HOW ANGEL INVESTORS GET THEIR WINGS

By Christopher Farrell

Not only can John Reid claim to have been visited by angels, he is one. The 61-year-old entrepreneur founded his Parkers Prairie (Minn.) medical-device company, AbbeyMoor Medical, in 1997 with seed money from so-called angel investors. Such people invest in promising startups too young and raw to attract the attention and money of professional venture capitalists. Reid has also helped fund several early-stage ventures, on his own and with fellow angels.

The credit crunch and economic downturn have some angels feeling skittish. But others see opportunity: Studies show that the best time to start a business is when the economy is down. That's because entrepreneurs with good ideas will find cheaper land, labor, supplier contracts, and other ingredients that go into starting a business. Angels that back such ventures can earn impressive long-term returns—one study cites a rate of return of about 27%, on average, or 2.6 times the investment in 3.5 years. The risks, of course, are steep. Still, 258,200 angels pumped $26 billion into 57,120 ventures last year, according to the University of New Hampshire's Center for Venture Research.

ILLUSTRATIONS BY SONIA ROY

Any angel will tell you there's a significant learning curve. But a big transformation in angel investing is making it easier to move up that curve: the rise of more formal angel investing groups. It wasn't all that long ago that angels largely hooked up with entrepreneurs through ad-hoc social networks, friendships created over the years, perhaps at the country club or local philanthropic events. Since the latter part of the 1990s there has been a proliferation of more professionally organized groups—usually with a Web site—that screen investments and pool money on a local and regional level. Estimates of the number of angel groups in the U.S. and Canada go as high as 275. The groups even have their own trade-and-education association in Washington, the Angel Capital Assn.

While many angels are current or former

entrepreneurs, and that background can prove invaluable, they also need to develop investing skills. The successful angel adheres to the same disciplines that make for a good investor, from Berkshire Hathaway's Warren Buffett to Yale University's David Swensen. Understand the risks. Follow an intellectual framework. Have a well-thought-out methodology for buying and selling. Do due diligence. Diversify. "Angel investing isn't easy, and it's very high risk," says Tony Stanco, executive director of both the National Council of Entrepreneurial Tech Transfer and of Angel Investors of Greater Washington. "But it's high reward."

Experienced angels recommend that investors create a diverse portfolio as a buttress against inevitable failures. After all, these are companies with little cash flow and no operating history. Angel groups funded, on average, about seven companies in 2007. Only a small percentage of an angel's capital should be at risk—no more than 10% of investable wealth, counsels Susan Preston, currently general partner of the California Clean Energy Fund's Angel Fund, a public investment fund that takes equity stakes in alternative energy ventures. Longtime angel Richard Holdren, a Houston-based serial entrepreneur who has founded or invested in over 26 health-care startups, adds that it's critical to keep emotions in check. "You make money in angel investing by killing off your losses early, as quickly as possible," he says. "The entrepreneur really believes that success is just around the corner, and you'll quickly go broke investing for 'just-around-the-corner.'"

Angels rightly tend to focus their efforts in the industry they know. Stanco, for example, was formerly an attorney at the Securities & Exchange Commission working with the

$26

Billion in total angel investments, 2007

Data: University of New Hampshire Center for Venture Research software and computer group. His investments are concentrated in software. Reid is well-schooled in the medical technology business. But to get a wider range of perspectives and deals, and to pool resources, many angels—including Reid, who lives in a largely agricultural community with a population of 1,032—join angel groups.

THE "REAL DEAL"

Reid belongs to a group of 26 angels affiliated with a larger umbrella network, RAIN Source Capital, based in St. Paul, Minn. RAIN organizes small groups of angels in mainly Midwestern states into a network of some 400 members. That makes it easier to develop a deal flow, pool money, and share expertise. Angels living in Grand Rapids, Mankato, St. Cloud, and similar Minnesota towns have invested some $7 million in Reid's company. "We get prospects in front of the network to find the members who will say: 'I used to be in that business' and to tell us whether it's a real deal," Reid says. There could be a deal coming in Mankato, he says, that "we never would have seen without the RAIN network."

The level of professionalism at angel groups is all over the map. Some mimic professional venture funds, a number have forged close ties to universities, and others are more like social clubs engaged in for-profit philanthropy. A common mantra among angels and angel groups is the importance of due diligence. That means pursuing questions like: What is the market opportunity, barriers to entry, and business model? What's the company's competitive edge? Is there an exit strategy? What is the entrepreneur's background? "The biggest fallacy is that 98% of people think if they have a wonderful technology the business will take care of itself," says Holdren. "But the character of the entrepreneur is more important than the technology."

What sort of return can an angel expect? There's that rate of return of about 27%, on average, a result reached by professor Robert Wiltbank of Willamette University and Warren Boeker of the University of Washington in a study of 539 angels from 86 groups in North America from 1990 to 2007. The return figure comes from 1,137 "exits" during this time period through mergers and acquisitions, initial public offerings, bankruptcies, and shut doors.

51

Hours spent on due diligence per investment, on average

Data: Robert Wiltbank, Willamette University

Of course, averages can be a bit misleading. Remember, on average Lake Erie never freezes, and the stock market returns, on average, some 11% a year. With the return number for angel investing, keep in mind that 7% of the venture exits that the professors studied had returns of 10 times investment while 39% had a multiple of less than one times investment. The Center for Venture Research estimates that angels enjoyed a rate of return in 2007 between 20% and 40%. "Invest what you could lose without changing your lifestyle," advises Jeffrey Sohl, director of the Center. Inevitably, part of the reward will be psychic. But it's fun to remember the outcome of a $100,000 investment that Sun Microsystems co-founder Andrew Bechtolsheim made to two Stanford University graduate students. The check allowed the students to move out of dorm rooms and start marketing their revolutionary idea. The result: Google. | BW |

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