Angel Investing

July 2012

“Aut viam inveniam aut faciam.”
(I will either find a way, or make one.)

Hannibal

Dear Friends,

Please see the attached notes on seed-stage or "angel" investing. I hope this document proves a useful guide and perhaps it will help you avoid a mistake, especially those of you in New York where the technology-investing culture is taking off.

As many of you know, my current fund, Formation | 8 Partners, focuses on early-growth investing. This investment mandate offers the best risk-reward, because my connections in LA and New York and those of my partners with Asian Conglomerates add the most value to early-growth stage companies. Yet, because access to growth companies does not happen automatically, my fund also allocates a portion of its investments to early stage companies. These seed and series A rounds create optionality to gain access to some of the best early-growth deals.

Early-growth investing and angel investing present different challenges. At the early growth stage, one can measure the existence of a strong technology culture and see other business metrics before success is priced in. The business fits into its ecosystem, engages customers, and builds distribution channels. An investor may even gain a feel for what margins might look like later. Put simply, growth investing involves real businesses that show early signs of greatness and traction. These are the most sought after companies and it's a full time job to find access to them, invest in them on good terms, and give them advantages to make sure they win.

At the early stages, companies have overcome some market, technical, and management challenges, yet they still face obstacles in scaling and solidifying the early momentum. Investors do not know, and usually can't tell, what margins, engagement, and distribution will look like. They may not even know if the product will fit the market. Fortunately, these factors are not dispositive for angel investing.

To see what truly matters, please open the attached document and enjoy. Please also feel free to ask me before investing in a seed deal. I'm happy to give you my feedback and I won't steal your deal. In fact, such early investing benefits from collaboration and it's a usually a positive sum game. Although the majority of seed investments underperform, it's great for the technology ecosystem to have so many people involved. And it can be an exciting and high-return area if done with discipline and with the right deal flow.

Best regards,

Joe Lonsdale

Ten Principles for Angel Investing

1. Invest in the very best engineers. At least one of the founders should be a technologist. There should be more than one founder if possible. Founders should have a loyal early team that they have known or worked with before. Design cultures are very helpful, but engineers matter most. All the returns in angel investing come from the top companies and virtually all the top tech companies are built by the best engineers.

2. The team should have a concise, inspiring vision. The vision should be unique and ambitious. A smart person who hears about the company should get excited and want to be a part of it.

3. Salaries should be low and upside for employees should be high. This holds especially for the founders and the first few employees. If possible, see that great engineers are willing to come on board for low salary and high upside after the initial team. In Silicon Valley in 2012, low salaries means 40k to 75k. In New York, it might mean 50k to 85k.

4. Invest in a team that creates a top technology culture. In addition to the points just discussed, a) the company should be based in one place without multiple locations, b) people should work late at night and on weekends much of the time, and c) employees should generally display passion for what they are doing and near-obsession with their mission. Perhaps most important, an engineering culture means that engineers should determine the scope of the problem and the approach to solving it. The product guys should not dominate decisions, nor should the business guys. If the company consists of business guys trying to find an engineer to get something done or, worse, ordering engineers to build something, run.

5. The company should focus on a small, well-defined target market. The company should achieve a creative monopoly somewhere. If the team wants to conquer everything in a big area out of the gate, help them narrow it down. Attacking an underplayed or heretofore ignored niche in a large space allows the business to grow without sacrificing future market opportunity. All great entrepreneurs have an expansive bias, but they also know how to apply discipline to focus.

6. Great companies work on really hard problems. They take top technology cultures and expose them to a known problem in a valuable area of the economy. The idea itself is not the value. "Stealth" companies or those that don't want to reveal their technology almost never win. Rather, teams that create new technological solutions, produce big insights every day for breakfast, and take on and solve really hard problems are the companies to bet on. Incremental improvements are not sufficient when investing in seed companies, because, by the time they reach market, incumbent technology may have improved enough to eliminate seed company advantages.

7. The best teams collect the best directors and advisors. A good company should attract top people from the industry to help it grow. If the company can't raise money from key people in the industry, that's a bad sign. Consider bringing in a friend from the industry to invest along with you as a bar.

8. Good teams honestly revise their timelines. Most teams constantly change their timelines and want to forget what they promised in the past. Almost all startups miss their timelines, but those that are honest and adapt and learn from their misjudgments outperform.

9. Don't invest in me-too commerce, payments, deal-related companies, and media plays. These areas are over-crowded. Unless you have an unfair advantage on your side and know that you have found one of the very best teams in the world, back off. Similarly, don't invest in tricks. Tricks may include companies in China giving distribution, special deals with a big pharmaceutical group or mobile phone company, or a patent licensing or litigation scheme. These methods may add advantages at the right time, but a company's team and its principles are what matters early-on. Finally, always ask, "why is this deal coming to me?"

10. I will either find a way, or make one. Everything else aside, you are betting on their drive / determination to succeed ... that is perhaps the most important quality, and as far as we know it's an art to measure this. If you are the militant type, ask yourself: would I go to war with these guys at my back? Don't bet on any team, or any fund for that matter, that is not obsessed and determined to prevail.