ANGEL CAPITAL ASSOCIATION

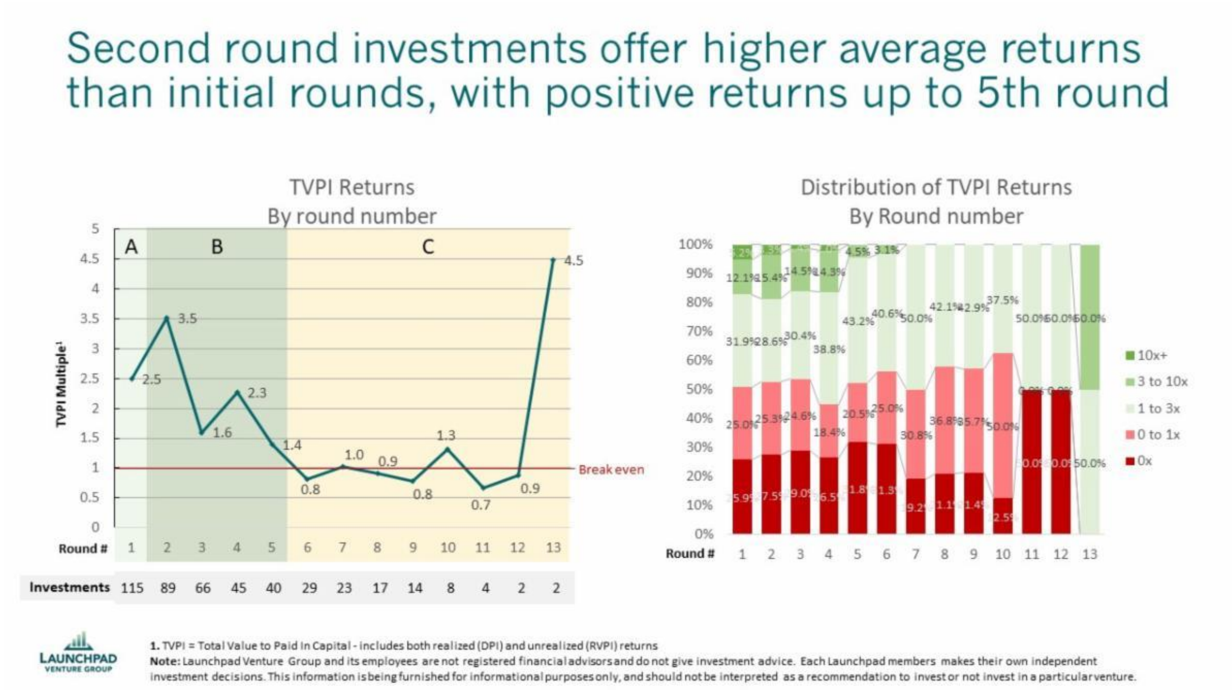
ACA Data Insights
What We Learned From Our Data

Which Investment Round Has the Highest Returns?

At Launchpad Venture Group, we enjoy as strong culture of “continuous improvement” that looks to learn from our 20 years of past investment data to make better investment decisions today and going forward. We also make a habit of supporting our founders through multiple rounds of fundraising; and one question we frequently get from our members is, “which round of investment in a company offers the best returns?” Some members prefer to make a single investment in each company to maximize diversification across companies, while others use investments across several rounds of an individual company to “knowledge cost average” their returns. **Can our data tell us anything about better strategies for follow-on investing?**

To do this, we looked at 484 individual investment rounds that the group has made using Total Value to Paid-in-Capital (TVPI) return multiples for rounds with at least 18 months since the initial investment. This metric measures the current value of the investment (both realized and unrealized) as a multiple of the cash invested. To get a clear picture of round-level returns, we needed to link back the ultimate payout from a company to the actual round where capital was invested. For example, if we invested in a convertible note round that later converted into equity as part of a subsequent fundraising, and then paid a return over two separate milestone escrow payments, we needed to determine what portion of each escrow payment came from shares converted in from the note into equity in order to determine that note’s ultimate return.

The analysis of Launchpad’s results are summarized in the charts below. **The left-hand chart shows average TVPI return multiple by round, and the right-hand chart shows the distribution of return outcomes for each round.**



The return profile by round appears to fall into three ranges, each with insights for investors:

A. **The first round of investment does not have the highest average return.** There are roughly 5% of rounds that see more than 10x returns, but on average first round investments only return an average of 2.5x vs. 3.5x for second-round investments, which have the highest average return.

As early-stage investors, we know that we tend to overpay for companies at their first fundraising. Very often, these rounds happen before the product is completely proven, and almost always before the company has demonstrated market traction. If we valued the company at its true worth at this stage, the founders would need to give up too much equity to keep them well-incented to carry the company to a successful exit. While average returns are not the highest, they are still attractively positive and buy us a seat at the table…plus, it is essential that enough people invest in that first round to get to subsequent rounds of fundraising. We salute the investors willing to step up and meet this need.

B. **Rounds 2 thru 5 have positive, but generally declining expected returns with each subsequent round**. By the second round, companies have typically grown into their valuations and can offer a greater probability of a 3-10x return, in particular. With each following round, we see a notable decline in probability of a >10x return as the company consumes more capital. (and would need to exit at much higher valuations to return 10x)

Investors considering a follow-on investment in their portfolio companies in these rounds should assess whether the company is progressing well down a path of de-risking the investment, and thus able to successfully "grow into" the next round of financing. They should also track and be mindful of which round of funding a company is raising.

C. **Investments after the 5th round do not drive positive average returns.** The probability of a >3x return all but disappears after the 5th funding round, and the probability of a money losing investment generally rises with each new round beyond 5.

Some companies need to keep raising more and more rounds of capital over time. In a few cases, they just need a little more runway to get the business model turning over well; however, there is a growing risk with each new round that they are becoming dependent on external subsidy and will never achieve "escape velocity." While there are always exceptions (like one company that delivered a 5x return on its 13th round) that prove the rule, and "defensive" follow-ons to protect earlier investments may still make sense, investors should be realistic about the odds of success in these later Angel funding rounds.

THE TAKEAWAY

Taken together the lesson for investors is that, while "one and done" may not be the best strategy from a returns standpoint, slavishly following-on in companies that have become dependent on "investor welfare" also problematic. **As often, the best strategy lies somewhere in the middle, and a disciplined investor needs to monitor how each of their companies progresses through the capital formation process when making follow-on decisions.**

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About Launchpad: Boston-based Launchpad Venture Group is a diverse 170-member network of talented Angel's that has been successfully investing both financial and human capital in over 200 New England-headquartered tech-enabled B2B service companies since 2001.

We hope you are enjoying these Monthly Data Insights. If you have an insight (chart with narrative) that you'd like to share in a future edition, please send us your submission to insight@angelcapitalassociation.org. Our goal is accelerate learning from each other.

For the first Annual Compilation of Action Learning from Leading Angels, The ACA Investor Insights Report can be accessed by clicking the button below and using password "ACA2021".