10 BEST PRACTICES TO GET STARTED INVESTING IN STARTUPS

What is Startup Investing?

Startup investing goes by many names. Below are just a few that I've heard often enough:

- angel investing
- early-stage investing
- private company investing
- private offering investing

I'm sure there are still other ways that people refer to it. But everything that I talk or write about refers to investing in early-stage companies (or startups) for people who qualify as accredited investors in the U.S.

So, first of all, to get started in startup investing, you have to figure out whether you qualify as an accredited investor or not.

Accredited Investor Definition

Currently in the U.S., to be qualified as an accredited investor a person must:

- earn income over $200,000 (or $300,000 together with a spouse) in each of the prior two years and reasonably expect to earn the same in the current year OR
- have a net worth over $1 million, either alone or together with a spouse, excluding the value of his or her primary residence.

You can get more detailed information directly form the horse's mouth (oops, the SEC) HERE (http://www.investor.gov/news-alerts/investor-bulletins/investor-bulletin-accredited-investors).

Whether you qualify under the current definition or not, don't get too comfortable or too disappointed. In December of 2015, the SEC staff issued a recommendation to update the accredited investor definition.

If you qualify as an accredited investor now, but are on the lower end of the spectrum for income or net worth requirements, the recommendation is to limit how much money you can invest in startups to 10% of your prior year's income. To be able to invest unlimited amounts in startups, you would have to have over $500,000 annual income or $2.5 million net worth ($750,000 / $2.5 million joint with a spouse). A big bummer is that the proposal requires these thresholds to be indexed annually to inflation, so they would rise each year.

In the good news, the proposed revisions will allow sophisticated investors to count as accredited, regardless of income or net worth. These sophisticated investors will include anybody who passed the Series 7, 65, or 82 exams; anybody who made over 10 private investments; and a couple of other suggestions. But the 10-private-investments qualification is the most exciting because it does not require for these 10 investments to be made with your own money. So, if a person participates in an angel group and actively engages in the process of investment (like screening, due diligence, terms reviews) in 10 deals, then that person would be considered as accredited investor.

Remember that these are the recommendations and are not currently the law. I will keep you posted on any updates to the definition of accredited investor via my email list (thanks for subscribing). Meanwhile, you can read more on the SEC recommended updates HERE (http://www.angelcapitalassociation.org/blog/sec-staff-recommends-updates-to-accredited-investor-definition)

Now that you know you qualify as an accredited investor (or most likely will once the SEC recommendations become the law), let's talk about best practices to get started in angel investing!

How Much Money Do You Need to Get Started?

So, the first four best practices deal with the subject of how much money you need to get started in startup investing. Please, please, please, read this through before jumping into action with the next section.

Best Practice #1: Create a budget

It's obvious from the accredited investor definition that you need to have a certain level of financial security before you can invest in startups. There are many opinions and rules of thumb out there that can help you figure out your startup investing budget.

I actually like the guideline from the proposed update to the accredited investor definition that you should invest no more than 10% of the amount you use to qualify as an accredited investor.

Example 1:
For example, if you're a single person with $250,000 annual income (over the last three years), then your max angel investing budget is $25,000 per year.

Example 2:
If you're a couple with a joint net worth of $1.5 million (excluding your primary residence), then your max angel investing budget is $150,000 total.

Remember that the 10% rule of thumb is just that—a rule of thumb and a starting point. You will need to adjust this starting number with the following guidelines in mind (most likely you'll adjust it down):

1. Only invest money that is left over after covering regular expenses and your personal emergency fund.
2. Only invest money that you can afford to lose.

Remember that you won't get rich off of your initial startup portfolio. Build your initial portfolio with the goal of building a history of picking successful startups. Once you get the confidence, you can invest larger amounts of money.

Best Practice #2: Determine your portfolio size

A lot has been written and spoken on the size of the startup portfolio. In fact, two of my podcasts guest shared a traditional (http://angelinvestingpodcast.com/011) and a contrarian (http://angelinvestingpodcast.com/012) view on the startup portfolio size.

Under the traditional approach, the minimum angel portfolio size that is most commonly recommended is 10 companies. The optimal startup portfolio size is around two dozen or 24-25 companies.

If you have less than 10 companies in your portfolio, you don't have enough diversification. Without proper diversification, you are likely to lose all or most of your money or to see very bleak returns.

Startup investing is known for its great returns of 26%-28% IRR (internal rate of return) for properly diversified portfolios. However, you should not build too large of a portfolio (30+ companies) or your winners would get watered down by too many losers.

So, for maximum returns, you should have an startup portfolio of 10 to 25 companies (24 seems to be almost ideal).

<u>Best Practice #3: Determine your timeframe to build a portfolio</u>

For some reason, I've seen very little discussion on this particular topic. So, I'll be thorough.

One of the worst things you can do, as a new startup or angel investor is to get so excited that you invest all of your max budget in the first year. First, you'll run out of "dry powder" (more money to invest in the angel investing and VC world). Without dry powder, it's easy to lose interest in angel investing, and we (me and the startups out there that need funding) don't want that to happen.

Second, you will miss a chance to diversify your portfolio over time (not just over different companies). You know that the economy goes up and down in cycles. It is best to build your portfolio over several years, to make sure to catch the upward swing in the economy.

So, what should your timeframe be? If you look at the VC (venture capital) world, it is typical for a VC fund to make investments over a 5-year period. But you have to remember that many VC funds invest for institutional investors (like pension funds or family offices) or very wealthy people. So, the timeframe is at a longer end of what angel investors can tolerate.

For startup investors, building your startup portfolio should take from 3 to 5 years. What happens at the end of these 3 to 5 years? Do you just walk away? Sit back and relax? You can … but you can also take any returns from your portfolio companies and reinvest the returns into new startups. The idea is that after the initial portfolio-build stage, you will continue maintaining a 25-company portfolio for an indefinite amount of time (until you get sick of it, I guess).

<u>Best Practice #4: Determine your investing frequency</u>

Use your desired portfolio size and timeframe to determine your investing frequency.

Example 1:
If you'd like to build a small portfolio of a dozen startups over the next 3 years, that gives you an investing frequency of one startup per quarter (12 startups in a portfolio divided by 3 years is 4 investments per year or once

per quarter).

Example 2:
If you'd like to build a large portfolio of 25 companies over the longer timeframe, like 5 years, your investing frequency would be 5 startups per year or one investment every 10 weeks or so.

Your investing frequency is more of a firm guideline than a rule set in stone. Often, your deal flow would ebb and flow; so you would have some months under a dry spell and some months with more startups to invest in than you have money for.

When you have an abundance of deals to choose from, it's easy to get carried away and invest because of the fear of missing out. This is when your pre-determined investing frequency should come to play and help maintain your investing cadence.

Don't invest from the fear of missing out on the next unicorn; but rather focus on building a quality portfolio.

Getting Involved with Others

Best Practice #5: Join an Angel Group

There are numerous organized and informal angel groups all over the country (and the word, too). Angel investing is best done as a team sport, especially in the beginning. You can learn a lot from being in a group of more experienced angel investors.

Local angel investing groups should be the first place to look. Just do an online search for your location and "angel group." I bet you'll find an organized angel group near you. To learn more about organized angel groups, check out Episode #2 of the Angel Investing Podcast (http://angelinvestingpodcast.com/002).

If you are not able to find an angel group near you, there are several organized angel groups, like Keiretsu Forum (http://angelinvestingpodcast.com/003), that operate in many locations via chapters or even online.

Best Practice #6: Work with Accelerators and Incubators

Startup accelerators and incubators are another great placer to get involved and learn as a new angel investor.

Y Combinator out of Silicon Valley spearheaded accelerator/incubator movements, and now you can find these organizations all over the country.

Here are several ways to get involved:

- Become a mentor. Many of the accelerators and incubators are in constant need of mentors to help startup founders prepare and practice their pitches, develop go-to-market strategies, and refine their business models.
- Attend demo days. Quite a few of the accelerators and incubators hold "demo days" where the startups demonstrate their companies to potential investors.
- Invest via a fund. Some accelerators and incubators operate a fund

from which they invest in the startups going through their training program. Such a fund can be open to accredited investors, like you and I. To learn more about one such accelerator fund, check out Episode #5 of the Angel Investing Podcast (http://angelinvestingpodcast.com/005)

By getting involved in accelerators and incubators in the ways described above, make sure you network and form connections with people who run the organization (and the fund, if they have it). Also, network and make friends with other investors that you get to meet.

Best Practice #7: Invest via Equity Crowdfunding Syndicates

Equity crowdfunding syndicates are a great way to get your feet wet in angel investing.

What I'm talking about here is a group of angel investors who pool their money together on a deal-by-deal basic to invest in startups via an online crowdfunding platform (like AngelList, Circle Up, or Healthfundr [http://angelinvestingpodcast.com/revolutionizing-the-healthcare-startup-industry-with-sean-schantzen-co-founder-of-healthfundr]).

Typically, each syndicate will have a lead (a person, group of people, or even an entity like a VC firm) who does a lot of the work (deal sourcing and screening, due diligence, negotiation of the terms of the deal, and post-investment relationships with the startup). The lead usually charges a carry or carried interest, which is a share of the profits (if the investment is successful at some future time).

Unlike many VC funds that charge a carry AND a management fee, equity crowdfunding syndicates typically do not charge ongoing management fees (some do charge setup fees though).

Many equity crowdfunding syndicates allow investments of as little as $1,000 per deal. Though it is more typical for a minimum to be $2,500 or $5,000, depending on the online platform and the syndicate lead.

To learn more about syndicates, check out Episode #7 of the Angel Investing Podcast (http://angelinvestingpodcast.com/007).

General

Best Practice #8: Build and Maintain Your Investor Reputation

As you get involved in the world of angel investing and startups, you will start getting a reputation as an investor. One of the most valuable traits an angel investor can have is to be a VALUE-ADD investor.

You hear all the time founders and investors talking about smart money vs. dumb money. Well, investors who bring more than just the money to the table are the value-add investors. You want to be one of these!

The easiest way to build a reputation as a value-add investor is to help startup founders and other investors to expand their networks by making connections.

A huge part of my days is spent on the phone or in person meeting new people I've been referred to. And in turn, I spend a lot of time sending emails out introducing people I know to each other.

The biggest value you can add to a startup as an investor is to make connections.

To help you build your reputation, you should use online tools like LinkedIn and AngelList. If you have not yet, create and maintain profiles on these sites. Update your online profiles often to reflect any new investments and projects related to angel investing.

Best Practice #9: Focus on What You Know when You Start

Look at your background. What did you study in college? In graduate school? What are your hobbies and interest? Look for startups in those areas first because you will have expertise, experiences, and even a gut feeling to help you make decisions. Check out Episode #4 of the Angel Investing Podcast for an investor with a focus on healthcare (http://angelinvestingpodcast.com/innovating-the-care-in-the-healthcare-industry-with-dave-chase).

As you get a few angel deals under your belt, you might discover new areas of interest to invest in. Learn all you can about those new areas and expand your investing to include them!

Best Practice #10: Just Invest!

We can talk about angel investing until the cows come home, but the best way to learn is to just start investing.

I know it can be hard to try something new, like angel investing. That is why I am working on creating an online video course that will walk you through the entire process of angel investing in much more detail.

I will keep you posted on when the course becomes available. Meanwhile, if there are any specific topics related to angel investing that you want me to address in the course, send me an email to tat@angelinvestingpodcast.com

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