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Options for Angels – When are they relevant?

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Angel investors are often the first external and professionalised investors in an early-stage start-up. Joining a company at pre-revenue stage is a risky proposition and that is a key reason why Angel investors typically seek a substantial minority equity position. For a successful venture, they fully expect, even with participation in subsequent rounds of investment, that their equity position will be substantially diluted.

Valuation at time of investment is NOT a question of control for the Angel investors. It is such a concern for most founders. This is the primary source of tension in agreeing on valuation as the parties are not fully aligned on the reason for determining the 'right' number.

One way of thinking about this is that the Angels are focusing on the early valuation of the company to ensure they can secure a meaningful share of the returns when they reach the exit. For the purposes of this discussion, let's assume the simplest exit scenario, preferred by most Angel investors – the all-cash trade sale. Our insights will apply to all other exit scenarios but, each will bring its own particular wrinkles to how we might structure investment terms.

Most often it is possible to come to an agreement whereby a meaningful round of seed investment, say $250k or more, will buy a viable share of the equity, say 20%-30%, of a pre-revenue start-up. However, sometimes the founders will insist on a much higher pre-money valuation and that's when things can get challenging for investors concerned about the eventual return on their investment.

That high pre-money valuation may be justified by the level of effort and state of development already achieved in the product/service of the company. This is often the case in complex hardware products and other ventures where the development progress has substantially lowered the risk of both time-to-market and speed of scaling revenue.

So, let's say you are looking at an investment opportunity seeking $500k on a $10m pre-money valuation for a highly innovative manufacturing automation solution well-protected by patents and targeted at a high-volume, high-margin manufacturing sector eager for this solution. The team are compelling, the big revenue driver is in the high margin consumables, the product is a proven pre-production prototype with one industry trial validating the appeal and a large industry player ready to place a volume order. Investment is required to move into a fully qualified production model with all the supporting manufacturing data, quality control procedures and quality assurance data required to satisfy the customers who operate in a tightly regulated industry. A $5m round will be required in the next 6-8 months to fund production for that first volume order. The founders aren't going to budge on the valuation and you do want to invest. How?

Options are a great tool in this scenario. With the upfront purchase of equity, the investors are seeking to secure a share of the exit, knowing that the path to exit is likely to include substantial dilution. With an option, the investors are simply giving themselves the choice to buy a larger share of the exit at the time they know the details of the exit.

What is an option?

> *An option is a form of right that gives the holder the right, but not the obligation, to buy a share in the company for an agreed price (the 'exercise' or 'strike' price) by exercising the option during a certain time period. These are often referred to as "Call options".*

The variables for a basic option are the exercise price, the trigger or time period for exercise, and the type of share purchased upon exercise.

The exercise price should be sufficiently low as to offer a clear profit to the option holder based on the anticipated share price at the time of exercise. Sometimes known as being "in the money".

The trigger should be entirely in the hands of the option holder since exercising an option involves the option holder, at least notionally, providing new capital to the company. For a simple investment option there should be no time limit but, there may be an existential limit on the life of the option determined by a liquidity event, e.g. a change in control or a listing on an exchange may be used to force option holders to exercise or forgo their options.

The type of share purchased is most often ordinary shares, or it may be the same class of shares as purchased when the option was purchased.

That last point highlights an important distinction. These options are similar but, different from the options used in an Employee Share Option Plan (ESOP). Those are to attract, retain and reward staff and other key contributors so they involve vesting schedules and tax considerations that do not apply to the options we are discussing here.

How do you acquire an option?

The most common scenario is what are sometimes called 'stapled options', i.e. the options are attached to the shares that the investor buys. For each share purchased the investor gets a number of options at an agreed exercise price for a particular type of share with a clearly defined trigger and duration.

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What do options mean for the founder/company?

An option conveys no other rights on an investor so the founder retains a higher percentage of the equity and the option holder has no right to vote the options in any decisions by the company.

Options add complexity to the captable when one wants to model the 'fully diluted' position of all shareholders. This is similar to the impact of other converting securities like convertible notes, preference shares and SAFE notes.

"As converted" describes a captable where all the convertible securities have been converted using their default terms. It shows the impact of the rights held by non-ordinary shareholders on the final diluted position of all shareholders at the time of an exit. This is a common requirement at subsequent rounds of investment when incoming investors want to understand the impact on the shareholding they are buying if all the rights holders convert.

Options allow the founder to show their appreciation for the significant risk taken by their Angel investors and to offer an upside that aligns interests over the life of the investment.

What do options mean for the investor?

The investor has the choice to buy a larger share of the exit at a known price and only has to make that decision at the time that the exit is already known.

Depending on tax treatment, options may not be recognised as capital gains since the shares are typically only held for a very short time. This consequence must factor into the investor's determination of whether exercising the options is a profitable choice.

If the company never reaches an exit, or does not achieve an exit or triggering liquidity event that puts the options in the money then the investor will benefit only from the original investment.

Investors must remain vigilant to ensure that subsequent rounds of investment do not seek to disenfranchise, or otherwise disadvantage the options, such as by securing liquidation preferences.

Options allow the Angel investors to get due consideration for the extreme risk they take while maintaining an alignment of interests with the founders throughout the life the investment.

Exercising an option

The most common scenario is to exercise the option at the time of exit. In most cases the liquidity event and the exit are essentially concurrent. In those situations where the liquidity event may be a significant distance in time from the eventual exit the choice to exercise the options may be a little harder, e.g. listing on a stock exchange is a liquidity event but, the exit doesn't occur until the inventor sells the shares, which may be years later.

In the scenario we are discussing, the exercise of the option is a paper exercise.

1. Typically, the exit transaction is proceeding on the basis of signed contracts. Thus, option holders will know their exercise price and the share price due to shareholders from the sale of the company so, they can determine if they want to exercise their shares.
2. A condition precedent to the sale is the exercise of options at the agreed exercise price. That sale of shares is recorded in the captable without any cash being provided by the option holders but, the debt to the company for those options is recorded in the capital ledger of the company.
3. Then the company is sold on the basis of the as-converted, fully-diluted captable. All the shareholders receive their prorated entitlements except that for those shares purchased under options, the price of exercising the options is subtracted from the proceeds distributed to those shares.

Let’s consider our example:

- A $500k investment for ordinary shares on a pre-money valuation of $10m is buying ~4.76% in equity.
- If the Angels were buying their preferred equity position of 20%, they would have to buy 5x as much, that is $2.5m.
- So, the Angels negotiate to invest $500k at a share price of $1 (for easy example) and with each share purchased they get four stapled options with an exercise price of $1.
- Throughout the lifetime of the investment the Angels have only invested $500k with the concomitant small equity position, which is diluted by subsequent rounds of investment.
- At the time of the trade sale exit the shares are being sold at $11 per share, which delivers $5.5m to the Angels, for a 10x ROI (after a return of capital). This infers an exit value of $275m if the Angels have only been diluted to 2% of the equity. Likely, they will have been diluted further and, thus, the exit value is much larger.
- On the basis of that share price the Angels decide to exercise their options, costing them $2m, to realise an additional return of $22m. Less the cost of exercise, the Angel walk away with an additional $20m. A total return of $25.5m for an original risk capital investment of $500k. A 50x ROI (after a return of capital).

See, the Angels used the options to buy a larger share of the exit without having to deploy any additional risk capital. So, provided the total value of the exit can sustain that additional dilution, it is a good deal.

If the share price is appealing but, the total value of the exit cannot sustain the additional payouts then the exit was not properly modelled on the as-converted, fully diluted captable.

If some option holders decide not to exercise their options, then it will depend on the terms of the contract of sale. Either the sale value will be reduced by the value of the shares not acquired by option holders, the sale share price stays static; or the value of the sale remains the same and all shareholders enjoy a higher share price and, thus, a larger distribution. In practice, these considerations are normally all clarified as part of the finalisation of the contracts so there are no surprises.

In summary, stapled options can be a good solution for Angel investors to offset unappealing pre-money valuations at first investment. Options don’t confer any additional rights or obligations on investors and don’t detract from any rights or equity position of founders during the life of the investment. Options can create a sustained alignment of interests between the Angel investors and the founders.

About the Author

Jordan Green AM, initiated and led the organised Angel investor community in Australia, is founder of the Melbourne Angels, is an internationally sought after thought leader and adviser to governments on innovation ecosystems, a serial entrepreneur, successful VC and an optimist. The first and only person to be invested as a Member of the Order of Australia for services to Angel investing.