A Comparison between Venture Capitalists and Angel Investors in the Startup Funding

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Abstract. In 2021, many start-up companies raised a large amount of development funds, and many technology companies even listed at relatively high valuations. However, according to data analysis released by Crunchbase, venture capital in the global market will reach 445 billion dollars in 2022, a year-on-year decrease of 35% from 681 billion dollars in 2021. It is against this backdrop of slowing investment growth that this paper is written. The paper mainly analyzes the operation process and advantages and disadvantages of the two early financing methods of venture capital and angel investment, and on this basis summarizes how startups should choose the financing method that suits them. Each financing method has its own advantages and disadvantages. For start-ups seeking funding for development, they need to make the right financing choice depends on the ultimate goal of the company's development and adjusting the financing strategy according to the specific needs of different industries.

Keywords: Venture capital; angel investor; private equity; round of financing.

1. Introduction

Venture capital companies are composed of professional investors, whose financing funds usually come from companies, individuals, and public pension funds. The job of this type of company is to find companies with high growth potential and development prospects. After selecting the target company and completing the transaction, the venture capital company usually holds the shares of the company and has a certain say in the company's future development and operation. In exchange for participation, venture capital companies hope to obtain high return on investment and may sell their shares back to the original owner of the target company after a period of time. The venture capital company may also promote the listing of the company through initial public offering, so as to obtain more return on investment. Venture capital usually involves a relatively large amount of funds. It is estimated that in December 2022, the total amount of global venture capital financing will be 19.71 billion US dollars [1].

Angel investors are people who put their own money into a startup at an early stage, sometimes advising the business on its growth. In return for their investment, they will also receive equity in the business. Different from venture capital, the investment amount of angel investors is relatively flexible and relatively small. This paper will analyze the operating process, advantages, and disadvantages of the two in detail below, and make suggestions for startups to choose financing methods based on the differences between the two parties.

2. Venture Capital

In this section, the paper will focus on the forms of venture capital investment, its objectives and the implications for companies choosing to make venture capital investments. This is followed by an identification of the operation mode and different roles that venture capital plays at different stages of a company's development.

Venture capital is a form of investment that targets companies with strong growth potential. These companies are usually in the early stage of company development and have fewer tangible assets [2]. Venture capital organizations usually provide financial and business expertise support for projects with potential high returns by purchasing equity when the company is still privately owned, thus help the company grow and succeed. Investee companies sell their ownership stake to a venture capital organization in exchange for financial, technical and management expertise. Venture capital organizations usually participate in company management to help senior management make decisions that are conducive to growth. The ultimate aim of a venture capital organization is to generate returns by investing in early stage or start-up companies with high growth potential innovation business models. Venture capitalists usually work for raising funds from external investors. These external investors can consist of institutional investors such as family offices, pension funds and insurance companies. Venture capital companies use the funds raised from these institutional investors to invest in target enterprises. As the target company grows and develops, it will go through different stages in the process of venture capital.

The first stage is seed stage. The seed stage refers to the period when venture capitalists provide relatively less funds for the company’s product development, market research or business plan implementation. In addition, seed funds can also be used to invest in plant, equipment, logistics and other investments. Seed round is usually the first institutional round of financing for a company, and investors located at this stage could receive equity as a return on their investment. Heliogen is a technology company focused on renewable energy research and raised 20 million dollars in seed capital in 2017 [3]. Then, the next stage is the startup capital stage. In this stage, the company begins to carry out customer marketing and product publicity, after analyzing the market and formulating a response plan. The venture capital funds at this stage may be used for talent recruitment and further research of products or services.

The third stage is early stage. The early-stage funds of venture capital are specially targeted at companies in the development stage. The financing funds in this stage are usually larger than the total funds in the seed stage, because once the new enterprises in the development stage have feasible products or services, they need more funds to invest in the operation, so as to expand the market. Venture capital is invested in the form of rounds, usually expressed in letters. Planet FWD, a developer of a carbon management platform founded in 2019 and focused on helping consumer brands reduce their carbon footprint. In May 2022, it raised 9.96 million dollars in early Series A venture capital funds [4]. Furthermore, it is the expansion stage. This stage is also commonly referred to as the second or third stage. Expansion stage funding is provided to companies that have moved beyond the start-up category. This means a stage where the company's revenues are growing exponentially, and additional funding is required to meet growth needs. This may include a significant increase in the workforce of the business or the option to expand into international markets. For example, Astera Labs, as a developer of dedicated data and memory link solutions that study the performance bottlenecks of consumer data center systems, raised 135 million dollars in the D-round financing in November 2022 [5]. Finally, the process is continued to the pre-public stage. This stage is the final stage of venture capital financing, and the company is at a mature stage. The funds received at this stage are often used to support a merger, acquisition, or initial public offering. At this point, many investors choose to sell their shares and end their relationship with the company, which can result in a significant return on investment.

3. Angel Investment

This section mainly introduces and analyzes angel investors, the investment process and the role played by angel investors. Then the article identifies what stage of development angel investors invest in. Angel investors refer to private equity capital providers of small private capital [6]. This means they exchange their own funds for shares in the companies they invest in. Providers are usually wealthy private investors or groups, rather than intermediaries such as small business investment firms. Angel investors usually invest in the early stages of a company's development. According to estimates by the UK Business Angels Association, the annual angel investment in the UK is about 850 million pounds, which makes it a relatively important source of funding for UK startups [7].

Early-stage startups often need sufficient capital to support business development and generate revenue through marketing. However, the income generated by the company at the current stage may not be able to effectively meet the needs of business development, so the start-up company may lose its long-term development potential due to insufficient funds. Angel investors provide small-scale financing for these start-ups to cover the development costs of their difficult times when they are not attractive to venture capital firms. Angel investors do not have fixed requirements for the investment amount of start-up companies, but the investment amount is usually related to the attractiveness of the start-up company's product or business and its development space. At the same time, angel investment has a higher relationship with the higher survival rate of start-up companies [8]. In comparison with venture capitalists, the angel investors will go through the different stages in the process, as follows.

First, startup pitches to the potential investors. Investors need to understand a company or team's business, financial needs, and ultimate development goals before they can invest. At this stage, angel investors need to visit the intended investment company, and the company introduces the actual operation situation to investors in the form of commercial promotion and enables investors to improve the connection with the founders. Subsequently, the angel investors conduct content reviews. angel investors will review the company's development materials and other relevant information. This process may involve the business plan of the enterprise, the forecast of future development.

If the transaction between the angel investor and the intended company is successful, the angel investor or team will contact the founder of the company to further discuss the terms of the transaction. At this stage, the two parties will discuss the transaction valuation, process, and structure. The parties will also negotiate a mutually acceptable clause based on the final discussion result. When framing the terms, investors and founders must weigh the amount invested and any additional capital that the business may potentially need as it grows. Finally, legal advisors typically complete and draft the final transaction documents within one to two weeks before the parties can exchange funds, depending on the size of the transaction. Once the deal has been signed by both parties, the angel investor can begin to provide business development advice, mentorship, and financial support to the company.

4. Venture Capital vs. Angel Investment

This section will make a comparative analysis of the advantages and disadvantages of venture capital and angel investment. Then based on the analysis, this paper recommends how different companies should choose the two investment methods.

4.1 Advantages and Disadvantages of Venture Capital

Venture capital is certainly a viable option for fast-growing startups looking to scale up. In addition to meeting the capital needs of business development, venture capital firms will also provide business and human support to potential investment partners. One of advantages is that large amounts of funds can be raised. The sources of funds for venture capital companies vary greatly depending on the country, but they are mainly banks, pension funds, and insurance [9]. Loans for most small businesses often have difficulty obtaining adequate growth capital, typically up to $5 million, compared to the $25 million or more that can be raised through venture capital [10]. Venture capital does not require repayment of funds, and startups can continue to prepare to raise several rounds of financing. Besides, a venture capital firm or team can help startup founders with risk management experience. It can avoid major problems in the company's development to a certain extent by having an experienced team oversee the daily operations of the company and capital growth. According to the survey data of the US Bureau of Labor Statistics in 2016, the failure rate of most start-ups in the United States is 20% in the first year. When the development of the enterprise is faced with complex situations, venture capital firms can send experienced partners or investors to help the company formulate corresponding development strategies and maximize the probability of making the right decision.

Venture capitalist can help startups to network and connect. Venture capitalists often seek investment opportunities through their social networks, so startups have the opportunity to gain access to their social networks to help them form new partnerships, customer base, and even raise funds for future development. At the same time, venture capital firms can help start-up companies hire more professional employees to promote the company's development. Additionally, startups do not need to offer regular payments. Venture capital firms typically invest in equity in start-up companies. This means startups don't need to make regular payments. The need for regular monthly payments allows companies to obtain more operating funds, which can help companies innovate and upgrade products and operations, thereby expanding the scale of development.

Although venture capital can provide funds and contacts for the development of enterprises, choosing venture capital also means giving up a certain degree of business control. While venture capital firms provide startups with huge amounts of money to grow, startup owners need to dilute their equity to issue new shares to investors. Many companies will have greater funding needs as they grow, and startups may continue to raise additional development funds from venture capital firms to meet their growth needs. This may lead to the gradual loss of equity, decision-making power, and percentage of control of the company by the founders of the startup company. Another disadvantage is that the approval cycle is long. In order to ensure that they can obtain a good return on investment, venture capital firms need to conduct research on the business development and operation of the start-up company, which usually includes the target market, the target company's product or business development potential, and the strength and expected return of the enterprise. This is a lengthy investigation process, and because the investment amount is large, venture capitals also need to decide whether they need to invest. Venture capital is an important source of development funding for start-ups, but the lengthy waiting period for approval can be a disadvantage for companies in the development stage.

4.2 Advantages and Disadvantages of Angel Investment

Angel investment is a good alternative financing option for start-ups that cannot obtain corporate loans, or are in high-risk industries. One advantage of angel investors is that startups don’t need to make monthly repayments, like a business loan, which saves businesses short-term cash flow. Similar with the venture capitalist, angel investors can help companies connect with potential customers and further form strategic partnerships to help companies grow further. This may also involve further strategic investments in start-up companies. The other advantage of angel investment is Less paperwork required when applying compared to venture capital. While startups are still required to present financial projections and business plans, angel investment applications don't require a lot of paperwork to complete. Startups often finalize their investment using convertible notes, which investors can convert into preferred stock on a specific date or event.

Although angel investors can provide development funds for startups, not all startups that need funding can find suitable investors. Finding investors can be challenging for companies. There are many online sites such as AngelList that can help start-up companies find angel investors, but finding the right ones is not easy. Often the best chance for a start-up to receive angel funding is to establish business contacts with potential investors [11]. Because investors have a basic understanding of the company's business operations, which helps to improve the effectiveness of investment and further promote the company's development. Besides, as with venture capital, the reward for getting funding is that the investor gets more equity, which deprives the founders of some control. Angel investors typically get convertible bonds at a 20% premium [12]. Investors have the right to convert the debt into equity at the company's next valuation. The more times a company raises capital, the more equity owners have to give up.

5. Conclusion

As above, this paper mainly introduces and analyzes the advantages and disadvantages of venture capital and angel investment for the financing of start-up companies. This section will summarize the above content, and mainly summarize and distinguish two financing methods in terms of operation mode, investment amount and main functions.

The main body of venture capitalists is generally a company or a subsidiary department of a company, and their investment funds generally come from pensions, insurance, etc. Angel investors, on the other hand, are more private investors who invest their own money in companies. Venture capital usually has stricter review conditions and requirements than angel investors when selecting startups. In terms of investment amount, the average amount invested by venture capital firms is around $7 million, but it can exceed $25 million. But angel investors generally invest between $25,000 and $100,000. Venture capital is more dependent on venture capital business, they seek companies with strong competitive products or services, and mainly participate in the early stages of company development. On the other hand, angel investors mainly provide financial assistance to the company, providing financial support for the company's later business development and market entry.

Entrepreneurs have many financing options when it comes to raising growth capital for their companies. But each financing method has its own advantages and disadvantages. In addition, entrepreneurs must have a clear understanding and planning of their company's short-term and long-term development goals and market significance when choosing a financing method. For start-ups seeking funding for development, they need to make the right financing choice depends on the ultimate goal of the company's development and adjusting the financing strategy according to the specific needs of different industries.

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