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Angel Investors and Startups: An Analysis

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Abstract – For start-up companies, angel investors are a critical source of capital, with many relying on them for a major amount of their total funding. Angel investors are the most important source of external funding for emerging enterprises, behind founders, family members, and close friends, among other sources. Angel investment may it be individually or collectively as angel networks are very beneficial for the Startup environment. Startups need seed money to grow at initial stage and that is the reason angel investors are crucial for them. These investors are also helpful in initially managing the business because they are having experience. The article discusses about the process of angel investment and also suggest some very important aspects needs to be regulated by the authorities, for better clarity in Capital markets.

Key Words – Angle Investors, Angel Networks, Startups, Venture Capital, Crowd Funders

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INTRODUCTION

The Angel investor is a wealthy individual who invests in small firms or entrepreneurs in return for a piece of the company's ownership, sometimes known as a privately owned investor or angel investor. Angel investors are typically found in entrepreneurs' relatives and friends. Angel investors may invest in a company to help it get off the ground or stay afloat during its early stages. Generally speaking, these are high-risk investments that account for no more than 10 percent of an angel investor's whole portfolio. These investors have surplus funds and are searching for opportunities to earn higher returns.

Angel investors are more interested with the entrepreneur's capacity to start a business than with the feasibility of the enterprise. Angel investors are more interested in helping early-stage firms rather than profiting from the company. Angel investors and venture capitalists are two different things.

Angel investors are also known as angel funders, informal investors, seed investors, private investors, and business angels. Angel investors are people who invest money in enterprises in return for ownership stock or convertible securities specially debt securities. Some angel investors pool cash by investing through online crowd financing platforms or by forming angel investor networks.

REVIEW OF LITERATURE

Gerald A. Benjamin and Ellen J. Sandles: Angel Investors: Culling the Waters for Private Equity

This article addressed the previous debate over patient capital, concentrating on institutional and public markets. This article studies business angels and their investing behaviour from an entrepreneurial finance approach. Entrepreneurial ecosystems are critically dependent on these external risk capital sources. Based on fresh survey data, the results of the study reveal that angel investors only comprise a small percentage of exit-centric investors. Generally speaking, most angels are patient investors by accident rather than purpose. Most people ignore the need for patience and to exit the investment appraisal stage.

David M. Freedman and Matthew R. Nutting: Angel Investors

The article talks about angel investors who invest in startups and early-stage firms for a variety of reasons, one of which being the chance to make a huge profit. Only a few people genuinely do. Many seasoned angel investors (who diversify their angel portfolios) frequently make reasonable annual returns of around 25%. However, interest rates aren't the only reason to invest in angels. The essay delves into the many benefits, hazards, and costs. Also discussed is how the rise of equity crowdfunding has given rise to a new breed of angel investor, with some of the same motivations and rewards as conventional angels but also some new ones, particularly social benefits.

Susanne Chishti: Angel Investing – Access to "Smart Money" to Fund the Best FinTech Companies

This paper discusses that FinTech companies often start-initial up's round of external investment from authorised, high-net-worth (HNW) investors. FinTech Circle angels are invited to mentor the best FinTech entrepreneurs.

ORIGIN OF ANGEL INVESTORS

The term "angel" originated in the Broadway theatre, where affluent patrons contributed funds to help fund theatrical shows. William Wetzel, founder of the Center for Venture Research at the University of New Hampshire, coined the phrase "angel investor." Wetzel undertook a research project on how entrepreneurs raise funds. Several country-level studies assessed the investing activities of angels in their various countries in the 1980s and 1990s. The profile of angel investors, as well as their investment strategies and preferences, are often described in country level research. Aside from their methodological flaws, they fail to provide a helpful understanding of market features or investment performance outcomes in such markets.

Lone wolves and angel networks are two categories of angel investors. Lone wolves are people who make investments on their own behalf; angel networks are groups of investors that make investments on their own behalf. Entrepreneurs can connect with investors through angel networks, which are considered a low-cost method of doing so. However, despite the fact that angel investors are active in India for many years, data on their investment activity has only lately been made public. Approximately 855 investments in 756 firms were made as of June 2016, according to Venture Intelligence (VI), a commercial source of statistics on venture capital, private equity, and angel investing activity in India at the time of publication.

NORMAL INVESTOR TO ANGEL JOURNEY

Angel investors are often "accredited investors," although they don't have to. The Securities and Exchange Commission (SEC) says that a "accredited investor" is a person with a net asset worth of $1 million or more (not including property), an accredited investor with income of $200 million or a married couple with a total income of $300 thousand. On the other hand, it is not equal to being an accredited investor.

To put it another way, these individuals possess both the financial resources and the willingness to invest in commercial enterprises. Angel investors, on the other hand, have a greater attraction to cash-strapped enterprises than conventional, predatory forms of funding.

PROFILE OF INVESTMENT

Angel investors that invest in firms that fail in their initial stages lose everything they have invested in them. This is why seasoned angel investors prefer companies that have a clear exit strategy in place, such as mergers or initial public offerings (IPOs).

On a successful portfolio, an angel investor should expect an effective internal rate of return of approximately 22 percent. Although this may seem attractive to investors and excessively costly for enterprises with early stage companies, cheaper options of capital, for example banks, are seldom available to such companies. Angel investments are therefore suitable for entrepreneurs that are still in the early phases of their business and are having financial issues. Because of the temptation of profit, angel investing has been a primary source of capital for many entrepreneurs during the previous few decades. As a result, innovation has exploded, propelling the economy forward.

ANGEL NETWORKS

Different angel networks have different organisational structures and operating procedures, which will be explained more below. Individual angels who join angel networks formally have access to new business opportunities. They also enable participants to take part in transactions even if they just have a small amount of money to invest or are operating from afar. A portion of their investible resources is also set aside by these angel investors for further ventures. Angel networks, in terms of investment approach, are more equivalent to venture capital funds. Angel networks are supposed to increase the flow of dealings and investment in a way that closes the financial gap between angel investors and corporate capitalists (VCs). A former "notoriously inefficient" process of transaction sourcing and investor selection is made more efficient through the use of angel networks. Angel groups should be able to invest in locations that are further distant from their headquarters since they interact with peers from all over the world, resulting in increased transaction flow.

In some aspects, angel investors and institutional venture capitalists have comparable investing strategies. Individual angels, on the other hand, vary widely in terms of financial sophistication and entrepreneurial experience.

THE DIFFERENCE BETWEEN ANGEL INVESTORS AND CROWDFUNDERS

Crowd funders (CF) invest in enterprises that are in the same stage of development as venture capital or angel finance. Crowd funders can't negotiate for protection, or actively involve the company to monitor the entrepreneur, in contrast to venture capitalists and angel investors. In this scenario, Equity CF platforms can be useful, on the contrary. Initially they can (and often do) filter offers for the whole pool, just like individual angel investor pools do. There is limited evidence that screening is as reliable as screening angel investors as the incentives of platforms to screen usually are less than the incentive of an angel investor. If the timing is successful, they are reimbursed, but there is no financial interest in the performance of the fundraising companies.

Since potential CF investors are sceptical of the ability of a platform to screen projects sufficiently, in particular before a market renown has been created on the platform, another method is to engage the help of angel investors who have a proven trail record in the screening process. For instance, the United Kingdom website Syndicate Room "lists" companies that are already sponsored by business angels, that invest their own money and therefore actively participate in the evaluation of the strength of the offer. It provides members with the "same share class and same price per share" if the members decide to join them.

INDIA'S ANGELS AND ANGEL NETWORKS

Venture intelligence (VI) data was employed to develop an interpretation of this document as a public source of statistics on India's venture capital, private investment and angel investment industries. The research is based on data between June 2016 and June 2017. The research is focused on the number of investments rounds, the number of start-ups funded, the follow-up funding from angels and VCs and exits among the numerous data pieces available from the VI database. For a long time in India Angel investment has been prominent. In India, both lonely wolves and angel investors were active. Angel investors contributed to a vacuum in the capital market before the creation of risk capital and private equity enterprises. Author describe an angel network as a formal organisation of individual angels and investment companies confined by a formalised agreement to select investment opportunities, evaluate investment opportunities, engage with portfolio companies and enter into exiting investments at the right time, according to how different networks are arranged. This is normally done by a secretariat.

In the last 10 years or more a variety of angel networks have arisen with their own structure and set of objectives. There is no formal registration or regulatory entity in business to supervise the angel networks, there are no single data sources. In addition to its more active investment networks, it is believed that the Indian Angel Network (IAN), Mumbai Angels, Chennai Angels, Hyderabad Angels, Spark Angels (BITS), Chandigarh Angels and Native Angel Network are among the networks most active. There has been much more recent development of online networks.

A few of the newer ones, such as LetsVenture and Tracxn, have grabbed the interest of investors and entrepreneurs. In earlier forms of networks, human engagement was an integral part of the intermediation process; but, in newer types of networks, more of the intermediation is done through computers. Whether it's a single network type or multiple types coexisting is uncertain. A typical offline angel network in India is characterised by its structure and operation. Because of the vast level of information available on their website, the IAN makes for an intriguing case study. More importantly, despite the fact that their degrees of activity may differ, the IAN and the other networks seem to be equivalent in terms of their business operations as well as how and to what extent they are linked to the innovation ecosystem.

The International Association of Nuclear Engineers (IANE) was established in 2006. As of December 2016, it had 478 members, which included previous entrepreneurs, lawyers, and corporate leaders. The network works in a cyclical manner to find new transactions, which it assesses, which it arranges, which it distributes contract templates for, and which it manages. A secretariat helps the members of each cope with investment-related issues. The membership agreement prevents conflicting interests between members or individual members who engage in various firms and the investee company. Members that pay an annual cash subscription fee to the network are compensated with equity from the investee enterprise. There are offline angel investor clubs like the IAN that offers economies of scale and scope from across investment cycle. Its members can invest in enterprises all across the country and the world.

An investigation into the levels of AI movement in India

The number of angel investment rounds has progressively increased over the years. Between 2000 and 2008, the number of transactions increased at a rate of 25 per year, then 60 per year between 2009 and 2011, and 90 per year from 2012 forward, according to the Bureau of Labor Statistics. The increase in 2015 and 2016 was really significant. Concentration is evident in the overall portfolio of all angel investments when they are taken together. Angel investors appear to have concentrated their efforts on a small number of industries.

Online services represent 37 percent of transactions, with 18 percent of IT products, 13 percent of mobile value-added services, 5 percent of food and food services, and 11 sectors of the remaining agreements. Because some internet services are integrated into bigger mobile businesses, more than half of all investment in the US is made by the mobile centric industry. An inspection of the data demonstrates that the sectoral pattern did not change significantly from one year to another throughout the course of the study period, as seen in the year/sector cross-tabulation. However, this does not rule out the potential of investors' sectoral preferences differing from one another in the near future. When the data is evaluated in terms of years, it becomes clear that investor preferences have changed over time.

As a result of a preference for various industries at different times, sectoral inequalities could also exist. In the early years of the 21st century, when lone wolf AIs aggressively invested in these firms, the BPO (business process outsourcing) and the analytics industries were particularly popular. As well as the sector's attraction, variables such as acquaintance with the founders and proximity to the site of the firm may influence angel investors in the United States when deciding where to place their money.

In the southern (39.7%) and the western (287%) areas, two-thirds of all deals took place, and 26.27% in the north, 1.17% in the east and 4.3% for global investments in all deals. According to city-by-city distribution statistics of the angel-funded enterprises, 24.9% of the investments were received in the Delhi National Capital Region, including Delhi, Gurugram and Noida followed by 20.1% in Mumbai. Although Pune was the fourth largest city, just 5 percent of the total transactions were made by it. In contrast to India, US angel investments have tended to be more widespread throughout the country. The Angel portfolio was very expanded as a result of the post-investment activity.

After two or more rounds of angel funding had been completed, 237 companies continued to leverage one or more rounds of venture capital finance, whereas the study shows that angel investors were leaving 62 companies based on figures from Venture Investments. Approximately 18 percent of angel-funded enterprises received additional funding from the same angels or from other angels, whereas 28 percent of those businesses received funding from venture capitalists, according to the National Venture Capital Association. The lack of statistics on the investment returns on these investments might be regarded as an indicator or measurement of how far angel investors have progressed.

Given that risk capitalists employ staged investment to improve their commitment to supporting firms as fresh information is available on their performance, the number of VC rounds signals a company's long-term viability in its early stages. This is because institutional investors who supply financial support at an early stage would stop if they were not confident in the quality of the management group of a firm and in the chance to achieve an appropriate return on their investment.

INDIA'S LEGAL PROCESS FOR ANGEL INVESTING

The Indian startup ecosystem has constantly raised the bar for the rest of the world's startup ecosystem. Angel investors have made a significant contribution to the success of businesses by offering financial support and guidance as they expand their operations in the market. Here, the complicated regulatory norms of angel fundraising and domestic investing has been simplified into seven basic phases that may be used as a reference for new start-ups and investors to better understand what happens behind the scenes in the process of obtaining funding. In order to comply with the law, the following processes must be followed.

Non-Disclosure Agreement (NDA)

Non-Disclosure Agreements (NDAs) must be signed by both the investor and the entrepreneur. This ensures that both parties retain ownership of the meeting and pitch, minimising the risk of idea theft and misuse. To acquire access to company information as an angel investor, you must sign a non-disclosure agreement (NDA). This allows you to analyse potential firms and, as a result, invest in successful ones. The NDA further states that the details of the investment and the amount of capital invested between the company and the investor are "not disclosed."

CA Assessment of Company

In order to go to the next investment phase, the assessment of the company must be studied and determined by a certified CA, and this must be approved before the investment is made further. The prices are either issued at a price equivalent, a discount, or a premium based on the situation when the firm valuation has been calculated. Registered startups are entitled to claim a tax exemption on the amount of money received by them in conformity with Section 56(2)(viib) of the Income Tax Act 1961.

Extensive research and compliances

The investors are diligent to study the important material relating to their desired company and to evaluate the future market potential of the company before moving further before moving forward with the funding. It is the job of the investor to monitor due diligence, including cross-questioning, to verify crucial assumptions and detect possible costly errors.

Agreement for Subscription or Loan

In order to make his angel money work for him, an investor must clarify how he intends to invest it in a company by entering into a subscription agreement or a lending arrangement. By acquiring shares within the firm via a Subscription Agreement or loaning to it via a loan agreement, the angel investor might finance the startup.

a. Subscription Contract

An investor's intent to buy shares and qualification to buy such shares in the company are stated in a subscription agreement. It stipulates that the business promises to sell a certain number of shares at a given time and price, allowing the subscriber to become a shareholder. In exchange, the subscriber promises to purchase the shares at a given time and for a specific price.

b. Loan Contract

A loan agreement is a document that specifies the mutually agreed promises between the investment party and the startup (in the form of debentures or other debt instruments). The investor obtains his investment returns by funding the money as a loan for a defined interest to be paid after a specified time period by signing a loan agreement. When funding a business, investors frequently use a combination of equity and loans.

Agreement of Shareholders

The agreement of shareholders and the subscription agreement are frequently misunderstood, despite the fact that they serve distinct objectives. A shareholder's agreement establishes the shareholders' relationship and their rights in the company. Along with other terms, the contract describes the investor's shareholder transfer rights.

Terms of Investment and Negotiation in Term sheet

At this stage, an investor must debate the terms and conditions of the investment agreement, which are subsequently formalised in a Termsheet. Ensure that the important agreement terms are addressed in the Termsheet as an investment. The following are some of the most important Termsheet clauses to remember:

a. **Liquidation Preferences:** When a startup intends to wind down or restructure critical aspects of the business, an investor can protect his investment by asking a specific liquidation preference. His participation and non-participation liquidation are both options for him. Another notable example is the recent $10 million investment in a startup made by an investor. The investor requested a 1x liquidation preference and, based on the company's post-exit valuation, he will earn INR 10 crore upon closure.

b. **Warrant coverage:** Investors or shareholders that choose to take advantage of this agreement, called warrant coverage, are able to purchase a warrant that entitles them to a specified percentage of the company's equity if the value of the investment increases. The offering gives investors the opportunity to purchase shares at a defined price. This shows how an investment of Rs 5,000,000 is made up of 1,000,000 shares at Rs 5 each. Warrants covering 20% of the total value of the stock and issued at Rs 1 million in value to the investor. According to technical standards, the organisation promises to grant 200,000 additional shares at a Rs 5.00 per share exercise price.

c. **Conversion Right:** Series A preferred shares give investors the opportunity to convert into regular stock at a set rate at any time.

d. **Automated conversion:** A provision in the agreement for automatic conversion of the investor's shares into common stock will allow investors to elect to have their stock converted at the applicable conversion rate in the following events:

- a well-underwritten initial public offering comes to an end
- In the event of preferred stock, the shareholders' written consent is also required.

e. **Anti-Dilution Right:** A typical anti-dilution provision allows investors to maintain their percentage ownership in a startup by buying additional shares when the business issues a new security.

f. **Redemption rights:** Preferred stock angel investors who purchase redemption rights have the option to force the corporation to buy back their shares after a specific time period.

g. **Voting Rights:** A shareholder's voting rights define his or her rights in terms of corporate policy. Voting rights change amongst instruments, and in some circumstances, a majority vote is required to take corporate action.

h. **Dividends**: Dividends provide an investor with a guaranteed return. Often, dividends are not paid on a regular basis by startups. Frequently, investors allow startups to collect dividends by increasing the preferred size over time. The preferred dividend would grow after the investment period ended, i.e. during the startup sale or IPO, benefiting the investor from the fixed return.

i. **Board Participation**: Board participation allows an investor or a group of investors to run for a position on the company's board of directors if they so wish.

j. **D&O Insurance**: D&O insurance is a type of liability insurance that is paid to the company's directors and officers. It is given as compensation for losses or as an advance on defence costs in the event that an insured individual suffers a loss as a result of legal action brought against them for alleged improper acts committed while serving as directors and officers.

k. **Pre-emptive/pro-rata rights**: Pre-emptive/pro-rata rights give investors the right, but not the obligation, to keep their stake in the company across successive funding rounds.

l. **Information Rights:** Under the information rights, the corporation is required to provide the following information with its investor: Annual financial accounts must be audited within 90 days of the fiscal year's conclusion. Unaudited quarterly financial statements must be submitted no later than 45 days after the end of each quarter, with a comparison of the results to those expected in the firm's annual budget, and more.

m. **Letter Expiration**: The letter or term sheet's validity is determined by the letter's expiration date. If the corporation does not return the original or fax the executed version to the investor before the expiration date, the sheet is declared invalid.

After-investment assistance

The investment process is now complete and the investor is now an official small company angel investor. Investors are updated on a quarterly basis by the startups. Angel investors are typically willing to offer guidance to companies in order to assist them with operations and to use their industry expertise to the startup's benefit. The parameters of the relationship between an angel investor and a company differ from one to the next.

SCENARIO AT THE MOMENT

The year 2019 was a record-breaking year for Indian entrepreneurs, with a record-breaking number of foreign investors rushing to the nation to support them.. According to Tracxn, the startup community raised $14.5 billion in funding in 2018, up from $10.6 billion the previous year. According to Tracxn's data, 1,894 firms were launched last year, with nearly half of them (887) receiving funding.

In addition, nine Indian firms reached the Unicorn club in 2019, with four of them going public. The most valuable deals were taken by OYO Rooms, Paytm, and Udaan, followed by e-commerce firm Delhivery.

It goes without saying that huge, if not even higher, expectations have been put on 2020. After a promising start to the year, the breakout of the new coronavirus COVID-19 soon dampened the spirits of business owners and investors everywhere. Young enterprises braced themselves for the worst as many industries came to a halt, creating severe financial constraints for the fledgling businesses. As it turned out, their suspicions were well-founded. The stock market is collapsing, and venture capital funds are being increasingly careful with their investments. Global investors with deep pockets have also decided to postpone some significant transactions for the time being. But, while the overall picture is bleak at the moment, let us look at how the epidemic is affecting India's startup funding situation.

There was much less money collected in March than in prior months. According to Venture Intelligence statistics, start-up funding was more than 50% lower than in the prior month starting in March 2020. Start-up data tracker indicates that Indian companies raised just $354 million in March's 34 deal, down from $714 million in February's 46 deal. Companies received $1.74 billion in investments (across 126 transactions) in the first quarter of 2020, a 22 percent reduction from the same period the previous year. The numbers suggest that fundraising activity has decreased significantly as a result of the faltering economy and the ongoing national lockdown, according to the figures.

The new Foreign Direct Investment (FDI) policy in India is expected to have a chilling effect on startup funding. Indian authorities recently altered its Foreign Direct Investment (FDI) policy in the face of the pandemic in order to reduce "opportunistic takeovers/acquisitions of Indian firms," as the government put it. According to the amended criteria, any investor from a country that shares land boundaries with India would now be needed to acquire government approval before making a financial investment in the country. Previously, investors from such countries were not obliged to obtain government consent. The strategy to prohibit hostile acquisitions is well-intentioned; nonetheless, it may result in the creation of a new finance hurdle for domestic enterprises.

This is owing to the fact that China is a significant player in the Indian startup ecosystem. According to industry reports, 18 out of the 30 unicorns in India are supported by Chinese investors, including Tencent and Alibaba. The People's Republic of China has made over $8 billion in investments in Indian companies alone, outpacing the combined investments of all other neighbouring countries. As a result of the requirement that all Chinese investors gain official approval, larger investment rounds will likely take longer to finish than in the past. Businesses already struggling with cash flow problems will be exacerbated by a lack of available funding, according to forecasts.

The number of investors interested in specific industries is growing

Since the COVID-19 financial crisis, there has been a significant shift in the way startups are funded. Companies in areas like FMCG, online food delivery, home entertainment, etc. draw the attention of corporate venture capital companies which move their focus from digital entrepreneurs. Aside from that, EdTech, FinTech, and cyber security companies are experiencing an increase in client demand, which is attracting the attention of investors. Additional funding has been provided by the Indian government of $130,000 to Indian enterprises for the development of an encrypted video conferencing service that can be utilised on a variety of different platforms.

The epidemic undoubtedly has influenced the start-up funding climate for India, but it has also created incentives for firms to adjust to the current situation. Some businesses are already outperforming the market, which gives venture capitalists and angel investors cause to be hopeful about the future.

The long-term consequences of the coronavirus at this time cannot be foresee; nevertheless, it can be anticipated a positive trend by the year end. To do this, however, a concerted effort on the part of the government, venture capitalists, and corporations is required.

CONCLUSION

The number of enterprises financed by angel investors has increased significantly in recent years. But the rates of growth in informal equity capital must remain steady given the demand for and capacity for Indian entrepreneurship. There are a number of fascinating and critical questions. When it comes to investors and entrepreneurs, what are the advantages of investing through angel networks? When it comes to networking, which technique has shown to be more successful and efficient: the traditional approach or the internet model? Is it important to have networks that are governed? What level of oversight should they be subjected to? If so, are any changes to the regulatory system that regulates the entry and exit of angel investors from a business necessitated? As the number of angel networks increases, it is anticipated that public policy considerations about how to foster one or both types of angel investing would arise. The investment management strategy adopted by angel investors in the field of due diligence, evaluation and post-investment communication must be better understood. A detailed analysis of the connection between current practises and their influence on investment results is also vital. This will enable investors to refine their strategy, allow businesses to discover how to work better with angel investors, and allow policy makers to establish an angel investment-friendly framework.

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