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Attachment A

Issue Brief

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February 14, 2008

State Strategies to Promote Angel Investment for Economic Growth

Executive Summary

Governors are increasingly interested in entrepreneurship because of its key role in driving business innovation. While entrepreneurs face several common challenges, including developing business acumen and making connections with experts and mentors, often their greatest challenge is raising capital. Entrepreneurs' emerging technologies are frequently viewed as too risky for banks, private equity firms and venture capitalists, yet many fledgling companies require more investment to grow than can be raised from friends and family. Angel investors are increasingly stepping in to fill this gap.

Angel investors are wealthy individuals with business or technology backgrounds who provide entrepreneurs with capital, connections, and guidance. They provide early-stage financing in a space once occupied by venture capitalists, who now invest primarily in larger deals and more mature companies. Individual angels invest between $5,000 and $100,000 in local and regional ventures, primarily in high-technology sectors, giving their investments local impact. In the past decade, many angel investors have formed and joined groups because investing through groups offers several advantages, most notably a large and more diverse portfolio, access to expertise, and higher deal flow.

States increasingly recognize the value of angel investments and are adopting policies to promote them. Some have created statewide networks to assist the formation of angel groups, link angel groups to share best practices, and help groups invest together in companies that need more funding than a single group can offer. Governors have several options to encourage the formation of angel groups to expand early-stage investment:

- Promote seminars on private equity investment for current and potential angel investors;
- Assist entrepreneurs by connecting them with existing entrepreneurship education and services;
- Facilitate the formation of statewide angel group networks to organize and empower local leadership and build investor knowledge;

This Issue Brief was written by Jonathan Loritz in the Social, Economic, and Workforce Programs Division, with special gratitude to Sam Leiken at the Council on Competitiveness for his contributions.

- Ensure that angel investors are well-represented on state economic development advisory boards, along with entrepreneurs, universities, and other industry representatives; and

- Identify and collect metrics to monitor the impact on policies to encourage angel investment.

Many states have also implemented financial incentives such as tax credits, conditional loans, or matching grants for angel investment. These policies can be controversial and their impact has not been rigorously evaluated; even angels are in disagreement as to the economic growth benefits of tax credits. However, if tax credits are to be implemented, there are several principles that states can incorporate from other states' experiences. Additional monitoring and evaluation will be needed in the field of angel investment to better determine the effectiveness of financial tools.

Angels Propel Jobs and Growth

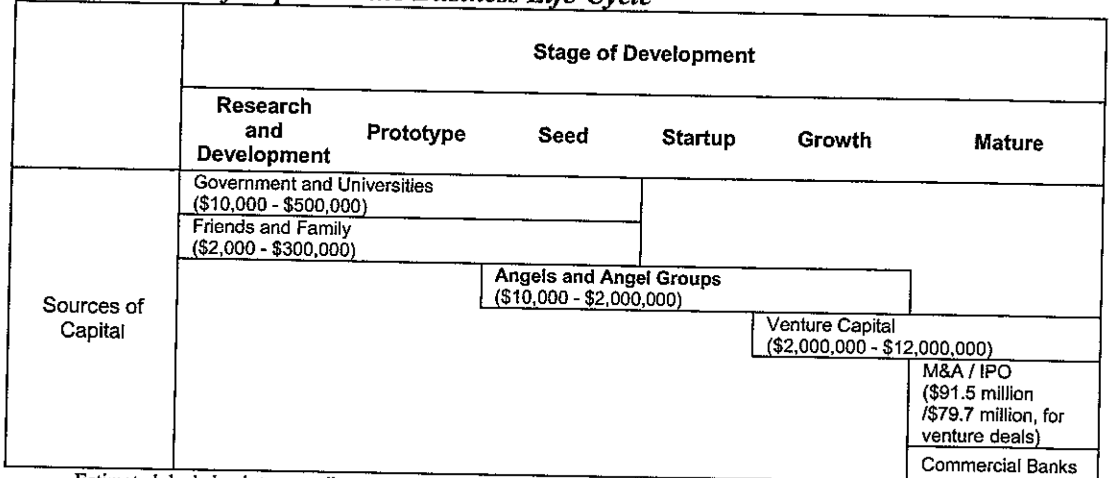
Development and commercialization of innovation are central to the United States' competitiveness, and entrepreneurs who engage in these activities are major contributors to growth in the country's productivity, wealth and jobs.[1] Angel investors can provide critical capital and guidance in turning entrepreneurs' innovations into successful products.

Angel investors are predominantly *accredited investors* (defined in Appendix B) who make equity investments in companies with high growth potential. These are often in the same industries pursued by states' economic growth strategies. In 2006, 80 percent of angel groups sought investments in medical devices and software, 60 percent sought biotechnology and business services companies, and 55 percent sought investments in information technology, industry and energy companies.

> ***Google***
> The most famous angel investment in recent years was probably the $100,000 check that Sun Microsystems co-founder Andy Bechtolsheim made out to Google after watching Larry Page and Sergey Brin demonstrate their search-engine software.
>
> The check was uncashable at first—as a legal entity, Google didn't exist yet—but once the company's incorporation papers were completed and filed, the money enabled Page and Brin to move out of their dorm rooms and into the marketplace. Likewise, Amazon, Apple, the Body Shop, Kinko's, and Starbucks all got their starts with the help of angel investors.
>
> Source: Indiana Venture Center

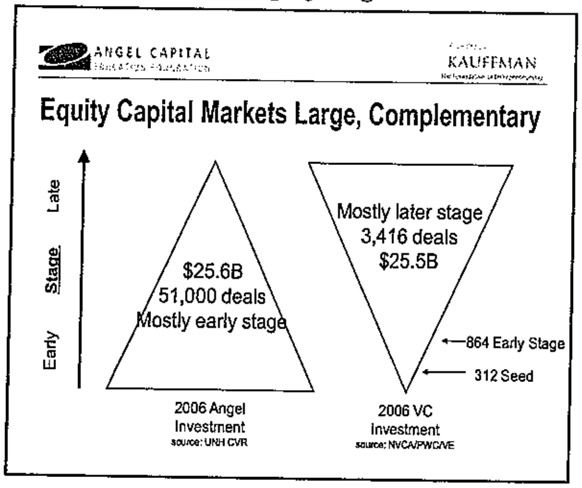
Angel investors are part of a larger continuum of capital sources during the life-cycle of a business (see figure 1). Angel capital is pursued by entrepreneurs typically after they have received funding from "friends and family" or government sources to fund research and prototype development, yet before the company reaches the point of maturity where it might attract venture capital. In fact, angels are responsible for up to 90 percent of early-stage equity not obtained from friends or family according to the Kauffman Foundation.[2, 3] In 2006, this investment was $25.6 billion across 51,000 ventures with an average of four to five investors per deal, according to the Center for Venture Research.

Figure 1. Sources of Capital in the Business Life-Cycle



Estimated deal size interquartile range or average in parentheses. M&A: Mergers and Acquisitions; IPO: Initial Public Offering. Sources: Thomson Venture Economics, National Venture Capital Association, Center for Venture Research, PWC MoneyTree.

Figure 2. Relationship of Angel and VC investment



Angel capital fills an important funding "space" once occupied by venture capital.[4] Venture capitalists used to invest in early-stage ventures but have shifted their investments toward more mature – and therefore less risky – businesses. In 1995, 38 percent venture capital investment was in seed and early-stage companies. But by 2005, companies at these stages received only 19 percent.[5] The most recent figures are depicted in Figure 2. Officials from the U.S. Department of Commerce and the European Commission have declared this a "fundamental market failure in early stage financing."[6]

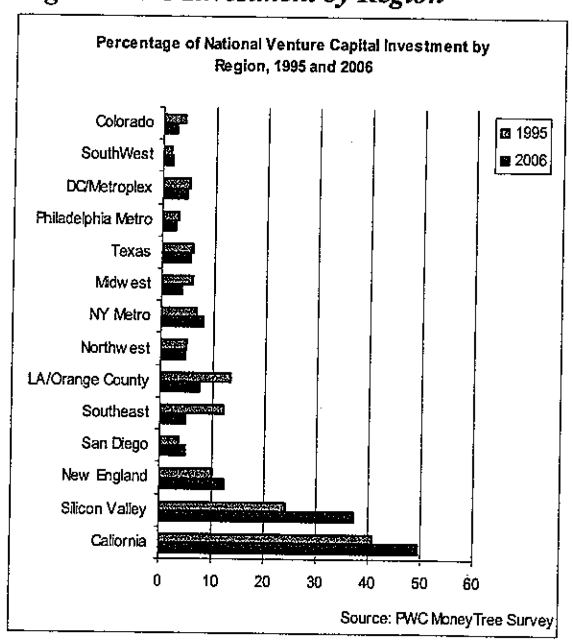
One venture capitalist replied to a survey by the Council on Entrepreneurial Tech Transfer and Commercialization, "In general, we need more [angel investing]. The venture capital community is moving more toward only wanting to invest in companies that have some customer traction and developed product. We need angel money to get companies to that point." And though venture capitalists are investing in later stage companies, many rely on angel investors to provide support for companies in which they will eventually invest: In a recent survey, 94 percent of venture capitalists responded that angels are beneficial to the venture capital industry.[7]

Investments by Region

Angel investors provide an important source of local investment capital for states and regions, just as venture capital is becoming more concentrated in but a few areas of the country. As shown in Figure 3, **California** and New England together account for 58 percent of venture capital, and entrepreneurs must often relocate to receive that capital. Alternatively, most angel investors invest locally and regionally, serving as a critical element in regional entrepreneurship and economic development strategies.[8]

A healthy angel community can be a great resource for entrepreneurs and help sustain a region's innovative companies. By supporting early-stage ventures, angels provide investment opportunities for venture capitalists and improve the prospects of developing a regional venture capital industry. Through these connections, angels support a vital link in the business cycle that may reduce the need for growing companies to relocate for venture funding.

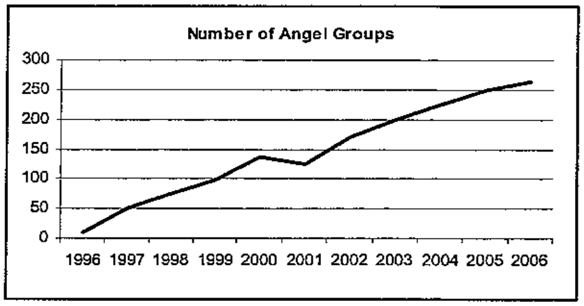
Figure 3. VC Investment by Region



Benefits of Angel Groups

Angels have begun forming structured angel groups to increase their economic impact and improve the success rate of their investments. The number of groups has grown to over 200 (see Figure 4; see also Appendix E for a list) from only 10 in 1996.[9] The main reason for such growth is that groups afford angel investors several advantages over investing individually or in informal partnerships:[10]

Figure 4. Growth in Angel Investor Groups



Benefits for Angel Investors	Benefits for Regional Economic Growth
• Increased deal flow • Social networking • Organized public presence • Shared expertise • Collaboration on due diligence • Ability to invest in larger deals • Improved diversification • Corroborated investment decisions	• More entrepreneurs receive funding • Larger early-stage financing rounds can be completed to reduce the financing gap • Entrepreneurs will be more successful as they benefit from a greater range of business expertise • Improved prospects of developing a regional VC industry

What Governors Can Do

Focus groups suggest that angel activity is correlated with four initial conditions: seasoned entrepreneurs, new wealth, a strong university base, and a relevant industry base.[11] By creating linkages between these factors, governors can improve the climate for early-stage investment in coordination with other initiatives for the innovation economy.

The strategies in this brief are the most promising practices for mobilizing local investment in innovative entrepreneurs. Together, these policies form a comprehensive strategy for the early-stage capital component of governors' economic growth initiatives.

In short, governors can:

- Expand investor education through seminars for accredited investors;
- Invest in resources for entrepreneurs and ensure angel investors are included in an overall portfolio of services to support entrepreneurship;
- Help establish and support statewide angel networks;
- Ensure that angel investors are represented on state economic development advisory boards
- Provide financial incentives to encourage angel investment; and
- Identify and collect metrics to monitor the impact on policies to encourage angel investment.

Expand Investor Education

Governors can further encourage angel investment by promoting and subsidizing seminars on private equity investing for accredited investors. Seminars and workshops are effective because equity investors need to understand complicated financial and legal documents as well as the group investment process. Education builds investor confidence, increases investment activity and can result in more successful ventures. According to experienced angels, the cost of learning the business of private equity is about $250,000—or 10 investments gone sour. With the learning curve being risky and expensive in terms of money, time, and reputation, subsidizing angels' education is a promising strategy.

Programs such as the Power of Angel Investing (PAI), a seminar series about angel investing, are another way for governors to promote angel investment in their states. PAI includes guidebooks for starting angel groups and workshops on contracts and term-sheets to help angels make smart investments. **North Carolina** offers the PAI seminars through its Small Business and Technology Development Centers, and **Wisconsin** offers PAI modules in addition to tax credit and industry workshops through its technology council and angel network.[i] Many angel groups already promote and offer PAI seminars, as do several state technology organizations such as **Maryland's** Technology Development Corporation (TEDCO), **Washington's** Technology Council, and **Pennsylvania's** Innovation Philadelphia.

Benefits of PAI Programs

"To sit down in a room with colleagues and discuss the real-time experiences of seasoned investment veterans is quite insightful."

Angel participants point to the following as primary benefits of PAI educational programs:

- Tools and knowledge that encourage angels to become more active;
- Best practices, models, checklists, and resources to increase efficiencies and success in angel investing;
- Opportunities to meet angel colleagues and local experts;
- Increased membership in angel groups; and
- Encourage the formation of new groups.

Source: Ewing Marion Kauffman Foundation

Connect Entrepreneurs to Existing Resources and Social Networks

Another way to strengthen angels' relationship with entrepreneurs is to improve entrepreneurs' understanding of markets, access to technology services, and opportunities to develop social connections. These resources help entrepreneurs prepare their ideas and nascent companies for prospective investment by creating realistic expectations, accelerating technological development, and increasing opportunities to learn from other entrepreneurs. Many angel investors believe that the best way to increase angel investing is to improve the quality of entrepreneurs' startups.

States can learn from several regional programs around the country when formulating their plans for entrepreneurship education. One promising educational program for women entrepreneurs is Jumpstart in San Francisco, **California**, which provides an intensive and highly selective 4- to 6-month seminar program. The seminars help companies develop funding strategies, go-to-market strategies, and prepare for expansion of the founding team.[12] In Cleveland, **Ohio**, the organization JumpStart, Inc. offers similar expertise to entrepreneurs. It has several groups that hold networking events, advise on funding strategies, and make available entrepreneurs/executives-in-residence to help companies prepare for investor presentations.

Through programs like NetWork Kansas, governors can also help entrepreneurs connect with existing business and entrepreneurship services throughout the state. NetWork Kansas is affiliated with the US SourceLink program, an online Web portal that connects entrepreneurs to existing entrepreneurship support services in a state or region. NetWork Kansas is unique in that it is the

[i] In this paper, *angel group* refers to all angel organizations that regularly assemble for investment purposes. Angel investment terminology is still evolving, and it is important to note there are different investment structures for angel groups. There are two prominent investment structures for angel groups: *angel networks,* where investors each make individual investment decisions, and *angel funds,* where angels make collective investment decisions with a pooled fund. In this paper an *angel network* will refer to institutions that formalize interaction among *angel groups.*

first statewide US SourceLink program, connecting entrepreneurs from across **Kansas** to resources that can help them grow their businesses – and providing angel investors another way to connect to entrepreneurs.

States can also connect angel investors to efforts that help entrepreneurs obtain Small Business Innovation Research (SBIR) and other funding opportunities from federal agencies. SBIR Phase I grants award up to $100,000 for six months of feasibility studies while Phase II grants award up to $750,000 over two years to successful Phase I grantees for R&D and commercialization evaluation. Companies applying for SBIR grants, especially Phase II grants, often have promising technologies in development. An SBIR award provides a signal to angel investors that these technologies hold promise and an opportunity to leverage their investments with another source of early-stage funding.

Rural Angel Investor Networks

A promising model for organizing local capital in rural areas is the Rural Area Investor Network (RAIN). Pioneered in **Minnesota** by Steve Mercil, RAINs are angel groups in rural communities that provide funding for local entrepreneurs; taken together, these RAIN funds make up a network of these funds called RAIN Source Capital (RAINSC).

There are 16 RAIN funds across **Iowa, Minnesota, North Dakota**, and **Montana**, each with 7 to 61 members and $500,000 to $2 million in capital. The RAINSC network has over $20 million invested in 40 companies and expects the formation of 10 more groups in the next year.

RAINSC supports and advises its RAIN funds, which each make their own investment decisions, typically by majority with quorum, and seek to make a return of 25 to 50 percent. Local investors pledge an aggregate minimum of $500,000 to start a fund, at which point RAINSC invests an additional 10 percent, up to $100,000, and assists with legal formation.

RAINSC furnishes deal structure templates tailored for individual RAIN funds, performs initial screening of business plans, administers a business plan database, and shares best practices across the network.

Membership in RAIN funds is limited to accredited investors who are interested in investing locally and promoting the local economy. RAINSC's expansion proves that angel investors can be found and organized in small towns and rural states.

Specialized assistance in applying for SBIR grants is helpful to young technology firms and many states have begun to offer this service. The SBIR Assistance Program in **Georgia** helps companies apply for SBIR grants by reviewing proposals and budgets at no cost. **Minnesota's** SBIR/STTR* Assistance Program provides topic-specific workshops in addition to helping companies develop a proposal strategy and assemble a research team.

Facilitate a Statewide Angel Network

Depending on existing levels of angel activity, governors may wish to create or support a statewide angel network to serve as a resource for angel groups around the state. Network directors in states with a number angel groups may concentrate on deal syndication and sharing best practices whereas networks in states with fewer angel groups might focus operations on forming and advising groups.

As states support these networks, new groups benefit from the guidance of experienced angels and investors. RAIN Source Capital (see sidebar), a community development financial institution, provides its regional funds with standardized term-sheets and up to a 10 percent co-investment. Such alliances build confidence and reduce fear of failure for new angel investors and groups, thereby encouraging more investment.

* The Small Business Technology Transfer (SSTR) Program is very similar to the SBIR program but is smaller and requires partnership between small business and research institutions. To see a comparison of the SBIR and STTR programs, visit http://scsbdc.moore.sc.edu/sbir_introduction/differences.html.

Organizing and capitalizing investor groups builds local investment capacity, benefiting state economies by creating opportunities for entrepreneurs. The following statewide networks were seeded with state funds and hope to soon become self-sustaining as nonprofit public-private partnerships:

- **Wisconsin:** The Wisconsin Angel Network, part of the Wisconsin Technology Council, is funded for two years with $300,000 from the Wisconsin Departments of Commerce and Financial Institution and the Wisconsin Technology Council. These funds support an experienced director, investment seminars, and an online forum to assist the formation and development of angel groups throughout the state.

- **Washington:** The WTC Angel Network was formed with a $250,000 grant from the United States Economic Development Administration that was matched by the Washington Technology Center (WTC). Managed by the WTC, its objectives are to create and develop community angel groups, facilitate deal flow, and prepare companies to secure investment. Since 2006, WTC has helped two angel groups transition to a self-sustaining and self-managing model. Going forward, WTC's focus is to develop a statewide network with the capacity for co-investment.

- **Pennsylvania:** The Pennsylvania Angel Network, a nonprofit organization, was begun with $350,000 from the Pennsylvania Department of Commerce and Economic Development to fund its first two years of operations. Based in Harrisburg, it also enjoys support from the Ben Franklin Technology Partners and the state's Innovation Works program. Its mission is to assist existing angel groups, help form new groups, facilitate education, and encourage collaboration between groups.

- **North Carolina:** The North Carolina Small Business and Technology Development Center has released plans to expand the state's Inception Micro Angel Fund. The fund was originally launched in the Piedmont Triad area in 2003. The expansion will create a statewide network of six angel funds. The funds will be member-managed and raise investment from individual angels, angel groups and venture capital firms.[13]

Wisconsin, Washington, Utah, Pennsylvania, and **Louisiana** have online forums to match entrepreneurs and investors but benefits have been difficult to measure. While such matching forums may have potential, many angel leaders believe the Internet cannot replace a handshake—trust and relationships are critical to angel investments and there are no substitutes for in-person meetings.

At an annual cost of about $250,000, organizing angel investment networks is likely to yield substantial benefit by laying the foundation for regional risk capital. A governor's initiative can catalyze the formation of angel groups, especially in rural areas where they are less likely to form without assistance. The networks need not increase bureaucracy when focused and carried out in partnership with the private sector.

Angel Investor Representation on State Economic Development Advisory Boards

The governor can improve the state economic development policy by ensuring that angel investors are well-represented on economic development advisory boards. One of the most important aspects of creating change is getting the right people on board. The presence of angel investors on state economic development advisory boards can help identify if and how state government should engage the angel community to craft a state-specific plan.

In **Wisconsin,** for example, Governor Jim Doyle's Economic Growth Council included a prominent angel investor and the governor's *Grow Wisconsin* initiative included plans for a statewide angel network. Part of the initiative is a statewide strategic plan to help meet the needs of the angel community. Charged with developing the strategic plan, Wisconsin's angel advisory committee is representative of the state's economic drivers both in and out of business. Finally, Wisconsin Act 255 established investment tax credits and created the Wisconsin Angel Network, which helped form five angel groups across the state in 2005.[14]

Provide Financial Incentives

Governors may also consider matching federal grants and private investments through tax credits, conditional loans, and matching grants. The most common incentive, and most controversial, is the personal tax credit: Eighteen states have early-stage investment tax credits with rates of 10 to 100 percent (see Appendix G), several of which have been recently enacted. **Kentucky** is trying a different model with the Kentucky Investment Fund Act, where professionally managed funds with more than $500,000 invested in qualified companies are offered a 40 percent personal or corporate tax credit.[15] **Michigan** has implemented the Angel Investor Incentive, a personal income tax deduction on reinvestment in qualified companies.[16]

> ***Angels shy from RFPs***
> States should avoid using competitive Request for Proposal (RFP) processes for awarding grants to angel groups. The money and time invested in responding to an RFP can be substantial, and failure is a reputation risk of consequence to angel leaders. RFPs tend to reward mature groups at the exclusion of newer and smaller groups.

There are many differences of opinion among angels, policymakers, and the public about the impact of tax credits on angel investment and sustainable entrepreneurial start-ups. Many angel investors are enthusiastic about tax credits because credits increase angels' return on investment. However, the economic benefits of the investment tax credit to states are unknown because of the lack of data and the difficulty of measuring economic impacts. Some believe credits likely increase the size of completed deals but that they are unlikely to increase the number of ventures funded because they do not improve deal quality. Recent studies also show that the benefits of investor tax credits also depend on a number of factors, such as whether the credit is temporary or permanent.[17]

New investment tax credits reward not only new angels but also those already actively investing, lowering the benefit-cost ratio of tax credits. At the same time, tax credits can establish a political platform to spark interest in early-stage investment, create a mechanism by which to measure state angel investment, and attract new investors through marketing by attorneys and accountants.

The most important aspect of a tax credit is its credit rate. States with tax credit rates of 10percent did not appear to experience significant increases in investment: **Vermont's** 10 percent investment credit was enacted in 2004 and no credits were claimed. In **Hawaii**, only $162,000 was claimed by 23 taxpayers in its credit's first year. In 2002, over $26 million was claimed in Hawaii after the state increased the rate from 10 to 100 percent. Programs can also be designed to allocate the following year's credits if current credits are exhausted, as in **Wisconsin** where credits are capped at $3 million per year.

Boosting private and federal dollars with equity capital or matching grants is another promising strategy for governors to increase risk capital. Several states match or fund the pursuit of SBIR grants and other federal resources:

- **Oklahoma:** The Oklahoma Center for the Advancement of Science and Technology (OCAST) assists entrepreneurs through its SBIR Phase I Incentive Funding Program, which reimburses 50 percent (up to $3,000) of a firms' costs for submitting an SBIR proposal. Its SBIR Phase II Matching Grants Program matches 50 percent of a firm's Phase I grant after a proposal has been submitted for Phase II.

- **Ohio:** The Ohio Research and Commercialization Grant Program, a component of the Third Frontier initiative, provides firms that have won federal SBIR, STTR, or Advanced Technology Program grants up to $350,000 over two years to commercialize their technology.

- **Maryland:** The Maryland Technology Transfer Fund, run through the state's Technology Development Corporation (TEDCO), makes nonequity investments of up to $75,000 in companies that partner with federal laboratories or universities to develop early-stage technologies with potential for commercialization or government procurement. No repayment is required unless and until the company receives revenue from sales.

The Utah Centers of Excellence (COE) Program helps startup companies commercialize technologies developed in Utah universities. Applicants apply for $50,000 to- $100,000 COE grants, with the opportunity to apply for additional funding up to a maximum of $500k over a two-year period. Startups are required to match state funds dollar-for-dollar, but may use other sources of capital, such as angel investments, to meet the match requirement.

Identify and collect metrics

The direct impact of these policies is largely unknown because until recently there have not been sufficient data for analysis. It is important that performance metrics be identified before program implementation to determine policy impacts. Economic development advisory boards can contribute to identifying measures; a third party should be used to analyze the data. The data can then be aggregated to protect information about individuals but also organized and released by a nongovernmental entity in collaboration with relevant departments. **Wisconsin** has a thorough data collection system in which:

- A consulting firm surveys angel investment;
- The Department of Commerce collects information from tax credit claims;
- Attorneys voluntarily disclose equity investments that pass through their offices;
- Sources are cross-examined to confirm accuracy;
- Data is compiled to be representative of angel investing in the state;
- Consultants analyze and report economic impacts; and
- Feedback is reported to policymakers.

By ensuring confidentiality and neutrality through a system like that of **Wisconsin**, states can better assess the impact of policies and programs to encourage angel investing and entrepreneurship within their state.

Conclusion

The benefits of supporting and encouraging angel investment can be great. Angel investors typically have investment portfolios in excess of $250,000 in multiple companies. The local businesses in which they invest create high-skill, high-wage jobs and make important contributions to states and their communities. The presence of angel groups also reduces the relocation of successful entrepreneurs to the coasts for early-stage financing so that states realize greater economic impact from entrepreneurial startups. Angels have already started to organize in many states, and gubernatorial support will magnify the benefits of angel activity.