Business angels who are devils in disguise

Business challenges

Unrealistic expectations and interference are two common complaints about early-stage investors, says Jonathan Moules

Fundraising is hard, especially if you are running an early-stage venture – which is why business advisers put so much emphasis on finding early-stage investors, known as business angels. But what if your angel turns out to be the devil in disguise?

Hussein Kanji is an angel investor and former venture capitalist at Accel Partners, who moved to the UK from California to get involved in European technology start-ups.

He was recently invited to invest in a UK company, where one of the two original angel investors quit the board just as the business was going into its first round of fundraising, seeking $6m. This money was eventually raised – but no thanks to the behaviour of the angel, Kanji says.

Good angel investors are those who offer guidance when needed and wait patiently for results, according to Kanji – and the best ones have already founded companies and sold them on.

"Folks who have done it before tend to be more patient," he says. "They also tend to know if what looks like a crisis really is a crisis."

David Giampaolo, chief executive of Pi Capital, a London-based investor network, sees two common mistakes made by angel investors, as well as company founders seeking investment.

First, some have unrealistic expectations about the performance potential or valuation of the business that they are putting money into.

This may not be purely the fault of the angel, because the entrepreneur may also have unrealistic expectations about his or her potential, Giampaolo explains.

Second, business angels can be either too hands-off or too controlling. "An angel investor can provide some real value, but there is a fine line between some advice and mentorship and interference," Giampaolo says.

But he stresses that problems in angel investing come from both sides of the table.

"I am very critical," he says. "I don't only think entrepreneurs need to be more careful about whose money they take, I think investors have to be equally careful with whom they give their money."

Giampaolo advises entrepreneurs to do due diligence and seek references for potential investors, just as they would expect to be checked out themselves.

"Focus on the calibre of the person rather than the valuation," he notes. "I would rather have an £8m valuation for my company with the right partner than a £10m valuation from the wrong partner."

Be diplomatic when you receive a business angel's advice, warns Alex Hoye, chief executive of digital marketing agency Latitude

Alex Hoye, chief executive of Latitude, a London-based digital marketing agency, is both an entrepreneur and an angel investor in internet, media and consumer businesses.

He says the risk in taking money from angels who have previously had their own businesses is that you get someone who thinks that the way he or she ran their business is the way you should run yours.

"Most successful companies are disruptive by definition, which means they run into unchartered areas," he points out.

"This means that the way someone else has run their business is unlikely to be the way this business needs to be run."

According to Hoye, the trick is to be diplomatic about how you receive an angel's advice, adopting the tips on more "timeless" matters – such as how to find a good sales person or how to launch a product – and politely ignoring advice on matters specific to the investor's previous forays into business.

> 'I would rather have an £8m valuation with the right partner than £10m from the wrong partner'

However, it is not just founders who can be stung by ill-suited or malevolent angels. Other investors can also fall victim.

Lois Cook had direct experience of this with a group of angels at a technology company she invested in four years ago.

After making her investment, another group of five angels came on board with an offer much larger than the founders had been looking for.

That group then installed their own chairman and finance director in the business and set out a new shareholder agreement that everyone signed up to.

"We didn't want to prevent the company getting another round of funding, so all the angels signed up to it," Cook recalls. "That probably wasn't the best thing to do."

Shortly afterwards, the new chairman put pressure on the company's founders to leave. Again, Cook gave the new angels the benefit of the doubt.

Then the new angels put in a new loan agreement for £50,000 and gave Cook and the original angels an ultimatum either to find the money to match the amount borrowed within 30 days, or face dilution of their combined stake to 10 per cent of its former value.

"We tried hard [to get the money], but we couldn't match it," Cook says. She consoles herself that she and the other early angels only lost tens of thousands of pounds in the process – known in the industry as 'whitewashing'. But it has made her wary of making any more angel tech industry investments.

Bad angels are a phenomenon that early-stage investing groups would rather not focus on.

Bill Morrow, co-founder of Angels Den – a matching service for investors and entrepreneurs – insists that only a tiny proportion of the deals his organisation facilitates will go bad. But this is little comfort if you are the unlucky one.

For both entrepreneurs and investors, the lesson is that angel relationships should not be entered into lightly.

As one entrepreneur puts it: bringing an angel on board is more like a marriage and should be treated with the same care.

Spotter's guide to business investors

Heavenly or hellish – what type is your angel?

Shark angels. This investor's sole intention is to take advantage of a business founder's lack of financial experience. Warning signs should start to appear during the due diligence or "term-sheet" process. If it gets difficult, it may be time to respectfully bow out.

Crazy, rich uncles. These angel investors are dangerous because they are so easy on the management team. They are mostly retired and living comfortably, and their mission in life is to "give back" to the next generation. They tend to have a weak statement of expectations.

Litigious angels. This type of investor is not trying to achieve a return from your company's growth but to make money by intimidation, threats and lawsuits. Litigious angels count on business owners lacking the resources to fight them. A good lawyer is vital if you end up with one of these angels.

Superior angels. These people believe that they are destined for greatness and generally have an inflated opinion of their own ability. They are usually overbearing, negative people who are hypercritical of every decision a founder makes. The lesson is not to be intimidated by these people into making bad decisions.

Megalomaniac angels. This type of angel starts out looking like your new best friend. He waits until you hit your first pothole and then points out "gotcha" clauses in your agreement that give him more control. This escalates into a requirement that he must step in to run your company himself. Only your board can save you.

Chief executive angels. Their real agenda is to run your company from the back seat. They are very intrusive and will push you to make decisions and commit resources that will put your company at risk.

Meddling angels. These investors are not after control, but want to hold your hand on every issue. You may be attracted by the offer of mentoring, but will soon realise that their desire to be helpful 24 hours a day is a curse. Keep your distance.

Has-been angels. These are usually high-flyers with a liquidity problem. They will meet with you and ask a thousand questions, but never close the deal. The solution is to learn to ask the closing questions.

Dumb angels. You can spot these investors by the questions they ask – or rather don't ask. They are rich but have a complete lack of understanding about how to run a business. They may be useful, however, in introducing you to other angels. After all, rich people tend to know other rich people.

Jonathan Moules