPLE**

Shares held by  
founders 70 (70%)  
investors 30 (30%)

The subscription price has been (à €10), in which case the company's premoney is €700.

Two new shareholders join the company and a share issue is implemented at 5 shares per shareholder. On account of mechanical hedging, the investor is given additional shares too.

Founders: 70 (61%)

Investors 1: 33 (30%)

New sh one: 5 (4.5%)

New sh two: 5 (4.5%)

*continues...*

In some cases it is possible to agree on so-called anti-dilution protection, whereby one or a number of investors for legitimate reasons do not lose their holdings during future rounds.

## Anti-dilution protection

Anti-dilution protection means that an investor desires compensation for an investment made in the event that in a follow-on round the company's valuation is lower than in the round in which the investors themselves joined the company. Protection is thus employed to secure against reckless promises of entrepreneurs and excessively high valuation demands.

**Mechanical anti-dilution protection** refers to a contractual term whereby the company commits to issuing an investor new shares, without additional investments, so that the investor in question retains his or her holding. For example, in such a way that ordinary share stocks for personnel do not decrease the holding of investors.

**Price-based anti-dilution protection** refers to contractual terms whereby it is agreed to adjust share-specific pricing on the basis of later events. There are three main types of price-based protections:

**Full ratchet anti-dilution protection** refers to determination of the ownership structure of company retrospectively according to the valuation if it is lower than the current round. A full ratchet condition is harsh for a entrepreneur team if they do not achieve the targets they have promised investors and they are forced (e.g. owing to a cash crisis) to seek new share deposits. When the clause is triggered, the investor

gains a larger holding in the company than agreed with the original investment.

**Broad-based weighted average anti-dilution protection** is similar to the full ratchet mechanism, but here the ownership structure is decided retrospectively using a formula which also takes into account the size of the next round and not just the valuation. Compared to full ratchet protection, this method provides the founder shareholders with better protection against changes in ownership structure. An example of the formula is shown below

$$NCP = OCP + \left( \frac{SOB + NS \times NSP}{OCP} \right) \div SOA$$

**Narrow-based weighted average anti-dilution protection** works in the same way as the above, but only specified share classes, instead of all share classes, options and convertible bond loans, are used in calculation.

Anti-dilution protection also usually covers exceptional situations, where it is not complied with. These situations are typically

- incentive shares and options issued for key personnel in the company or strategic partners
- equity-linked instruments used in corporate restructuring (purchases with own shares) and in joint ventures.

...continues

The valuation of a company in the first round has been excessively high and the second round is executed with a €400 premoney valuation, additional financing need standing at €100.

In full-ratchet protection, the ownership structure changes with the valuation. An investor obtains a share at the price of €4 instead of €10 (conversion ratio 1: 2.5) so that  
 Founders: 70 (**41%**)  
 Investors 1: 75 (**44%**)  
 Investors 2: 25 (15%)

The board-based conversion ratio is only 1:1.55, as the next round is small. The subscription price changes from €10 to €6.47.

Founders: 70 (**49%**)  
 Investors 1: 47 (**33%**)  
 Investors 2: 25 (18%)

The narrow-based formula works in the same way as the broad-based formula.

## Liquidation preference

### EXAMPLE

Shares held by founders have 70 (70%) ordinary shares and investors have 30 (30%) preference shares

The subscription price for founders has been €1 per share and for investors €10 per share, in which case the company's premoney is €700.

A buyer offers a) €500 and b) €4,000 for all the company's shares. Investment **a** brings a loss for the investor and **b** a profit

#### Without preferences

	A	B
<b>Investor</b>	150	1,200
<b>Founders</b>	350	2,800

#### Straight

	A	B
<b>Investor</b>	300	1,200
<b>Founders</b>	200	2,800

Liquidity preference means the asymmetrical distribution of the purchase price in favour of the investor, ensuring through this that the company's founders or management are unable to benefit from the company financially should it not be possible to realise the company's value appreciation potential. The clause thus protects the investor in a manner similar to anti-dilution protection against reckless promises of entrepreneurs and excessively high valuation demands.

Situations in which a liquidation preference is applied are listed frequently. These are, for example, mergers, divestments, reorganisation of operations, bankruptcy or a situation in which over 50% of the shares or IRP change hands. A liquidation preference is sometimes arranged through two different series of shares from which preferential entitlement to a share in the profits is given to the other of these in some ratio if the company's assets are (see preference share, page 58).

Under a **straight liquidation preference structure** investors can sell their holding if the company's value has fallen below the valuation at the time of the investment, and receive funds up to

the amount to the amount invested in full themselves.

A **participating preference** entitles an investor to the return of the entire amount he or she invested and a specified share of surplus assets. Distribution of the surplus share can be full or capped. In a full structure, the investor is entitled to receive a pro rata share in the profits and in a capped structure to a given amount (generally 2–10X invested amount), after which the remainder is distributed to the other shareholders in proportion to their holding.

A **capped participation liquidation preference** is a variation of the previous structure. When the investors' capital has been returned, the remaining profit is distributed first in proportion to the holding of preference shares to a given amount (usually 2–10X invested amount) and only afterwards in proportion to the holding of ordinary shares (founders).

A **senior liquidation preference** is based on two different series of shares in which preferential entitlement to a share in the profits is given first to the other (X euros) and only the surplus is given to the other share series. This solution is generally used in so-called bridge financing when rapid temporary funding is needed between investment rounds.

...continues

Full PP

- a)  $300 + 30\% * (500 - 300)$
- b)  $300 + 30\% * (4,000 - 300)$

	A	B
<b>Investor</b>	360	1,410
<b>Founders</b>	140	2,590

Capped 3X PP

- a)  $500 < 3 * 300$
- b)  $3 * 300$  (capped) vs. 1,410

	A	B
<b>Investor</b>	500	900
<b>Founders</b>	0	3,100

Preference, full 4X

- a)  $500 < 300 + 4 * 300$
- b)  $300 + 1,200$  (4X)

	A	B
<b>Investor</b>	500	1,500
<b>Founders</b>	0	2,500

Senior, full €2,000

- a)  $300 + 200$
- b)  $300 + 2,000$

	A	B
<b>Investor</b>	500	2,300
<b>Founders</b>	0	1,700



A **multiple liquidation preference** functions in the same way as a basic liquidation preference, but the original subscription price has a multiplier (usually 1.5–5). In some cases a combination of seniority and this structure may be used.

In theory, the company's management and the founder shareholders should be entitled to the assets, as they are responsible for the company's increase in value. On the other hand, however, the investor has borne the financial risk of success and the founder shareholders have gained the assets invested in the company as remuneration and bonus arrangements by working in the company.

## **Other special rights of investors (covenants)**

At the time of the investment an investor wants to ensure, above all, that the money invested is used in accordance with the wishes of the investor to develop the company and increase shareholder value. For this reason the investor typically proposes in connection with the negotiations a shareholder agreement in which special conditions are agreed on for the protection of the investor.

The number of the members of the board of directors and definitions of who is entitled to appoint members are essential parts of the agreement.

## **Right to information**

Investors generally have extensive information rights. It is expected that an investor will be on the board of directors, even though he or she would not actually participate in the work of the board.

## **Breach of contract/contractual penalty**

The willingness of all the parties to comply with the provisions of the agreement is secured through a contractual penalty. The amount of the contractual penalty usually varies between 20,000 and 200,000 euros for each breach, and it is usually paid to the shareholders whose rights have been infringed or, if required by all the relevant parties, to the company. The infringing party usually has the right to redeem his or her shares in accordance with the bad leaver clause immediately, without vesting terms.

## **Withdrawal and exit**

When a positive investment decision reaches a company, the entrepreneur should realise that the company is growing towards success together with the investors, not for the investors.

Between three and seven years is the span usually determined for an investment, but occasionally the investment time approaches as much as 10 years. For the entire period of the investment the investor strives to boost the value of the target company and thus achieve an increase in his or her investment. Numerous different factors, however, influence the success of the target company during the investment period.

A successful exit process is started already in conjunction with making the investment decision. The company is exited in one of the following ways:

- **Divestment** The investor sells his or holding to the next investor, the new management (MBI) or a company (industrial exit).
- **Repurchase:** The entrepreneur, the company itself or the company's management (MBO) buys back the business angel's shareholding.
- **Repayment of loan:** When a capital loan is used, the company repays the debt with interest to the investor.

- **Refinancing:** The new investor purchases the shareholding of the original investor. The new owner can be, for example a venture capitalist or another angel, who has specialised in financing the company's next development stage.
- **Listing:** The company is listed on a stock exchange – not very common.

In the event of an unsuccessful exit, the company is wound up or it applies for/an application is filed for bankruptcy proceedings.

The shareholder agreement usually specifies various conditions in respect of exiting: how and under what time scale exiting takes place and how to proceed if exiting does not go as planned.

# 5

## **Implementation of investment – technique**

## **An investment can be implemented in various ways**

The capital of a limited company is divided into two main groups: equity and liabilities. A monetary investment made by a business angel is usually equity-based or a combination of the characteristics of equity and liabilities, so-called mezzanine financing.

In sweat equity-type investments, an investment can be executed either in advance, as in monetary investments, or retroactively, for example, through option rights.

### **Equity: Shares**

Shares can be transferred to an investor in three ways: when a company is formed, in a directed share issue or when purchasing them from founder shareholders. The most typical method is a directed share issue in which the company offers new shares to investors and the invested amount is recognised in the company's equity and the money becomes available for the company's use.

Purchases from shareholders are less common, as in that case the money is transferred to the shareholder(s), from whom the shares have been purchased, in person. The model may, however, be used in situations where there is a desire to change the ownership structure of founder shareholders.

Occasionally, share arrangements (and also option arrangements) may include different series of shares, which in their basic form are "ordinary shares" and "preference shares" as well as related conversion rights. A convertible (right to convert to an ordinary share) share usually provides an investor with the best protection against failure. This is because a preferential right can be linked to the structure, either through redemption, repayment or a liquidation preference clause.

Conversion options may, in a worst-case scenario, alter a company's ownership structure in the follow way:

	Holding before	Holding after conversion
<b>Founders</b>	60%	10%
<b>Investor</b>	40%	90%

The conversion price can be determined either in advance as fixed or as based on certain terms, and the conversion may be automatic and/or voluntary.

## Equity: Option arrangements

An option constitutes the right to subscribe new shares of the company, provided that the terms of the option right are fulfilled. Options are not usually an actual investment instrument, but they may be used as a part of the investment, especially if a business angel invests sweat equity or networks. Options can in that case be linked to the achievement of targets proposed to the investor. If the targets are achieved, the options, too, will be realised.

Option rights are also used to encourage and establish a sense of commitment in the personnel and occasionally to secure the holdings of certain shares (anti-dilution).

## Capital loan

A capital loan is a special type of loan. As distinct from an ordinary loan, a capital loan is recognised on a company's balance sheet as an

item which accumulates equity, and to which exceptional terms can be applied, for example, (Finnish legislation):

- 1) capital and interest may be paid in liquidation and bankruptcy of the company only with a preference which is lower-ranking than other debts;
- 2) the principal may be otherwise repaid and interest paid only in so far as the sum total of the unrestricted equity and all of the capital loans of the company at the time of payment exceed the loss on the balance sheet to be adopted for the latest financial period or the loss on the balance sheet from more recent financial statements; and
- 3) the company or a subsidiary shall not post security for the payment of the principal and interest.

In other respects, the terms of a capital loan may be agreed upon freely. As a capital loan has the lowest priority compared with other loans, its risk level is higher, therefore a higher interest rate is generally paid on it.

A capital loan provides investors with the opportunity to carry a company's risk without having any holding in company.

In its basic form, a capital loan is a long-term financing method.

## **Convertible bond loan**

A convertible bond loan is more flexible than a share arrangement and it is easier to exit. A convertible bond refers to a loan to which an option right has been attached. On the basis of the option right, the loan capital and the unpaid interest can be converted into a share investment if the loan is not repaid.

A number of conditions can be determined for repayment or conversion (e.g. the date of the next financing round, minimum size, turnover, result, etc.) on the basis of which the loan must be repaid or the right to enter as shares begins. The loan conversion ratio can be deter-

mined in advance or it can be linked to the company's performance, turnover, development of the company's value, or any other unambiguous figure that can be measured. For example, the conversion ratio to shares for a loan linked to turnover could be like this

$$\textit{The subscription price per share} = \frac{\textit{Actual turnover} \times \textit{Default subscription price}}{\textit{The targeted turnover}}$$

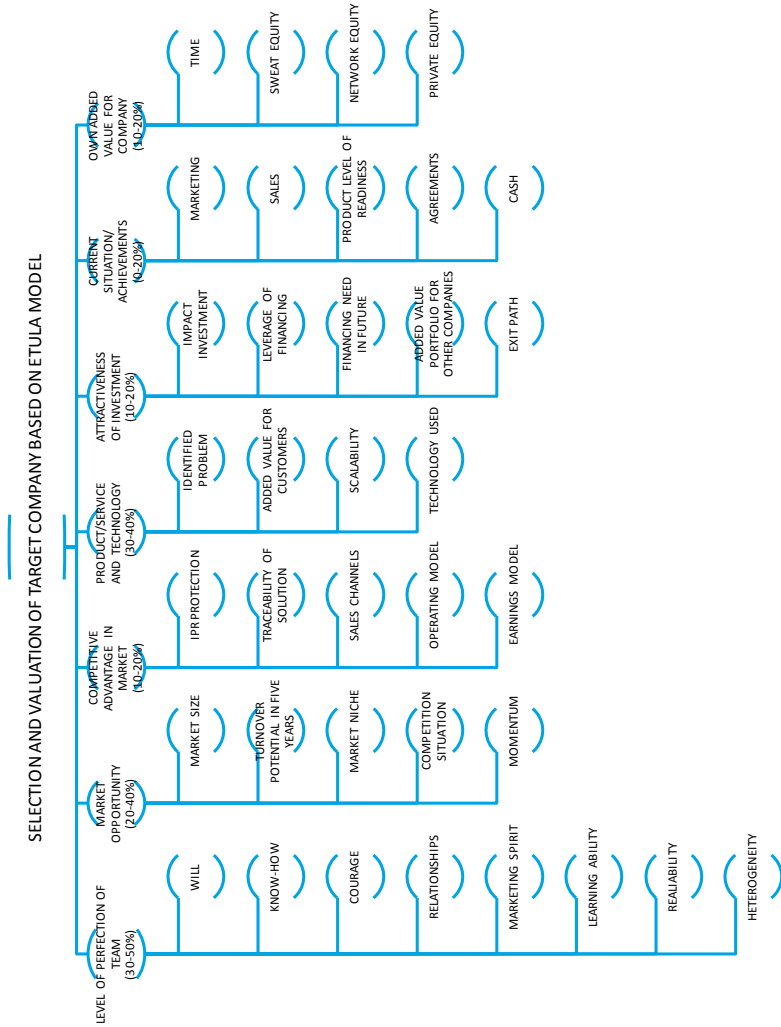
Upper and lower limits within which subscription prices must be are also typically determined for the conversion formula. The limits can be determined case by case anywhere, or they can be tied, for example, in accordance with the valuation of the previous and/or next financing round.

A convertible bond loan usually includes a fixed interest rate, which the company amortises regularly. Interest on the loan can be a part of the aggregate, which can be converted into the company's shares. The loan can be (and often is) at the same time a capital loan (see previous paragraph).

The party granting the loan is not entitled, in the manner of shareholders, to participate in decision-making in general meetings of shareholders, therefore the parties granting the loan may require amendments to the shareholder agreement or the articles of association. Special terms of the bond may contain different points in relation to this, in which case they will be guaranteed special rights as though they were shareholders in the company. A convertible bond is frequently used with a directed share issue when subscribers are minority shareholders.



# APPENDIX 1. Selection of target company in accordance with the Etula model.



(Based on approximately 200 International studies)



**SAMI ETULA** (@samietula) has served for over 10 years in various specialist, training and company board duties. He has acted as a sounding board for hundreds of companies and has served on the judging panel of numerous growth company competitions. Sami is currently a **portfolio entrepreneur, sweat equity investor** and **active member of FiBAN**.

**FiBAN** (@fiban\_org) is a Finnish, national, non-profit business angel network that aims to improve the possibilities for private persons to invest in potential growth companies. FiBAN has almost 600 members and currently one of the largest business angel networks in the world.

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**SWEAT, NETWORKS, EQUITY –**  
**Guide to Finding an Angel Investment** is aimed especially at you, who are wondering where and how to find business angel investment.

The Guide will provide you with information on:

- › How a business angel thinks and what motivates him or her?
- › What, how and under what terms do angels invest?
- › What issues in your company need to be in order before you apply?
- › What do business angels check in a company?
- › How do I determine the valuation of my company?
- › How is a pitch made?

Everything that you need in order to apply for angel investment.