An Interview with John Morris

John Morris, Partner, GKM Partners speaks with Growthink University's Dave Lavinsky

Dave Lavinsky: Hello everyone. Dave Lavinsky here from Growthink and I'm really excited today to be able to interview John Morris.

John Morris is the managing director of GKM Ventures which is a venture capital firm which has made investments in companies in the communications, IT, digital media and semiconductor spaces.

John is also the immediate past chairman of the Tech Coast Angels, the largest angel investor corporation in the United States companies which invests in start-ups and early stage companies. John is also the past president and a co-founder of the Tech Coast Angels' Los Angeles Network and John is also the president of the Western Region Association of the Small Business Investment Company. John also has a lot of operational experience as well as he sits on the board of directors for several companies.

Overall John has wealth of knowledge on raising capital for companies at numerous stages of their development and as such I'm really excited to speak with John today on these topics. John, thank you for taking the time to speak with me today.

John Morris: OK. Glad to be here.

Dave Lavinsky: Excellent. So John I was hoping you could start by telling us your views on what is the difference between funding between individual angel investors versus angel investor networks and venture capital.

John Morris: There are pretty big differences. Individual investors really represent people that are the hardest to organize because they're doing it for individual reasons, maybe they have domain expertise or they know the founders. There's some connection between them and the founding team.

Angel networks are a more common phenomenon over the last 10 years, especially in the United States. Most of the major metropolitan areas have formed one kind of angel investor network or another. Most of it got started in Silicon Valley in the mid-1990s.

The Tech Coast Angels was founded following a model built in the mid-1990s, the Band of Angels in Silicon Valley. They kind of used that model to build out what has become the largest organized angel network in the country with five locations – five individual networks: Santa Barbara, West Lake Village which is a suburban community west of Los Angeles, Los Angeles, Orange County and San Diego. We're even starting a smaller network out in an area east of Los Angeles in an area called the Inland Empire.

Angel networks are trying to source deal flow, provide a process for vetting members and vetting deals so that individuals can work together, share that domain expertise, do the diligence, help founders and kind of be a little more process-intense and employ together the necessary early stage rounds.

Venture capitalists are professionals. They're writing bigger checks. They're investing other people's money. They're not investing their own money per se and have perhaps a more strident diligence process. Typically they are somewhat flexible in amounts of money they want to invest, but many times depending on the size of the fund, they are struggling with making investments that have sufficient opportunity to put money to work so that the returns can actually make a difference.

Often angel investors are called on to make the first round of investments and the venture capitalists come by and try to make the second professional round.

Here in Los Angeles just an hour ago, a local venture capitalist said, "*Geez I really like these people, I really like the model. It's a little too early for us. Our minimum would be $2 million. They really need to raise sub $500,000 in an*

early stage, seed stage round to kind of prove out that it works and then bring it back to us and we'd love to invest in it. We'd love to help you do the Series B."

That's not a commitment. That's just showing interest and it's a good referral. The founders are well-represented coming into an angel investor network from a venture capitalist. But the angels are kind of called upon to take some of the more serious risk and vetting the early business plan. That's a long-winded answer to your question.

Dave Lavinsky: That's a great answer though. One thing that you mentioned that sounded really interesting was the story you just told about the company, the founders that were referred to angels from the venture capitalists. Based on that would you think it was a good idea for a company seeking a small round of capital to sort of do the same, to start approaching venture capitalists sooner rather than later and start thinking about longer term and possibly also getting references from VC firms?

John Morris: It's certainly a good thing to do and not every entrepreneur has got the network resources to do that and may not be able to get into the appropriate venture funds.

These people had a prior relationship with a venture capital firm – they were in a previous venture-backed company that got successfully sold. They didn't make a lot of money but they were familiar with the process so they were on a first name basis with this particular venture guy. Founders that have that capability are always well-advised to use those relationships, keep them alive – and they're very meaningful to the angel investor networks when they get them.

I always encourage entrepreneurs that are getting started to make sure they understand the vocabulary, they network to get to know VCs, and also in parallel they're approaching the angel investor networks.

In Los Angeles now there are several sources of early stage capital. There are some successful entrepreneurs holding themselves out as kind of private family office venture funds. They work often with what we call the established angel networks. And there are small VC funds that are kind of looking to collaborate with the angel networks and help source the deal flow and participate in early Series A rounds, where these small venture funds are kind of like angel funds, because they're investing hundreds of thousands of dollars, not billions of dollars. So their appetite is trying to get into deals ahead of the better funded more traditional venture funds.

But it's always a great idea and to make sure you know the vocabulary, you know who the players are, you know how the game is played – so that when you come into angel investors, angel investor networks, you're well familiar. You know where the exits are. You know who your next investors are likely to be. That little community you've kind of networked into will really help you make sure you're aware of the pitfalls but you're also aware of the process. The evaluations and the terminology often get entrepreneurs really confused about what they can do and what they should do.

That's a great suggestion if you can do it and in most case there's no reason you can't do it, it's just taking the time to do. A lot of misguided entrepreneurs jump right in thinking they're going to raise angel money off the bat without having done that kind of homework. And those guys usually come to a rude awakening that they're poorly prepared.

Dave Lavinsky: Venture capitalists, they write bigger check. That's sort of how the venture capitalist invests.

John Morris: It's as varied as there are number of members. Most of our members come from existing members. The member that's inviting a friend to come in, they say, "*This is a great group of guys. Maybe I make some money*

and maybe I can find interesting companies to be a part of, to be on the board of, to be an investor in."

They've had some success in their life, they're an accredited investor. They're looking to do something else or they're close to being retired or retried early. Can't be on the golf course all the time and this is a wonderful group of people. I think the camaraderie of the network. These are best friends that have been working together at meetings and dinners and screening sessions and diligence sessions for more than ten years. Some of my best friends are fellow members.

Dave Lavinsky: Excellent. And can you give an average profile? Is it mostly former entrepreneurs? Is it mostly executives? Former executives or current executives? Makeup or mixture?

John Morris: There's a great deal of entrepreneurial activity. We have a few guys that came out of big companies, but for the most part, most of our members had their own business or were involved in a small business – not large Fortune 500 companies.

That mindset is not interested in angel investment. They really don't understand it. They don't have any experience and really don't view this is as something they want to do.

It's the guys that seem to be in smaller business, that were entrepreneurs themselves, understand what it takes, understand how much benefit they might have had if there was such an organization when they were starting their companies.

I think for the most part the members of the Tech Coast Angels, while varied, tend to be on the smaller companies than big large corporations. Most of the members -- surprising amount of our members are fairly young, in their 40s that still want to be active, still want to be engaged. Occasionally some of our

members will step in to companies that they've invested in and take on a more full-time role than just a passive investor.

Dave Lavinsky: Excellent. That's something that most people are not aware of. That's a great thing because these are people that have a lot of operational experience, and that's why they're in the position they're in right now.

John Morris: And the professional investors, the venture capital funds, they're really trying to build a portfolio, trying to get a return. They're in the business of managing a fund and it's likely that they want to raise multiple funds.

So they're making decisions based on the portfolio effect and executing on a strategy that they raise the money with so they're a little more narrowly focused, where angel investors are investing their own money. There's no portfolio, maybe a little bit in the back of their mind but they're looking to invest in innovation and get to know up and coming entrepreneurs and be part of that ecosystem – a little bit different mentality.

Dave Lavinsky: Got it. You mentioned the word accredited. Do you think you can define that?

John Morris: From what I understand it's a million dollars. It's a legal term and I think it's a million dollars of liquid equity excluding your residence. In today's market that's not a very high barrier but we're trying to get our members to diversify. We don't want members piling in on any one deal. We try to democratize the process so that in every deal members are all kind of investing the same amount which on average ranges from a low of $15,000 to as high as $50,000. That is ninety-five percent of Tech Coast Angels investments are kind of maybe $25,000 would be the midpoint and the most common amount.

So it's not a lot of money and we ask members in the Tech Coast Angels that they be willing – we're not saying you must invest – but we want you to be thinking of

making two investments a year. If that's not what you're thinking of doing, then you shouldn't be a member.

Dave Lavinsky: Got it. Now when you say an average of $25,000 that's per member and a lot of times multiple members will invest in a certain company. Is that correct?

John Morris: Oh yeah. At $25,000 you need twenty-five, thirty members to make a decent financing work. You need a lot of members. So we have three hundred members across five locations. So the founding team that's out looking to raise Tech Coast Angel money is making presentations to San Diego to Orange County to Los Angeles and to Santa Barbara.

We have an intense process. It's good news and it's bad news because it's a virtual road show of presentations and you're picking up relatively small checks. You're not going out and getting five guys to write checks of $100,000 and raise $500,000. That's not our model. It never has been and highly unlikely it would be. There are individuals that consider themselves really high net worth guys that occasionally show up in the cap structure for a small company having made that kind of investment but they're not members of an organized group.

Dave Lavinsky: Got it. Can you talk about the difference between that – between individuals, call them "rogue" angels and a group. Do a lot of the members of Tech Coast Angels, did they start as individual investors on their own? And can you compare and contrast the difference between an individual investor and a group?

John Morris: One of the things that we've done in screening members is make sure they understand we have a process, can you commit the time to it? Dinner meetings, screening sessions twice a month, dinner meetings once a month, frequent diligence sessions periodically during the month. We're asking our members to do quite a bit. It's a team sport.

Taking on the leaderships of a deal is challenging and time consuming. So we're asking members on occasion to step up and lead a deal. You're not promoting the deal but you're organizing the deal. And the process of making sure adequate number of meetings are being held, the diligence is being properly delegated and collected posted to the website, the founders are making presentations, you're integrating the appropriate feedback in to the presentation, the Q&As are well prepared, that kind of thing.

You're getting a lot of members engaged in the process. It's a team sport. You're trying to get people that have domain expertise to be in the process, to help out the other members. On the next deal maybe you're doing less work and somebody else steps up to be the lead.

Large net worth individuals are really pretty much doing it on their own. They really are not integrated in a group. It's not a team sport for them and they come and go and sometimes the entrepreneurs find them and sometimes they don't. So it's much more problematic whether they show up or not.

Dave Lavinsky: Gotcha. I guess the entrepreneurs should be aware that the angel investment group process is a lot more formal. You talk about screen sessions, diligence sessions, domain experts, Q&A.

John Morris: Some entrepreneurs complain it's a lot of process, four or five networks, a lot of meetings. I'd rather just find three or four guys that are going to put in $100,000. Well yeah, no question. But those guys are harder to find. Sometimes it amazes me that entrepreneurs complain but that's the price of raising money and at such early stage situations.

What is also going on though is that in today's market the big concern is financing risk. Angels step up and do the Series A round, the first preferred round of stock. It lasts the company nine to fifteen months ideally, and hopefully

the company doesn't run out of money before that, and is well into a fundraising to raise the next round in advance of its needs.

But often times the angels expect venture capital guys to step in and sometimes the venture capital community doesn't seem to be interested in, so we're going to have to fund it or close it. So that's disappointing to angels.

What we're really trying to do now and have been is inviting the communities, the regions let's call them, the greater LA, greater Southern California area, to look at our deals early on so that we can get some feedback from them.

Sometimes they [venture capitalists] co-invest small amounts to get a seat at the table. Sometimes they say, hey, this is something we want to track. Let's stay in touch because we want to be your first call for the B round. We want to make sure that we have good feedback from our VC community as we go into deals.

Dave Lavinsky: Got it. As a result of that, are the deals funded by the Tech Coast Angels, are they going to be exclusively technology type deals that are within the VC appetite or does it possibly go out into retail or other types of ventures?

John Morris: It depends how much money is needed. If it's capital efficient – we do retail. We've done some products. We have funded companies that will never raise venture capital just because there's enough domain expertise around the table that the members understand the business, and they are willing to take the funding risk on their own. Sometimes that has worked and sometimes that hasn't.

We are not just about technology. We've done a pretty diversified portfolio. There certainly is a lot of internet component to the business model, software and so on, but we have done some off-beat investments. We're not investing in restaurants and we're not investing in shopping centers, but we are investing in

consumer products and medical products, and some biotech occasionally, medical devices, things that may or may not be traditional venture capital situations.

I sometimes discourage it because I say, "*Guys if you're going to fund this you're going to fund it from now until you sell it. Make sure there's enough capital around the table and the appetite is there and that the members reserve enough money for follow-ons because you can't count on third party financing*."

Dave Lavinsky: Got it. You just mentioned from now until you sell it. What are the angels' expectations on cashing out their investments? Do they most likely expect an acquisition and in what time frame? What type of returns do angel investors typically see?

John Morris: That's a great, great question. The model is changing. The time factor is going up. I think when the angels started this in '97 there was a legitimate opportunity that your better companies could end up becoming public companies. I think over the last ten years a lot of things have changed on Wall Street that make the smaller IPO kind of extinct. The minimum market caps for public offerings today are north of $300 million. It's an expensive process and there's just not a lot of venture-backed IPOs anymore.

Everybody is kind of in the mindset of, "*Well who is going to buy it if it's going to be a trade sale or M&A exit? Who's a likely buyer?*" And as the company matures, you're trying to figure that out more and more intently to make sure that company's got strategic conversations, it's familiar in the industry, it's done a good job marketing itself so it does show up on the radars of the appropriate buyers.

We're almost exclusively dependent now on M&A exits and unfortunately M&A exits take a bit longer. Buyers want to see things maturing. There's the odd exception where a Google or a Yahoo! or Microsoft or Oracle will come in and buy

some small technology because it's a piece of a bigger puzzle but you really can't count on that.

Unfortunately, I think the average length of a company holding period now is kind of seven to eight years. It's putting some real strain on the whole angel thesis that I can get a 10x return in five to six years. That was the original expectation. With the ten year going longer, valuations have to be appropriate so you can make your money and make sure it is a venture capital fundable deal so that there is enough money that can take it to the full term.

Dave Lavinsky: Got it. So is that 10x figure over five to six years, has that changed as well? Or has that stayed the same in terms of your goal?

John Morris: No. I think the 10x has stayed the same. I think the five to six years is probably seven or better. Most VCs recognize that. I think angels are now realizing that.

We've seen a couple of situations where there are some start-ups to organize private equity interest exchanges so that angels that are in a company five or six years and it's done really well and it's on its fourth round of venture capital. Angels have an opportunity to get out because the later rounds of venture capital are waiting for even a bigger outcome and that just delays the opportunity for the angels to ever see any money.

There may be some solutions to this problem but the angels tend to get locked up for a long time. Oftentimes there are piles of preferred stock on top of them which can be very dilutive to the final outcome. But 10x is still the expectation and, like I said, it's putting pressure on your thinking – how much do I have to reserve for this company and what should be the appropriate pre-money value.

Dave Lavinsky: Got it. Where do entrepreneurs go to look for angel investors? Maybe you can talk about the Tech Coast Angels, is the preferred contact to go to

your website and fill out a form? Or is it to find an individual member and that member presents to the group? If so, how do you suggest finding that initial angel member?

John Morris: Well that's just good networking. There are plenty of events. Tech Coast Angels are in Los Angeles, Orange County and San Diego. Members are actively involved in a variety of organizations that have panel discussions on entrepreneur financing, venture capital financing. So we're easy to find.

Often the better entrepreneurs are really good at finding out who they need to talk to and getting appropriate introductions, whether it's from their law firm or accounting firm or other CEOs that have been successful. There are mentorship programs going on here in Los Angeles that are encouraging entrepreneurs to work with other VC-backed CEOs as mentors and try to make those introductions.

But we're easy to find. The website is really where you have to go to file the application. It certainly helps if you can file that application with the coaching of one or two members that has an interest in what you're doing and is willing to introduce you at a screening session. So, the more personal touch that you can put into the process, the more you understand the vocabulary and some of the issues in raising outside money – third party money, other people's money – the better you're going to be.

Good entrepreneurs put the time in to understand that process. I can't stress that enough. Valuation, amount of money, team building experience, organizing your founding team, being properly prepared with appropriate information, being prepared for diligence when it does come – all of those things make a huge difference in whether or not you're going to raise money or not.

Dave Lavinsky: Agreed. One of the last things you said was preparing the appropriate information. What information does an angel want to see before

deciding to invest in a company and in what order? I know that Tech Coast Angels has a specific form that they want filled out.

John Morris: That form is fairly detailed. It was originally designed so that we wouldn't just get people posting executive summaries. We wanted specific ingredients – competition, financial model, management team, directors, business case, description of product, feature matrix. We wanted those kind of things thought through and presented to the site so the application screening team had something to go with as opposed to a self-promoting executive summary or a brief set of slides. We really wanted to make entrepreneurs be thoughtful about the application.

The currency today is largely PowerPoint, largely a set of slides that can be conveyed in twenty minutes. With a real premium placed on clarity and coherence and business model and explaining what's different, what's unique, how they're going to get paid, how they differentiate themselves, how well they know the competition, what are the primary assumptions of the financial model.

Ultimately it's a PowerPoint, possibly an executive summary, a financial model, competitive matrix, organization chart, bios for the team, cap table, any kind of history that's relevant, marketing materials, website, those kinds of things. Those are all the ingredients.

The issue of whether or not you need a thirty or forty page business plan, it's more about a process. And I think I like to say that that always helps because the more work that goes into that, the better preparation, the better thought that's gone into the business model, in terms of the logistics makes sense.

Oftentimes companies that have great PowerPoints, but have not done the business planning, really fall out at diligence, because members say, "*These guys don't' have a clue how to get things started. It's clear they haven't done any thoughtful work on a business plan and it shows and I'm losing confidence.*"

The execution skills often get questioned if the business plan is not there. It doesn't need to be in a final PDF but the ingredients have to be there. I think I'm kind of old school there that the business plan is helpful. But believe me the way that business plan is communicated is in a series of PowerPoint decks.

Early presentation, first meeting presentation, then a bunch of subset diligence session, financial model, competition, product, road map, marketing and sales, how we get paid, how we go to market, what's the hiring we need to do, what are the key positions we need to fill to fill out the org chart… Those are all the issues that come up in the diligence.

Dave Lavinsky: Got it. In doing that, what are the most common mistakes you see entrepreneurs making when pitching to angel investors?

John Morris: I tell you I could write a book on that and I've threatened that to myself.

What I think is most common is that the early funding, the early friends and family round, is not properly documented – or it was sold at an outrageous valuation – so now they're coming to raise money on expectations that the angel pre-money, the valuation, is now high because it has to be, because we sold our friends and family round at $5 million pre-money. We have to be that or better. That makes no sense at all. Your pre-revenue, this is maybe $1.5 to $2 million pre-money – not five.

A lot of companies get lost in the valuation. A lot of entrepreneurs don't understand the vocabulary. They don't' understand term sheets. They don't understand the Tech Coast Angels process. They don't understand what it is to have a board, a cap table, that kind of thing. I think mistakes are most commonly valuation, listening and being coachable, not thinking about how much money they need to raise and how to stage it.

Not thinking about the go to market, how do I get my first five customers? Who's going to generate the first years of revenue? Is it the CEO? Is it somebody else? How well is the team and this is a huge case where a good founder recruits weak members to be his founding team.

Misappropriate background, misappropriate experience, misappropriate domain expertise. A lot of founders end up recruiting the wrong people in key spots and it often breaks down in diligence and people think, "*Geez this team is pretty weak, pretty young, pretty inexperienced. He has no background in this before. What is it thinking?*" Just because he thinks it's a good idea doesn't mean he's the one to execute it.

Those are some of the most obvious. I think one of the things a lot of entrepreneurs try to have answers to everything, and entrepreneurs not listening and not looking for coaching and feedback, not looking for a partnership, but just looking for the money and not really understanding that your early investor is going to be a six, seven year partner and where that compatibility and chemistry is really important.

In other cases a good example where you have some early money is raised. Now you're looking for Tech Coast Angels money and the early money and could be a family office, could be a particular individual who feels that they're still in charge and "*We just need the money. We don't need any input. We don't need partner. We just need to take the money. We're trying to get the best value we can. That's all I need.*" That tone, that kind of mindset blows up in this – if not in the presentation in the first meeting where you've got chemistry issues that will never be solved.

Dave Lavinsky: Now when you talk about a six or seven year partnership. What about Angel Investors taking a seat on the board. Is that common?

John Morris: Oh yeah, absolutely common. It's really important that the best member take that seat, the one that can add the most value. It's always the case. We oftentimes want to stay through the next round.

Then we go to an observer round. But we want that board member to be very active with the company. We want that board member to hold the CEO accountable for good information and reporting back to the fellow Tech Coast Angels investors. Delicate issue because we want that board member to be our spokesperson for the company.

In follow-on rounds, the company gets into trouble, we lean on that person to helps us get good information so we can make good decisions about what to do about the company. What to do about the company. Does it need more money? Does it need new people? Does it need a new product? Does it need a new marketing campaign? We really want our members to be involved in that.

Dave Lavinsky: Does a board member get compensated in this case?

John Morris: Sometimes yes but it's rarely cash. Sometimes the company, the compensation committee of the company will put together a stock option plan for key employees and designate some of those options for directors. It's not real meaningful but we certainly expect that someone who is playing a very active role for the benefit of others should get some option package but oftentimes those have limited value.

Dave Lavinsky: Got it. What about protecting ideas? As you know, a lot of entrepreneurs are very protective of their ideas, borderline paranoid on letting people know what they're doing and concerned about non-disclosures, et cetera. How do angel investors handle that? When, if ever, will they sign a non-disclosure, and how does that work?

John Morris: That's a good question and a lot of first time entrepreneurs are paranoid about it and it's misplaced paranoia. We rarely sign an NDA going into a deal. There are some cases where we've agreed to sign an NDA as part of intense due diligence on a particular area, particular focus of the product but we really tell entrepreneurs, it's really a business issue. We don't think you should be telling us the secret sauce. We need to understand what it is in general but we don't need to know much about it early on.

If we do get into diligence we can give you some comfort that we certainly want to keep it secret because we're going to be your investors and we don't want that value outside of the company. We can really work that in the diligence. Entrepreneurs that come in and do the screening process and say, "*Well I want to sign an NDA before I show you my business plan.*" They go, "*Well if that's easily copied and it's not a good sign for the home team.*"

We certainly have a policy where we don't sign NDAs when we're just getting to know you. We don't want you to tell us anything that would be included in an NDA. Let's put that off on a diligence issue and solve it when we really have to.

Dave Lavinsky: Got it. Just one last very broad question for you is what else did I forget to ask you that you think an entrepreneur should know about raising capital from angel investors or angel investor networks?

John Morris: I think a good entrepreneur does his homework and understands that he's trying to put his own business plan together, how his product is going to win customers, how he's going to beat competition, how he's going to recruit a world class team, how he's going to build value and ultimately manage an exit where somebody is going to pay a lot of money for the company.

We certainly want entrepreneurs to be thinking about those kinds of things but the entrepreneur also needs to think about the business plan for the investors. How are they going to make money? How much money do I need? Where can I

be thoughtful about spending it? How can I be really efficient in its use and make sure I'm not just spraying my marketing dollars around because I don't really know how to do that? If the investors are trying to make 10 times their money, how am I going to show them a way to make ten times that's credible?

I've got to be thoughtful about who's the exit. We've said already it's going to be a trade sale. It's not going to be an IPO. Don't think it's going to be an IPO if the market is telling you something else. I think good entrepreneurs understand how investors make money and that it's definitely not a loan.

It's a partnership. You're willing to listen. You're careful about who you bring on as investors. You want value-added investors. You want active investors. You're committing yourself to full disclosure and transparency. You're going to give them a lot of information. You're going to educate them on the business so they can help you when you need it. And you're going to listen to that advice when you get it.

If you put a little bit of effort into how do my investors make money so this is a win-win is something a lot of guys just don't do. A lot of entrepreneurs think about their business model and just say how you make your money I don't know. I'm hoping I make a lot of money. Whether you make money or not depends.

If you're not thinking about that very clearly you're not going to get though the diligence. I think more time spent on what's the outcome of this and how can I make it a win-win for my investors.

Dave Lavinsky: That's a great point. That's a series of great points. John, this was extremely helpful. I think the entrepreneurs that listen to this call are going to get a ton of value and realize exactly what they need to do in order to prepare and approach angel investors and ultimately be successful in raising angel investment and growing their company.