



## “Angel vs. Venture Capital Fund Investing”

Many accredited investors are interested in the high potential growth rates, breakthrough technologies and game-changing economics associated with emerging private companies. The question is, whether to invest directly in the equity of private companies as an Angel, or indirectly as an investor in a Venture Capital fund?

While Angels and VC funds often invest side-by-side in the same private companies, theoretically buying the same underlying asset, the dynamics of how they invest can differ radically; so the choice of investment vehicles is critical. Some of the key differences include: total amount of investment, due diligence required, degree of diversification achieved, terms governing the investment, and overall time commitment.

### 1. Amount of Investment

An investment in a Venture Capital fund is capped at whatever amount you designate when you subscribe. It is the VC's responsibility to budget and allocate that money over the life of the investment, maintaining plenty of “dry powder” (committed but uncalled capital) for potential follow-on investments in the portfolio. To see how well the VC fund does this, you can look at their past investment track record, and ask pointed questions about their investment philosophy. For example, of the estimated lifetime investment the company will require, what percentage is the first round? The answer should be no more than 50%, for all but late-stage VC funds.

In direct Angel investing, you are responsible for budgeting your own dry powder. The first round of investment raised by an early stage company is likely to be 25% or less of the total capital eventually raised, especially if the company is growing. Whatever amount you're being asked to put in now, consider whether you're comfortable putting in four times that much before you see any money back. If you don't keep investing, your ownership will be diluted, and worse, you are likely to lose key stockholder “preferences,” which could result in your investment being devalued or even “washed out.”

### 2. Due Diligence

Due diligence is the process of vetting an investment opportunity – its growth prospects, quality of management, market size, technological strength, competitive positioning, and likely exit strategy and valuation. Diligence takes an enormous amount of time, as well as the right skill sets. It requires understanding the particular industry, knowing the metrics on which companies in it are priced, and a strong resource network for specialized data like testing patent claims and running background checks.

Individual Angels are typically frustrated in the due diligence process by lack of time (angel investing is not their only responsibility), depth of industry exposure, and geographical constraints. While they may have a large rolodex, their resource network is scattered and takes many calls and emails to access.

Investing in a Venture Capital fund, by contrast, requires a single due diligence process focused on the VC fund's management, track record, and current deal pipeline. The resulting investment buys a diversified portfolio of 20-40 individual companies. The VCs are paid to do the rest of the work.

### 3. Diversification

Diversification is, of course, the classic ingredient in total risk reduction. Traditionally a securities portfolio of 20+ stocks was thought to be adequate, but as markets grew more volatile that number has risen. While there's no exact formula for optimal diversification, it makes common sense to spread investments across a variety of non-correlated industries and geographic areas, as well as a number of individual companies.



This kind of breadth is difficult to achieve through time consuming, deal-by-deal Angel investing.

Venture Capital funds by definition provide investment diversification, typically among 20-40 individual companies per fund. Selecting a handful of VC funds with different focus areas (life sciences, clean technology, emerging markets, etc.) can provide geographical and industry diversification as well. There are also "Venture Capital Fund of Funds" in which one investment can achieve representation in 10-30 funds, and thus hundreds of individual companies, at the cost of an extra layer of management fee.

Angel and VC fund investing are not mutually exclusive strategies: investing in Venture Capital funds can provide diversification, while you make selective Angel investments as your time and expertise permits.

#### 4. Terms

The importance of investment terms to the value of private equity holdings cannot be overemphasized. In public stock markets, "buying low and selling high" is enough to make money. But in private equity, the terms of the purchase and sale are what determine the value received. Venture Capital funds are almost always in a position to negotiate better terms than Angels, because they are investing more money up front, bring powerful coinvestors in with them, and can be relied on for continuing investment when the company needs help. Some of the key terms that VCs usually receive, but Angels often don't, include:

- Information rights, to demand and receive financial statements
- Board seats and/or observation rights
- Preemptive voting or veto rights
- Follow-on investment rights, without which you can be washed out
- Liquidation preferences, without which you can be washed out even more easily.

The critical question in a private equity transaction is not how much the company was bought and sold for, but who made money on the deal.

#### 5. Time Commitment

Finally, Angel investors often find that all their work in finding and diligencing the deal was just the beginning of their commitment: after the investment is made, they are called on not only for additional money, but also for customer referrals, emergency brainstorming on operating problems, sessions to build or save team interpersonal relationships, employee recruiting, or even to step in (often without pay) as temporary CEO, CFO or VP. That can be fun and rewarding – or painful and exhausting. It's necessary to keep the investment on target, though, and that is what the VC is paid to do.

In summary, the amount of Angel investing you do should depend on the amount of financial exposure you want, the time you can commit to due diligence and ongoing supervision, the diversification level you're targeting, and your negotiating power in securing protective terms. The answer to the question of whether to invest directly in private companies as an Angel, or indirectly as an investor in a Venture Capital funds, is that smart money does both.

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