Collaboration between VC and business angels

In September 2020 Pitchbook published an insightful research on the role of angel investments in the startup ecosystem. It is quite clear from the research that not only business angels are essential for early stage financing, but they also make a positive contribution to the long-term startup success. The probability to raise follow-on rounds appears to be materially higher for companies whose first investment came from angels.

Such a significant difference is impressive but might be not intuitively obvious. I have two hypotheses somehow explaining this fact:

> At early stages a syndicate of strong business angels could be more helpful. Angels usually have a strong professional background and can help startup with necessary first customer introductions. Even more than that, sometimes angels play such an active role in operational processes that they are hardly different from co-founders
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> Startups that decide to skip business angel round and raise more funding from VCs at the start, usually end up with higher post money valuation. This puts more pressure on a startup's performance and leaves less flexibility to

make pivots.

While the role of business angels is important and well known, surprisingly, I haven't observed an active collaboration between angels and VCs. Business angels actively collaborate with each other: form angel networks and syndicates, network together through events and web chats, actively share deals. In a similar way, VC funds build relationships with other funds. However, interactions between two worlds are limited and, in some cases, are not even friendly. I can see several fundamental reasons for that:

VCs and angels target different type of companies. While everybody wants to invest in future unicorns, these "beasts" are extremely rare. Vast majority of M&A deals are happening at below $50M valuation. Such exits could still guarantee a strong ROI for an angel investor. That's why angels are always happy to consider companies, that might operate on a small or very competitive market, but at the same time have strong IP or can reach profitability with low capital requirements.

VC funds usually have significant AUMs and they need to deploy this capital within a short timeframe. This means, that VC fund has to invest a significantly larger check per company (maybe through several follow-on rounds). And so, VC funds will usually pass on very strong companies that have limited short-term growth potential.

VCs and angels hold different classes of shares. In most of the cases angels are the least protected type of shareholder. They don't have protective mechanisms granted by preferred shares (like VCs have) and they don't have operational control over the company (like founders have). This usually does not matter much, if a startup is growing fast and target high value M&A. But in other cases, interests of shareholders might not be 100% aligned and angels are usually the ones to sacrifice their interests.

Angels have limited capital resources. During the first few years an operational support provided by early investors is extremely important for a startup. However, at later stages a startup could already have a strong team, advisory board and prominent customers. At this stage startups don't need a lot of operational support, but still need capital to fuel growth or close cash gaps. Larger funds in a captable can guarantee an easier access to capital, which could be crucial in many cases. That's why VC funds always prefer to see other VC fund as a co-investor rather than a syndicate of angels.

Angels are sometimes perceived as amateurs. Sadly, you can still meet some VCs that do not consider angels to be investment professionals and

- don't see significant value-add from co-investing with angels.

With that in mind, I can see things changing in a positive way. The distinction between a large angel syndicate and a small VC fund is becoming less sharp and this opens more room for collaboration. Even larger VC funds recognise the value of business angels and try to use angels to scout new deals. In Europe such scout partnership programs were recently launched by Atomico, Backed.vc, Blossom Capital and Ada Ventures.

At Begin Capital we aim to build open trustworthy relationships with angel investors. Before founding Begin Capital my partner Alex was an active business angel, so we understand both sides. Internally we formulated few basic principles of such relationships:

- To share co-investment opportunities with strong angel investors and share allocation in the follow-on rounds (without any fees or SPV structures)

- To be transparent and fair-minded with all shareholders throughout the lifetime of a company

- To offer at least some extra liquidity for minority shareholders

Conclusion

The reality of "startup world" is often more complicated than it seems, and misalignment between shareholders is quite normal. However, both VCs and angels are in company-building business with long time horizon. And building a trustworthy relationship is absolutely essential to succeed in a long term.

I'm always happy to further discuss this topic and share experience with business angels. Feel free to drop me a line to ruslan@begincl.com

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