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Angel Capital

This article includes original and added content from Peter Kemball's Wikipedia entry "Angel Capital" and Peter Kemball's www.reference.com entry "business angel."

Angel capital is money invested in a business to provide equity capital, not debt which must be repaid regardless of the success of the business. More often than not angel investments are combination of funds and the business expertise of the investor(s). Angel investment transactions are made with the expectation of a very large financial return to the investor per dollar invested if the business succeeds. Angel investments are also made with the expectation of psychological rewards for the investors. These are obtained from their personal contributions to the growth of the business, time and business expertise. The investment decision is thus both financial and personal. Risk and reward take a more complex form than in almost any other financial transaction. It is risk and rewards.

Because of the high expected financial return, angel investment is only a realistic source of equity for the two or three percent of small firms which demonstrate a potential for profitable and rapid growth. Of these high growth rate firms, only five to six percent actually can present investors with plausible sales forecasts showing projected profitable annual sales of a hundred million dollars within a decade. For these few, angel capital is a planned prelude to receipt of the first of a series of formal venture capital investments, the ""Series A" round. For the majority receiving angel capital, it is an error to think of the investment transaction as a prelude to a receipt of venture capital. Angel investments outnumber venture capital investments by a factor of fifteen to one. Yet, venture capital investments and angel investments are roughly equal in the total amount invested in a year,. (US$25.6 billion vs. $26.1 billion in the US in 2006, into 51,000 companies vs. 3,522 companies[1], [2]). An

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Industry Canada study estimates that angel investment in Canada is $3 billion per year.

How it works

Angel investments occur in a market place, traditionally local, where sellers {entrepreneurs} compete to obtain some of the angel's {buyers} high risk investment dollars. Angel investors are a subset of equity investors, those willing to risk loss of capital when investing in companies who seek money from others to grow their business - {Other People's Money, OPM}. The angel capital market works like any other competitive market place for equity: entrepreneurs offer to sell future profits to angel investors, the buyers of the prospect of profits. As in all sales activities, the sellers {entrepreneurs} seek out buyers {angels}.

To succeed in this competitive market place, sellers need to understand the angel marketplace so they can offer buyers a compelling value proposition. To be compelling, the value of the angel investors' share of future profits must be large in relation to the dollars they provide because angel investing is the highest risk amongst equity investments. To get initial attention from buyers (angels) sellers must offer investors a high rate of return on their money in relation to other equity opportunities angel investors have. The benchmark is the returns available in stock markets. The challenge is to get investors' greed to overcome their fear of loss of their difficult to replace capital. A common entrepreneurial error is to benchmark their offer to bank deposit and lending rates. That comparison is as useful a guide for entrepreneurs as is comparing the price of cars to the price of obtaining an education.

In How to Raise Capital, (Timmons, J.A. Spinelli, S. and Zacharakis, A) a 25% or more annual compound rate of return is said to be "very healthy." Successful angel investors obtain a return of approximately 30% plus per annum compounded on their portfolio after taking into account the inevitable loses on individual investments. {Colin Mason, on the Braveheart Fund results cited by the Ottawa Angel Alliance} Thus any individual seller (entrepreneur) must offer significantly more, an IRR of 45% is a minimum. This amounts to about double the long run rate of return available to equity investors who purchased shares in Berkshire Hathaway, one of the most successful investment firms of the past 100 years. Equity is the most expensive from of capital: angel capital is the most expensive type of equity. Thus it is not surprising that few businesses create enough wealth to make a compelling offer to angel investors. Many entrepreneurs believe that if they could get the money their business would succeed. Most are mistaken: "…(A) lot of entrepreneurs think they need money …. when actually they haven't figured out the business equation." Greg Gianforte - quoted in How to Raise Capital.

Most people starting a business are not entrepreneurs as defined in Good Capitalism, Bad Capitalism And the Economics of Growth and Prosperity (Baumol, W. J., Litan R.E., Schramm, C.J.). The majority replicate what has been done elsewhere. When successful they make substantial contributions to their communities. As time passes they or perhaps their successors innovate and the firm

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becomes entrepreneurial. While the presence of replicative firms is valuable to their community, including their role as source of business apprenticeships for entrepreneurs, they are not likely to generate sufficient wealth to pay investors a rate of return sufficient to attract significant amounts of equity capital, hundreds of thousands of dollars or more.

When competing for angel capital, entrepreneurs face the angels' belief that three of four business owners should be employees. Thus even if the business opportunity is entrepreneurial in nature, the odds are that the owners/founders do not have the requisite personal capacity and talents to successfully exploit the opportunity at inception or later. This may explain why only 10 to 20% of those getting serious consideration from angel investors actually get funded. They are making a bet that the management team has the right business strategy and that the team can successfully implement it over a decade. That includes an assumption, that the individuals have the potential to meet the demands of the opportunity and that they can move from their current level of performance to meet the evolving demands of the business strategy when and as required.

In 2004, according to the Center for Venture Research, 18.5% of deals that got through the early screening of angel groups and were presented to investors attracted funding. This was up significantly from 10% in 2003, which is about the historical average. But since this figure discounts the tough initial screening performed by most groups, the percentage of all companies seeking angel financing that actually receive funding is closer to 0.5%-1% (but still higher than the 0.2%-0.25% of applicants who receive funding from venture capitalists). Approximately 51,000 US companies received angel funding in 2006, and on average, each raised about US$500,000.

Healthcare services, and medical devices and equipment accounted for the largest share of angel investments, with 21 percent of total angel investments in 2006, followed by software (18 percent) and biotech (18 percent). The remaining investments were approximately equally weighted across high-tech sectors.

Given that the number of firms getting angel capital in a year is fifteen times that getting venture capital, most angel investments do not receive follow-on investment from the venture capital community. Consequently from the perspective of how investors obtain their returns, the marketplace is segmented by exit path into two segments with very different views on what constitutes a good deal.

For the few firms that receive venture capital, their angel investors make their money the way venture capitalists do, exit by sale of the company in an M&A transaction or, less frequently, an initial public offering, IPO. These angel investors function as a farm team for the venture capital industry and tag along with the latter's exit mechanism. All other angel investors thus confront a dilemma, how do they exit? How do they recover their capital from a successful business and earn a return on their capital?

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Angel investors who do not function as a venture capital farm team can expect to "exit" in two ways: as venture capitalists do via an IPO or a sale of the business, or when the business generates a growing positive cash flow. The latter "exit" journey requires that the equity funds provided by angels creates sufficient wealth and liquidity for investors and entrepreneurs alike within the business. {Use of other but less expensive forms of external capital such as order financing, selling invoices at a discount or bank debt in conjunction with angel equity, so called "baklava financing", occurs frequently, as it does in venture capital backed businesses.}

The choice of exit strategy creates very distinct dynamics for building the business.

Venture Capital Led Exit. The farm team angel capital to venture capital investment path fills the gap in start-up financing between the "three F"s (friends, family, and fools), seed capital, and venture capital. While it is usually difficult to raise more than US$100,000–200,000 from friends and family, most traditional venture capital funds are usually not able to consider investments under US$1–2 million. Thus, angel investment is a common second round of financing for high-growth start-ups on the path to cashing in on the wealth created.

Angel Capital Led Exit. Recent developments within the angel community, including investments in a single firm by various angel groups across North America, suggest that angel investors can and will follow the classic venture capital industry exit strategy. The extent to which this will occur amongst the fifty thousand firms a year firms receiving angel investments is not known.

Exit From Profits. This numerically larger segment exists for one reason. There are many good investment opportunities that do not fit the venture capital style investment-exit model. Nor do they meet the venture capital industry multi-million dollar minimum investment level. Fortunately angel only capital does not need to seek its returns from a sale of the business, let alone from an IPO. In contrast with venture capital, most angel only investments are usually not well suited to such exits.

The most realistic means for angel only investors to exit is from their share of the wealth generated by the business receiving investment. A stream of royalty payments commencing after the business breaks even can provide an exit to meet the IRR target of angel investors. As a rule of thumb to attract angel investment entrepreneurs need to offer an annual royalty payment equal to the amount invested. Annual payments need to commence no later than three to four years after the investment occurred.

Unique features of angel only investment

The majority of angel only investment opportunities have more limited upside than venture capital ones. This means that one good investment is unlikely to make up for several bad ones, a venture capital perspective. Consequently angel investors in angel only deals are more sensitive to loss of capital in a single deal than they would be in venture capital potential deals.

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Recovery of capital is relatively more important to angels than venture capitalists and this is a second distinguishing feature of the angel capital marketplace. Hence use of investment techniques weighted towards protection of angel investors’ capital permits entrepreneurs to more readily secure angel funding. In Canada and elsewhere, the creative use of refundable income tax credits available to early stage technology firms performing research and experimental development can alleviate the investors concerns as can the appropriate use of the tax system.

Partial protection of capital can be provided while allowing entrepreneurs to capture more of the upside of success. The consequence is that it is possible for entrepreneurs to create more wealth for themselves than would occur with venture capital investment. At liquidity, a founding entrepreneur’s typical share is 2 to 4% of a venture capital financed business.

A third distinctive feature is that, unlike most other parts of the marketplace for raising money, there is a virtual absence of roles for parties (intermediaries) between the source of the funds, the angels, and the recipient of the investment, the entrepreneur. The reason for this is that the amounts raised are around half a million dollars. The amount of time and effort involved on the part of angels and entrepreneurs is substantial and traditionally neither has been expert in performing the tasks involved. Logically they would benefit from the presence of skilled intermediaries. Yet it is difficult for intermediaries to earn sufficient compensation. The sum required by an intermediary to make their time and effort profitable is too large a percentage of the value of the transaction. Competent intermediaries can expend the same amount of time and effort on larger transactions and for a smaller percentage of its value earn more. Thus there is an absence of an industry of experienced brokers with established track records. At best a low cost transaction web based search mechanism may emerge but a match-making hand-holding investment banking model will not survive. Thus some angel groups are choosing to internalize the handholding function.

The fourth distinctive feature, angels hiding their cash under a bushel, is in transition. With the advent of angel groups emulating venture capitalists in making their presence visible, for example via the National Angel Organization in Canada, the Angel Capital Association in the USA as well as The Angel Journal, entrepreneurs’ access to angel capital has improved. Even though not all angels will advertise their interest, some of those choosing to remain hidden will likely invest alongside their more visible brethren.

Entrepreneurs

Entrepreneurs are people who bring to market products or services that are new. They bring to prospects and customers better value than existing offerings and or open up new possibilities for customers. It is this that creates the basis for new entrants to succeed.

Commonly entrepreneurs are seen as risk takers. Examination shows that like many other high performers such as test pilots, many competent entrepreneurs simply

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calculate and manage risk in accord with the reality of the opportunity and their capability. Commercially successful entrepreneurs do this while abiding by commercial rules. To be successful their efforts must generate a growing and positive cash flow from sales to customers. They have a wealth creating business model for the benefit of investors and themselves. This complements the entrepreneurs' primary driving motivation to demonstrate that the vision they so passionately hold about the worth of their product or service is correct. As they see it, the world really cannot do without their product or service. However in exchange for accepting the fundamental rule of business - make sales and profits - most also expect that if their vision is right they will do well financially. In short they balance the requirements of all three parties, customers, investors and themselves.

Few entrepreneurs raising equity capital for the first time realize how much time it consumes. Months of preparation are required to prepare their story for the telling, then telling it again and again to investors, followed by managing lawyers and accountants - who are required to protect their clients interests - to get cheques. Throughout the entrepreneur must also run the business on which all parties depend for wealth creation. When capital is being sought, entrepreneurs have a day job, raise equity from angels, and a night job, run the business. In fact everyone in the company has a day job and a night job..

Angel investors

An angel investor (known as a "business angel" in Europe, or simply an "angel") is an affluent individual who provides capital for a business start-up, usually in exchange for ownership equity. Their motivation to invest is typically a blend of desire to earn a return on their funds combined with a willingness to contribute their expertise to building a new business and a sense of giving back to their community. Historically, angels invest close to home both in the geographic sense and in the area of their business and industry expertise. This is changing as angel groups network and through the supportive efforts of the Marion Ewing Kaufman Foundation, The Angel Capital Association and The National Angel Organization all of whom publicize the significance of the angel community as a source of equity capital for entrepreneurs and support that community. Activity to promote standards for angel investment activities is an example of such support.

Angels typically invest their own funds, unlike venture capitalists, who manage the pooled money of others in a professionally-managed fund. However, a small but increasing number of angel investors are organizing themselves into angel networks or angel groups to share research and pool their investment capital. Nonetheless angels make their own investment decision about their own money. The good news is that pooling means that entrepreneurs are no longer constrained by the financial capacity and business expertise of the individual and a few friends. Some angel investor groups have more than a hundred members.

The investment process used within the angel investment community is not standardized to the same degree that the venture capital industry process is. However efforts are beginning to introduce standards. One high profile group, Tech

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Coast Angels in southern California, has a well defined process. As described in The Angel Journal each investor acts as a principal: they make their own investment decision in respect of their own money. The twenty-five fold growth in organized angel activity is a promising development for entrepreneurs seeking capital to finance growth.

Just as there are many good businesses that can afford angel capital but not venture capital, there are many good businesses that cannot afford either. Angel capital is more expensive than non-bank working capital such as factoring. Thus for firms who cannot create enough wealth to meet the IRR requirements of angel investors, and many a good business cannot, working capital solutions such as factoring can also productively augment friends and family rounds of funds.