

ACA Testifies to US House Sub-Committee
Angel Investor Activity Down in Economy – Ideas to Catalyze

The Angel Capital Association testified on March 26th at a hearing of the House Committee on Small Business, Sub-Committee on Investigations and Oversight. The hearing on “Expanding Equity Capital in Small Business” included 6 witnesses, including three ACA members:

- John May, New Vantage Group (speaking on behalf of ACA)
- Catherine Mott, BlueTree Allied Angels
- Tom Walker, i2E Inc (speaking on behalf of BIO)

A copy of ACA's official testimony is below:

**TESTIMONY OF
JOHN MAY
CHAIRMAN EMERITUS
ANGEL CAPITAL ASSOCIATION**

**SUB-COMMITTEE ON INVESTIGATIONS AND OVERSIGHT
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES**

MARCH 26, 2009

Chairman Altmire, ranking member Fallin, and all of the other members of the sub-committee, thank you for holding this hearing on expanding equity investment in small businesses – and dealing with the impact of the economy on angel investments in start-ups. Our resources are essential for start-up companies, but are in jeopardy because of the economic recession.

My name is John May, and I am co-founder of New Vantage Group in Vienna, Virginia firm that organizes and manages four angel investor networks comprising over 250 men and women private investors in the mid-Atlantic region. I am pleased to represent the Angel Capital Association and growing community of sophisticated private investors known as “angel investors” who invest money and expertise in high potential start-up companies. The Angel Capital Association (ACA) is the professional alliance of angel groups in the U.S. and Canada, and includes 165 member angel groups in 44 states. More than 7,000 accredited angel investors belong to our member angel groups. ACA is focused on building the skills of angel investors so that they are better mentor capitalists to start-up companies and on increasing the number of angels participating in high quality groups in the United States.

Start-up Companies and Angel Investors

Innovative high-growth, start-up companies are critical for job growth and economic vitality in any year, and are even more so during an economic recession. A recent Census Bureau study¹ found that start-up companies create new jobs at a higher rate than all employers as a whole – in other words, if you excluded the jobs from new firms in normal years, overall employment in the country would decrease. Angel-backed companies have been some of the most prolific job creators and innovators in recent times: Google, Yahoo, Amazon, Facebook, Costco, and PayPal are just a few examples of these businesses. Without the angel investors who helped these companies get started, these businesses might not be around today.

Many of these promising firms need capital, mentoring and other support to hire new people and develop new innovations. Angel investors are the source of capital for about 50,000 companies every year, but it looks like that number will significantly decrease this year because of the economy, unless action is taken to promote investment and minimize investor risk.

Angel investors are high-net-worth individuals who provide money for start-up firms with growth potential. Many of them started, built and sold their own companies and are now in a position to invest not only their money but their time in new businesses. The nation's leading expert on entrepreneurship, the Ewing Marion Kauffman Foundation, estimates that angel investors may be responsible for up to 90 percent of the outside equity raised by start-ups after the capital resources of their founders, friends, and family are exhausted.² These firms rarely have the collateral to receive bank loans and they are generally too small and too young to receive venture capital.

The best angels provide more than capital to small businesses. These “mentor capitalists” give back to the entrepreneurial economy by making high risk investments directly in early-stage companies in their communities and using their entrepreneurial experience to mentor the companies as they grow. Many top angels got into this type of investment as a way to “give back” to their communities – by investing in local companies and providing them with mentoring and connections, they can help create jobs in their towns.

Until late 2008, the angel investment market increased each of the last five years by both amount of investment and number of small businesses funded. The Center for Venture Research estimates that

¹ John Haltiwanger, University of Maryland, Ron Jarmin, U.S. Bureau of the Census, Javier Miranda, U.S. Bureau of the Census, *Business Dynamics Statistics: An Overview*, 2009.

² Marianne Hudson, Ewing Marion Kauffman Foundation, *Why Entrepreneurs Need Angels – and How Angels are Improving*, Kauffman Thoughtbook, 2005.

angels invested \$26 billion in 58,000 companies in 2007, an increase of 1.8 percent over 2006.³ ACA surveys have also shown annual increases of 5 or more percent of average total investment by member angel groups over the last few years until late 2008.

One way in which angel investors are becoming better resources for entrepreneurs is through the formation of angel groups, in which angel investors join together to invest in these companies, share best practices, and bring the power of the group to help make the start-ups successful. There are currently about 300 angel groups in the United States, with at least one organization in almost every state in the country.⁴ These groups add efficiency to capital raising for small businesses because they can be easily located by entrepreneurs, lead to larger investments as individual angels combine their capital with other investors, and provide better feedback as angels work together to evaluate investment opportunities.

The Economy's Impact on Angels and their Start-up Investments

The toll of the economic recession on small businesses is becoming increasingly well known. Many jobs are being lost, companies going out of business, and promising companies, potentially capable of generating thousands of new jobs every year, are not getting started. When you combine the impact of the recession on angel investors individually and as an asset class, the impact on small businesses will be even worse. Here are several important facts to keep in mind:

- **The number of potential angel investors is down dramatically.** According to Spectrem Group, the number of “qualified investors” (defined by either net worth or income, and those primarily eligible by securities law to make angel investments) fell by 27 percent last year. Even more troubling, those most likely and able to invest in small businesses, individuals with a net worth of \$5 million or more, fell by 28 percent to 840,000 in 2008.⁵ We believe that overall angel investment will decline even more, as those who are still meet net worth definitions are less likely to make angel investments as they continue to worry about the impact of the recession on the rest of their net worth.
- **Angel group investment down as investors lose wealth.** Based on a survey of ACA member groups in December, 2008, the economic recession is having a negative impact on angel group investment – with a ten percent reduction in 2008 and a prediction of additional declines in 2009.⁶

³ Jeffrey Sohl, Center for Venture Research, University of New Hampshire, *The Angel Investor Market in 2007: Mixed Signs of Growth*, 2008.

⁴ Angel Capital Education Foundation database - www.angelcapitaleducation.org/dir_resources/directory.aspx, 2009.

⁵ Spectrem Group, *The Spectrem Millionaire Investor Index*, 2009

⁶ Angel Capital Association, *ACA Angel Group Confidence Report*, 2008

More than half the groups that had lower investment activity said that uncertainty in the public stock market lowered investment activity. Other significant reasons included a loss in member angel wealth and the need to reserve additional capital for existing portfolio companies.

- **Just as more entrepreneurs are trying to start companies, angels must focus on existing firms.** Angel group members are taking their mentor capitalist roles seriously and focusing on supporting the companies in their portfolios with mentoring, suggesting ideas to minimize costs, and helping locate additional capital when they can. They are trying to make sure that these growing companies do not go out of business and more jobs are lost as a result. While this is helpful for companies that have already received angel investment, it is bad news for new entrepreneurs (some of whom are trying to start businesses after being laid off from corporate jobs). The concern is that, on a national basis, many promising start-ups may not be able to get angel investment as easily because of the focus on supporting existing portfolio companies.

There is also some good news. There is angel money on the sidelines, which can and will be put to good use, given the right incentives, which we outline below.

Angels are Different than Venture Capitalists

While angel investors and venture capital firms (VCs) are complementary, there are several things about angel investors that make them quite different:

- In general, angels invest in start-up and early stage companies, while VCs provide “growth capital” for companies that are further along in their development. Individual angels are investing \$10,000 to \$200,000 per company, with angel groups making average investments of \$281,000 per company in 2008.⁷ This compares to average VC investment of more than \$7 million for the last several years.⁸
- Angels, by definition, risk their own personal capital in companies, not “other people’s money” like venture capitalists. Given a 2007 academic study in which some of the most skilled and active angel investors lost money in 52 percent of all of their investments, angels take incredible risks in backing start-up companies.⁹

⁷ Angel Capital Association, *ACA Angel Group Confidence Report*, 2008.

⁸ PricewaterhouseCoopers MoneyTree Survey, 2006-2009.

⁹ Robert Wiltbank, Willamette University, and Warren Boeker, University of Washington, *Returns to Angel Investors in Groups*, 2007.

- The estimated overall sizes of the angel and VC markets are roughly the same - \$20-\$30 billion per year – but the number of companies they invest in is different by a factor of 15. In 2007, VCs made 3,800 investments, while angel investors made an estimated 57,000 investments.¹⁰ And while more than two-thirds of all VC investments were in California, Boston, and New York, and half of all states had only one or no VC deals, angel investments happened in every American state.

Ideas for Catalyzing Angel Investment in Early-Stage Entrepreneurs

As the Angel Capital Association considers the federal role in supporting a healthier angel capital market for innovative small businesses, we recommend five inter-related concepts. The recommendations are in priority order for maintaining or increasing the flow of high quality angel capital to the early-stage companies that need this money to keep and create jobs.

1. Balanced tax incentives

Most ACA member angels tell us that the 15 percent capital gains rate for their successful investments has been one of the most important reasons for the increase in angel investments in the last six years. These capital gains rates have rewarded risky angel investments, but also put more attention on strong investment processes to ensure that the companies receiving the investment had the best chance of success. Any significant increase in capital gains rates will contribute to decreases in this type of risky investment. At a time when all other economic indicators point to less capital for small business and the sheer number of potential investors has plummeted in one year, why increase capital gains taxes for individual investors who take great risks to directly support innovative, start-up companies? ACA strongly encourages Congress to keep capital gains tax rates for angel investments in truly early-stage businesses at 15 percent or less when it renews laws for long-term capital gains this year.

In the current economic times, Congress may also want to complement a lower capital gains tax for successful early-stage investments with a tax credit for investments in innovative small businesses. Federal ordinary income tax credits for angel investments in small business start-ups could improve the flow of angel capital to small businesses in communities throughout the country. Twenty-plus states and several foreign countries have instituted income tax credits over the last decade. These credits are generally offsets against other investor tax liability and help lower the exposure angels face when investing time and money in high-growth, high risk opportunities in their neighborhoods.

A federal tax credit could ensure that innovative small businesses in all states and communities would benefit from the investor credits, rather than those in only certain states. A nationwide credit would

¹⁰ PricewaterhouseCoopers MoneyTree Survey, 2006-2009 and Jeffrey Sohl, Center for Venture Research, University of New Hampshire, *The Angel Investor Market in 2007: Mixed Signs of Growth*, 2008.

enhance the benefits in states that have such programs, as federal ordinary income tax obligations are much larger than for those states. In addition, a tax credit in all parts of the country could help encourage more syndication among angel groups in different states, which is becoming more and more important for entrepreneurs that need the combined funding of multiple angel groups, often crossing state boundaries. The federal government could learn from the experience of different states as it considers ways to ensure maximum economic results by having angels invest in the kinds of innovative companies that truly need this kind of capital.

A 2008 study of Wisconsin's angel tax credit program and related initiatives found that the state's initiatives helped increase early-stage investments in Wisconsin small businesses by 43 percent in 2007 over 2006. Angel groups in the state increased their investments during the same time period by 57 percent and more than doubled the number of small businesses that benefited from Wisconsin's policy initiatives.¹¹ ACA would be pleased to work with legislators and policy makers to develop an income tax program that addresses any existing policy concerns and helps meet goals to support the start-up and growth of small businesses that create high-paying jobs.

2. Education, training and awareness

As tax incentives are considered, it is important to ensure that investors have access to the best information and best practices to make good investments and support their portfolio companies. ACA works with two non-partisan, charitable organizations – the Kauffman Foundation and the Angel Capital Education Foundation – that provide high quality education for angel investors, potential angels, university leaders, and support organizations that help small businesses that need equity investment. An outside evaluation of these education programs found that they increased the number of accredited investors who made angel investments and increased their confidence in making good investments because they had a better understanding of best practices for evaluating investment opportunities and working with entrepreneurs.

Grant funding to national organizations like the Angel Capital Education Foundation to “scale” this type of education, so that it reaches hundreds of thousands of potential or new angels instead of just thousands of investors, could increase the number and quality of angels throughout the country.

Grant support of awareness campaigns – so that potential angels are aware of this type of investment as a potential opportunity – could also help increase the number of active angels from the pool of more than 4 million potential angels (who may have never heard of or thought of angel investing). In the United

¹¹ David Ward, NorthStar Economics, *2008 Risk Capital Report: Wisconsin*, 2008.

Kingdom, such awareness campaigns are leading to significant increases in the number of angel investors. Americans may want to adapt such a program here that is national in scope to leverage resources and that connects to strong education programs to ensure confidence and knowledge of best practices so that new angels make the best possible investments.

Awareness campaigns could be targeted in particular to women and minorities to consider angel investments. Through interviews and a few studies, it appears that many businesses receive equity investment because of the social networks they have developed. If more women or minorities became angels, one school of thought is that more women and minority entrepreneurs would receive investments because they may more easily connect to the networks of women and minority investors.¹²

These education and awareness campaigns could be done well and for results in all parts of the country for less than \$10 million. I am a lead instructor for one of these programs and have seen with my own eyes the benefits in diverse areas – rural, urban, university town, seacoast town – of increased activity after seminars and training. I personally recommend action in this arena.

3. Keep angel investment activities in private hands

A few federal initiatives or draft legislation have recommended the establishment of government offices to oversee angel investment or to operate angel investment initiatives. The Angel Capital Association believes that such intervention would not have the intended result of improving entrepreneurs' access to angel capital and/or it would lead to frustration by both small businesses and investors. Past federal government experiments to create databases or Web sites to match small businesses in need of capital with investors have not worked. Instead, there are non-profit links to all angel groups, such as the Web site of the Angel Capital Education Foundation (www.angelcapitaleducation.org) and some privately-based sites that try a variety of ways to connect entrepreneurs and investors.

4. Accredited investor standards and impact on high growth company investing

Beyond these legislative suggestions, one other fundamental of early-stage venture capital infrastructure should be noted and preserved. Maintaining the regulatory definition of sophisticated investors – “accredited” by the definition provided in securities law – will allow angels of all types to continue to participate in our venture capital system. Abruptly increasing the threshold of net-worth above the current \$1 million – for this particular asset class activity – could have potentially detrimental impact on

¹² Marianne Hudson, Maggie Kenefake, and Mary Jane Grinstead, Ewing Marion Kauffman Foundation, *Women and Angel Investing: an Untapped Pool of Equity for Entrepreneurs*, 2006.

seed stage funding in the United States. This is particularly true given the significant drop in the number of high net-worth individuals in 2008.

5. Leveraging private investments

If simple, non-bureaucratic techniques of directing federal funds to co-invest with angel groups could be developed, entrepreneurs may more easily access the funding they need and angels may be more easily able to diversify their investments in this risky asset class. Several groups, such as i2E Inc (which manages a seed capital fund in Oklahoma that co-invests with angel investors), the Ohio TechAngels (which has a co-investment \$2.5 million fund raised from The Ohio State University, Nationwide Insurance and the State of Ohio) and CommonAngels in Boston (which has raised a \$10 million co-investment fund from private sources in their region) have successfully developed innovative “side car” funds to leverage dollars invested into entrepreneurs in their region on the personal investment decisions of members of their angel groups. Scotland pioneered a government fund that automatically co-invests with qualified accredited investor groups to spur economic development and growth of high impact companies at a low overhead and bureaucratic cost. While there are a variety of opinions on this concept, many of our members hope you will consider such an innovative approach for American entrepreneurs, particularly as the economic recession has reduced the amount of private capital available in the last six months. (Or, alternatively, give a tax credit for funds invested in side car funds.)

Summary and Final Thoughts

Thank you for this opportunity to describe the unique role and significant impact that angel investors have in our economy and to provide some thoughts on the effective federal roles in supporting the growth of high impact companies and jobs in our economy in the coming years.

Our overall recommendation is that the best way to ensure a strong flow of angel capital into innovative small businesses throughout this country is to provide tax incentives and education to allow and encourage private citizens to risk their own capital to support start-ups and early-stage businesses. Focusing on the combination of keeping capital gains taxes to a minimum and developing well thought-out income tax incentives could ensure that more deserving small businesses get the capital they need, especially during our current tough economic times.

We also encourage you to let entrepreneurs in your districts know that angel groups are interested in learning more about angel investment to link to every known angel group on the Angel Capital Education Foundation Web site, www.angelcapitaleducation.org, and to review the “Info for Entrepreneurs” section to learn more about the angel investment process.

I would be happy to answer any questions you have and for the Angel Capital Association to provide you with additional information when you need it.