Becoming a better angel investor

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In the classic movie "It's a Wonderful Life," the angel Clarence advances in the heavenly hierarchy by helping the despondent George Bailey on earth. In the business world, angel investors also "earn their wings" by helping others. Angel investors are high-net-worth individuals who invest their own money and become personally involved in helping fledgling companies get started. Private investors become better angels by developing specific skills, learning from others and gaining real-world experience.

Investing in unproven, early-stage companies can be extremely risky. What should new angel investors know when considering business opportunities to finance? What are some of the pitfalls to avoid? Experts from three Seattle-based organizations-the Alliance of Angels, Northwest Capital Network and Investorship Training-share their insights here.

Understand accreditation.

When seeking angel funding, most entrepreneurs want to do business only with accredited investors, to make it easier to comply with Washington State securities laws. Accredited angel investors must meet one of several criteria. They must have a net worth of at least $1 million. Or, they can have an annual income of $200,000 if filing singly or $300,000 if filing jointly for two years. Accredited investors also can represent an organization with assets of more than $5 million, or represent an entity in which all the equity owners are accredited investors. People with these kinds of resources are expected to be in the best position to bear the financial consequences of their actions.

Be willing to accept risks.

Angels invest in the early stage when a company's future is highly uncertain. With this higher risk comes a strong equity position with potentially lucrative returns if the company strikes it rich one day. Still, experienced angels say that out of every ten new companies in which they invest, only one may emerge as a clear winner. Five will likely fail, and the rest will probably return about the same amount of money originally invested. To reduce risk, experienced angels typically invest from five to fifteen percent of their net worth in ten or so early-stage ventures at a time. "This means being willing to invest a large enough total amount to minimize the risk of any single investment," said Paul Heys, president of Investorship Training. At the Alliance of Angels, entrepreneurs typically seek initial investments ranging from $500,000 to $3 million for each business venture, with the typical angel investing $50,000.

Know what's motivating you.

Unlike other investors, angels often are driven by the desire to take an active role in the businesses in which they become involved. "This is one of the perks, that you help guide and direct the company," said Steven Loyd, Northwest Capital Network chairman and president of Loyd and Co. investment bank. But if your need to exert power is the underlying motivation, it can get you and the company into trouble, added Heys. "If you like being in charge, but lack critical business skills such as business valuation, you are better off doing something that's less financially risky," he said.

Know how to evaluate opportunities.

Experienced angels emphasize the need for a thorough, careful due diligence process when evaluating a potential deal. "Look at the risks involved with the management team, the market, manufacturing and the ability to raise additional capital later," Loyd said. It is not uncommon for angels to check out 100 opportunities before choosing one. The quality of the management team is the most important factor, angels agree. Look at the leaders' prior successes in launching new ventures. Startup companies are notoriously unforgiving places for on-the-job training. "Standardized tests can profile the management team to see how likely they are to work well together and reveal potential weaknesses," Loyd said.

Know how to help startups.

Angels should invest in industries that they understand, to add value. Once involved, plan carefully for your exit strategy, Loyd advised. "This means preparing the company for its next round of financing, such as venture capital, an acquisition or an initial public offering," he said. "Make sure all the pieces are in place to attract the next level of investors, including developing an intellectual property fortress and a management team with influential industry and financial connections."

Learn from others.

As a new angel, it is best to invest in deals with ten to fifteen other angels, experts say. Volunteering to serve on a startup company's board with other angels is a good way to learn from more experienced investors. "Understand the business side of the industry in which you're considering investing," Heys recommended. "Angels need the same skills as entrepreneurs," he added. He advises taking advantage of local and regional entrepreneurial education programs. Another way to learn from others is to join regional investor organizations and attend their events.