The Primer For Angel Investment In Canada

is published by

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National Angel Organization™

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CANADA MUST IMPROVE ITS ABILITY TO COMMERCIALIZE IDEAS

RBC Financial Group

Gordon M. Nixon, President and CEO, RBC Financial Group

Over the past decade, Canada has made great strides in developing the right macroeconomic conditions for improved growth and prosperity. But if Canadians are to sustain a high standard of living, they must become much better at turning innovation into profitable businesses.

This is what the innovation debate is all about. It is here that Canadians are lagging – in research and development, in commercialization, and in growing new companies into viable enterprises with the scale and scope for long-term success. And it is here that angel investors across the country can and do make giant contributions to our collective prosperity. I trust angels across the country will find this inaugural edition of *The Primer for Angel Investment in Canada* to be an informative resource as they consider investment opportunities in the future.

At home and around the world, Canadians have proven themselves as world-class researchers, innovators and entrepreneurs. Our big challenge remains our ability to commercialize innovation and create new and growing companies that provide good jobs in Canada and generate the wealth to sustain our quality of life.

Angels take the new ideas of our scientists and entrepreneurs through the so-called "valley of death" – that very early stage in the life of an idea where the level of risk is at its highest and the financing the most difficult. This is where proof of concept is either established or where many potentially good ideas can die from lack of relatively modest funding.

Angels also help facilitate the growth of at least some of our smaller companies into viable larger companies that are headquartered in Canada and have the potential to become international players. We don't want to be in the position of simply providing the seed corn for enterprises in other parts of the world to profitably exploit.

The time has come for the world of business, finance and government to review the regulatory, institutional and tax systems and consider changes that could be made to ensure that Canada has the financing system that meets the needs of the future economy.

RBC Financial Group applauds the efforts of the National Angel Organization and others in this regard. As Canada's largest financial institution, we support the activities of angel investors and others who are keen to contribute to our national prosperity. Quite clearly, the success of our economy and our ability to sustain and support a high standard of living for all Canadians will depend on our ability to start and to grow Canadian companies.

EDITOR'S NOTE

I first heard of angel investors more than a decade ago when I wrote a column on small business issues for *The Financial Post*. At that time, information about early-stage investing was largely anecdotal and tended to focus on the practice almost as if it were the domain of the privileged few. There appeared to be no common bonds — either in existence or in development — between Canadian angels, venture capital firms, merchant banks or other private investors. This was a time when the Canadian mutual fund industry was in its infancy, and Canadians themselves were yet to wholeheartedly embrace investing as a means to wealth creation and preservation.

Today, Canadians' knowledge and understanding of investing is exponentially ahead of where it was in the early 1990s. It is also clear that angels and other investors have a great deal in common in terms of their objectives and appetites to equate risk with reward.

But while Canadians have been quick to accept many different forms of investments and become a captive audience for an industry of financial experts, consultants and advisors, angel investors have not had a similar benefit of information sharing or counsel. Until recently, angels – who, by nature, take significant investment risk — have had to continue to rely on personal advisors and their own tried and true practices and principles for success.

This book is an effort to bring together the best practices and principles that have helped Canadian angel investors succeed over the past years. Its genesis was the program and discussion at the 2002 Angel Investor Summit held in Toronto, but its content is the result of angels from across the country sharing their experiences for each others' benefit. As such, this book is not exhaustive; it is a work in progress. As the National Angel Organization continues its work at raising awareness and discussion around issues related to angel investment in Canada, I hope that future volumes will improve and enhance the content of this effort.

Much study has been recently devoted to the significant impact that early-stage investing, entrepreneurs and small and medium businesses have on the Canadian economy and the country's prosperity. I hope this is a contribution to their continued success.

Chethan Lakshman
RBC Financial Group
Toronto
Summer 2004

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FOREWORD

In the summer of 2003 we printed 2,500 copies of the inaugural Primer for Angel Investment in Canada. Published as a starting point for building awareness of the economic importance of early investing we weren't quite sure what the demand would be. In the weeks that followed we received requests from entrepreneurs, investors, businessmen, consultants, academics and policymakers from all three levels of government across the country. By the time we reached the Montreal Angel Investor Summit in late October, we were already concerned about having enough copies for the almost 200 attendees.

We had struck a chord. Clearly there was and is an emerging grass roots awareness and realization of the importance of angel investing.

Angel investors have a reputation for being private, independent and even reclusive individuals that shy away from the limelight. They typically want to avoid being on lists, targets of junk mail and the recipients of ill-conceived business plans.

The content of this document is comprised almost entirely by the volunteer efforts of angel investors and professionals working in the early capital formation space. Proofing, layout and publishing services have been generously donated by RBC Financial Group. In this extremely busy world people found the time and money to put this together. Why?

A robust and active angel investor community is critical to the sustainable success of any economy. As multiple studies have shown, net new economic growth comes from small and medium sized enterprises. Collectively, angels invest more than five times the entire venture capital industry combined. Angels invest in some way or other in more than 60% of business start-ups. Angels address the funding, innovation and management gaps between love money and venture capital.

Clearly, as economic stakeholders, we all benefit from the success of angel investors. Canadians' standard of living can only be improved or maintained through continued prosperity that comes from ongoing productivity improvements. Productivity improves through innovation. Genuine innovation often is the result of the effort of small companies that are initially funded by angels, among others.

I am particularly pleased and proud of the accomplishment this document represents. We have no pretensions that the content is comprehensive, exhaustive and conclusive with respect to sharing ideas and making recommendations regarding angel investing in Canada today. The Primer was originally conceived as a vehicle to capture the content of the National Angel Organization's (NAO) Angel Investor Summit. As angels tend to be a diffuse lot, we hope the Primer will act as a collection area for ideas; a provocative catalyst to build awareness and offer support and encouragement for all of us to build and enrich our own businesses, angel groups and networks.

The Primer is a starting point not only for those new to angel investing or building a business but also for the NAO. The NAO's mission is to help angel investors become more successful and thereby help the economy. We are building a truly representative group of 100 Founders that will span geographies, industries, clusters, generations and cultures. All angel investors who read this Primer are invited to join us on our journey. Challenge the thinking of what you read in the chapters ahead and let us know your thoughts. We hope what you read inspires you to get involved or perhaps make a future submission yourself. Good things don't happen by themselves. Collectively we can and need to make a real difference.

In the foreword to the first edition we challenged readers to help us build on the angel initiative. NAO members were invited to speak at events from coast to coast. In Nova Scotia, we met nascent and emerging angel groups. In British Columbia we helped kick off the country's first women's angel network. As NAO Chair, I was invited to speak at separate national conferences encouraging business development in technology, life sciences and clean energy industries. In response to Finance Minister John Manley's request for input to the federal budget we conducted round table discussions with a total of more than one hundred angels in Halifax, Quebec, Montreal, Ottawa, Kingston, Toronto, Golden Horseshoe, London Edmonton, Calgary and Vancouver. At the Angel Investor Summit, NAO Public Policy Committee Chair Andrew Wilkes moderated a debate deliberating the benefits of various tax incentive schemes. I am thrilled to report that we have been able to include a three-page summary of those discussions in this second printing of this Primer (see page 73). The full version is posted as a PDF on our website (www.angelinvestor.ca).

We have received many ideas for follow-on editions of this Primer yet feel compelled to produce another run of this first issue as it is still relevant and there continues to be high demand. Angel investing touches every aspect of economic development that is critical to maintaining our standard of living. In subsequent issues and publications we will provide information on aboriginal angel investing, cluster specific investing issues, the importance of angels in social capital and venture philanthropy. We will also comment on the cultural and structural shifts that must take place if Canada is to become the most attractive jurisdiction in the world in which to make early investments.

To those that read this and see that it can be better, I ask you to join us. I look forward to hearing from you and hope to see you at the NAO Summit in Calgary on September 27-29, 2004.

Henry Vehovec
Chair, Founder & Member, Founding 100
National Angel Organization
Summer 2004

ACKNOWLEDGEMENTS

Pulling together this primer was an exercise that exhibited qualities typical of the work of successful angels: cooperation, selflessness, expertise and excellence.

Henry Vehovec, as the guiding and official leader of the National Angel Organization, and David Moorcroft, RBC Financial Group's senior vice-president of Corporate Communications, spearheaded the book's creation and made sure it came together. Chethan Lakshman, also from RBC, donated time and editorial skills to ensuring the copy flows. Martin Jones and the team at Advance Planning Communications smoothed many rough spots to make the piece better and Kathy Watt of Graphika is responsible for the project's compelling design and layout. Finally, Tony Payne of Transcontinental O'Keefe Printing brought all these efforts together in the bound volume you now hold in your hands.

In addition to all the authors and contributors who took the time to share their opinions and insights, Kerri-Lynn Hauck, Ian Campbell, Michael Brougham and Jamie Nelson served as scribes and note-takers during the sessions of the 2002 Angel Investor Summit – where seeds for much of this project were planted. We would also like to thank members of the NAO board of directors for their guidance and contribution: Alfred Apps, Ed Babineau, Ian Bandeen, Philip Belec, Bob Chaworth-Musters, Warren Dowd, David Glue, Bernard Hamel, Paul LaBarge, Andrew Wilkes.

Dan Mothersill while wearing many hats including contributing author, NAO communications chair and board member, continued to prove that he is a connoisseur of all fine things, including writing and ideas. Last, and certainly not least, the ongoing work of Rob Henderson, general manager of the NAO, deserves special recognition for this project's success – from conception to completion.

Henry Vehovec and Chethan Lakshman

SUMMARY

As Roger Martin, dean of the Rotman School of Management at University of Toronto, notes in the accompanying speech first delivered to the Canadian Club in Toronto in January 2003, Ontario is failing to keep pace with comparable economies in the U.S. In fact, compared with the 14 U.S. states larger than half Ontario's size – from Indiana and Massachusetts to New York and California – Ontario ranked 14th, ahead of only Florida. Worse still, our relative competitiveness and prosperity are falling. In 1980, Ontario ranked 11th among this elite group and was $850 per capita behind the median; in 2000, Ontario ranked 14th and was $5,900 per capita behind.

Martin, who is also chairman of Ontario's Task Force on Competitiveness, Productivity and Economic Progress, focuses on Ontario's performance. However, his remarks are relevant for Canada as a whole. Among his conclusions is that Canadians need to invest significantly more in our future prosperity.

By investing in and supporting the development of early-stage companies, angels are making a valued contribution to Canada's prosperity and helping to nurture a future economy that can be competitive with the best in the world.

CHAPTER 1

THE PROSPERITY CHALLENGE

by Roger L. Martin

I am pleased to speak to you today on behalf of my fellow members of the Task Force on Competitiveness, Productivity and Economic Progress. At issue is the competitiveness and economic prosperity of our province.

Let's start with the good news. Ontario is a terrifically prosperous place by global standards. If it were a country, it would rank second in the world in prosperity. And it is actually larger in population than all but the U.S. in the top ten countries. So it is the richest consequential jurisdiction outside America. This is very good news for Ontarians.

However, there is more sobering news, which we need to take to heart and take action on. We have looked closely at Ontario versus our true peers — which are not small countries, because we are considerably more prosperous than them. Instead, we compared Ontario to the 14 U.S. states larger than half our size — from Indiana and Massachusetts on the small end and New York and California at the large end.

Unfortunately, in this more elite group we rank 14th out of 15, ahead of only Florida. And worse still, our competitiveness and prosperity relative to this group are falling. In 1980, we ranked 11th and were $850 per capita behind the median; in 2000 we ranked 14th and were $5,900 per capita behind.

What does it mean to be $5,900 behind in GDP per capita? It translates almost exactly into $10,000 per Ontario household in after-tax disposable income. Think about it this way: $10,000 per Ontario household in after-tax income is slightly more than all the money spent in Ontario on mortgages, plus rent, plus new car purchases.

Raising our performance by $5,900 would fill the government coffers as well. It would enable Ontario to double annual spending on all levels of education with its portion and the federal government to use its Ontario portion to fund the entire Romanow bill.

So the harsh truth is, we are not keeping pace with the finest economies in the world. The difference between the standard of living in Massachusetts and Ontario is exactly the same as the difference between Ontario and Slovenia.

What explains the gap? At its simplest level, an economy generates prosperity when four factors are positive:

- a high proportion of its citizens are capable of working;
- a high proportion of those capable of work both *want* to work and can find gainful employment;
- those who do find employment, work hard;
- and they work productively and effectively.

We can relate Ontario's $6,000 per capita gap to these four areas as follows:

- On the first factor, it turns out that Ontario has more working age citizens proportionately than our peer states – providing us with an advantage of $1,000 per capita.
- On the second factor, more Ontarians seek to work than those in peer states, but our unemployment rate is higher – creating a net disadvantage of about $750 per capita. The state numbers are unavailable for 2002, but when they come out, they will probably show what the U.S./Canada numbers show, which is that Canada is $250 per capita ahead.
- On the third factor, Ontarians work approximately as hard as those in peer states – as of 2000, the disadvantage was $400 per capita.

On the basis of these first three factors, Ontario is even with its peer states. Proportionately, it has as many people working as hard as the leading economies in the world. Nothing yet explains the $6,000 per capita gap.

- The fourth factor, productivity is the big challenge. When dedicated Ontarians work an hour, do they work as productively as an employee in the average peer state? The answer is no, to the tune of the entire gap of $6,000 per capita. And why is that?

Is it because they work in bad industries, industries that have lower productivity potential? The answer is no. We have done the most comprehensive analysis ever of the structure of Ontario industry against the structure of the peer states and, in fact, Ontario has, on balance, a superior mix. This should result in an advantage of $1,000 per capita if everything else is equal.

Are these industries being hollowed out? That is, do we have the worst parts of the industries we are in? We don't yet have an absolutely definitive answer, but the initial data suggests strongly that the answer is "no". In fact an analysis of two-thirds of the industries suggests that the composition of our individual industries should provide an advantage of approximately $600 per capita, other things being equal.

This leaves an actual gap of over $7,000 per capita. There are two main pieces to the gap. First is our level of urbanization. It turns out that because of scale economies and the benefits of agglomeration, we can expect a worker in an urban environment to be more productive than one outside of an urban area. And Ontario is considerably more rural than its peer states – 72 per cent versus 82 per cent. As a result, we would expect Ontario's productivity to be $3,000 per capita less than the median of our peer states.

That leaves a gap of over $4,000 per capita per person – for a worker in the same part of the same industry in the same type of environment. What accounts for the remainder? We don't fully know yet, but there are pieces of the puzzle that we do know and others that we are in the process of exploring.

In total, we posit four pieces:

- The clearest piece of the puzzle is **investment**. In two critical ways, we invest significantly less in enabling our workers than our peer states.

  The first is investing in machinery and equipment (M&E) that makes workers more productive. Over the past 20 years (and probably more, but that is as far back with the data that we have gone), Ontario enterprises have invested 14 per cent less in M&E annually than the enterprises of our peer states. Suffice it to say, 14 per cent per year, decade after decade, adds up.

  The second is in higher education. While Ontario invests as much in K-12 and colleges as its U.S. peers, the U.S. peers invest just less than double, per capita and per student, in university education.

  And by U.S. peers, we don't mean governments. We mean the entire jurisdiction, from all sources, including government funding, tuition and donations.

  In total, we graduate 92 per cent of the university students annually and spend 55 per cent per student compared to our peer states.

  This is a major problem for productivity. The data is extremely clear: higher levels of education are tightly correlated with higher wages, and higher wages are tightly correlated with higher productivity.

  So more education produces more productive workers.

  On this front, we invest considerably less to produce considerably less productive workers on average. So investment is the first explanation and the data is quite clear: We invest less and we get less.

- The second issue, related to the first, is **motivation** – motivation as individuals to work and invest, and motivation as firms to invest. Motivations are influenced by the marginal tax rates faced by labour and capital.

  Ontario's marginal tax rates on labour and capital are considerably above those of our representative peer states, suggesting that our motivations to work and invest are lower – which may partially explain the investment numbers I touched on earlier.

- The third issue, which is related to investment and motivation, is **aspirations**. We are analyzing this question as we speak, but our view from the initial data is that Ontario firms have systematically lower aspirations with respect to competing internationally than their peer states. This results in lower investments in R&D, branding, international distribution and innovation in general.

- The fourth issue is the **structures** of our key markets and institutions. On this front, we know that one feature of the Ontario structure is that government is more highly involved in the economy than in the peer states when measured by the government's revenues as a share of GDP. Ontario's is higher than all peer states other than Florida, which is poorer than Ontario. And this may have an effect.

  The net combined effect, we hypothesize, is that because of lower aspirations, we invest less in education and M&E. And we are motivated to aspire lower and invest less by high marginal tax rates on capital and labour. These high marginal tax rates are a product of a structure by which our governments process a higher share of our output than those of our peers.

So what does Ontario need to do to close the $6,000 per capita gap in prosperity – or more to the point, the $7,000 per capita gap in productivity?

The $3,000 per capita attributable to our rural structure will take a long time and may not be in the interests of Ontarians in general. But what about the $4,000 per capita gap in effectiveness? Some suggestions:

- We need to raise our aspirations with respect to upgrading ourselves and the way in which we compete. This is doable. We just need to try harder.

- We need to figure out how to tax in a more effective manner — one that enables us to collect the revenue we need without producing the high marginal rates that reduce motivations. This is not a race to the bottom. Massachusetts, now the richest jurisdiction on the planet, has figured out ways to collect substantial revenues in a way that appears less harmful to motivations.

- We simply need to invest more in our future prosperity. This includes both M&E and higher education. We need to invest more instead of consuming. Our work on this question is incomplete, but from what we can tell, the various levels of our government spend more on consumption of current prosperity versus investment in future prosperity compared to our peers.

  In aggregate, Ontario and our 14 peers spend the same proportion of their total spending – 32 per cent – on a combination of debt service, basic government operations, environment and protection. Of the remaining 68 per cent, they can choose to spend on consumption of current prosperity – health care, social security, social services, income stabilization, culture and recreation – or investment in future prosperity – education, transportation and communication, infrastructure, and research and development.

Ontario's proportion is 72 per cent consumption and 28 per cent investment. The peer states show a markedly higher 36 per cent proportion of investment.

This is a big deal. If our proportion were the same as the peer states, it would mean $6.5 billion per year in greater investment in the province of Ontario, or $65 billion per decade.

That would mean a vastly different future, a future more like that of Massachusetts, which can spend three per cent more than Ontario per person on current needs while continuously spending 50 per cent more on generating future prosperity.

I believe this is doable, but it will take the will of individual Ontario citizens, of Ontario corporations and of our governments – provincial, federal and municipal. It will take a new kind of will, the will to overcome the comfortable but unproductive, status quo.

I will give an example of one such issue: university tuition, which is currently regulated at a level of $4,100 for everything except professional schools. And that level is in the middle of five years of increases regulated at two per cent — considerably below inflation, so that real tuition will fall steadily over the five-year period.

And before the conclusion is jumped to that this is all about self-interest, I want to make clear that all the programs in my school are deregulated already, so what I am talking about would not help me at all.

Thankfully, this government deregulated professional school tuition in the mid-1990s. Had they not done this, I most certainly would not be dean of the Rotman School, nor chairman of the Task Force on Competitiveness, Productivity and Economic Progress. When he was president of the University of Toronto, Rob Prichard first asked me to consider taking this job of dean of the Rotman School. My first reaction was to decline. A key reason was that I had been out of Canada for long enough to have been unaware of the deregulation of professional school tuitions. And my assumption was that they were still regulated. I felt that there was no reason to consider leading a school that had absolutely no chance to compete internationally. But fortunately, the current government made the change, and as a consequence we have taken on the challenge of building a globally competitive business school in Ontario – as have several of our fellow schools.

Let's explore the facts regarding regulated tuition.

Level of education is tightly correlated with wages, productivity and prosperity. A better educated population makes for a more prosperous province.

That notwithstanding, we invest only half the level of our peers states in higher education. We do this by having a system that, until very recently, has been a regulated monopoly – only public universities were allowed. And our provincial government, in addition to reducing real funding, maintained strictly regulated tuition at a low level and one that has been falling in real terms.

So students and their parents are prevented from investing in the very universities that the government underfunds. This suppression of tuition is bad for the prosperity of our province.

That notwithstanding, there is a universal consensus that tuition should be suppressed – an absolutely rock-solid, universal consensus.

Each political party believes it strongly. The Progressive Conservatives have been and continue to be committed to falling real tuition. The Liberals have promised to go further and freeze tuition. And the NDP — who knows?

But none of these parties are crazy. Their polling numbers show that the electorate is overwhelmingly behind suppressing tuition. And students are vigorously and vocally against any increases in tuition. Even university professors are generally against increases in tuition.

So what supports and sustains this powerful consensus? First, it is comfortable. "No increase" feels better, for all the above groups, than does an increase and the hassles that would come with it.

Second is the issue of access. The fear is that with higher tuition, access will be impacted negatively. This is a very important issue, which we should explore.

Tuition is indeed higher in the U.S., including in our peer states, though not nearly so much higher as the comparison to US$35,000 Ivy League tuitions make it sound. Fifty-four per cent of full time U.S. students pay tuition (including fees) of US$5,000 or less, many pay a lot less. The average across all full-time students is US$9,000. So tuition is indeed higher in the U.S. — and that logically creates a question of access.

However, it must be understood that increased education has a strong private return to the individual for each increasing level of education. This is well documented. Thus, it is in the student's interest to invest in his or her education because it pays off.

So, if the higher tuition in the U.S. discourages access among less well-to-do students, we should expect to observe higher participation rates in university education among the poor in Canada versus the U.S. Otherwise there would be no accessibility problem linked to higher tuition levels.

And among well-to-do kids, we would expect equally high participation in Canada as in the U.S., because they should be insensitive to the cost of education and should understand the economic benefit to which I just referred. If anything, participation among wealthy kids in Canada should be higher if they show any price sensitivity at all.

In Canada, wealthy kids should participate at a rate at least as high as in the U.S., and poor kids at a greater rate. We should observe higher participation in Canada than the US, if accessibility is the real problem.

So let's go to the data. Per 1,000 of population, the U.S. graduates more university students per year than Ontario by eight per cent and more than Canada by 23 per cent. This is the opposite of what the above accessibility theory holds.

So the U.S. has managed to deal with its accessibility problem better than Canada despite higher tuition. That is, unless our accessibility to the poor is higher, and our overall numbers are lower because our wealthy kids skip university because they are lazier and less intelligent than their U.S. counterparts. I don't believe this.

The political left, in particular, has this issue all wrong. It should actually read more Karl Marx, who in 1890 launched a blistering attack on subsidized university tuition, arguing that it is simply a subsidy for the rich out of general tax revenues. He is right and the left is wrong. High tuitions in the U.S. help to fund generous scholarships for needy students. Is U.S. accessibility perfect? Hardly, but higher U.S. tuition has not led to lower accessibility than in Ontario.

And the conservatives have it wrong as well. True economic prosperity depends heavily on higher education, and starving higher education isn't helping a bit.

Students also have it wrong. This is the most important investment they will likely make in their lives, and suppressing its quality does nobody a bit of good. And parents have it wrong. This is the best investment they can make on behalf of their children.

Basically, this is an issue in which every relevant constituency is dead wrong — and they have no logic or data to buttress their views. The status quo is comfortable and remains well entrenched in an unwitting conspiracy of corrosive complacency. As such, it is a challenge of will: will to do the best thing for Ontario's future.

Ontario faces a choice. We need to show will on this issue if we are to reverse the slide and close the prosperity gap. Without will, we will continue to slide, and in relatively short order, will lose complete touch with the lead pack of prosperous economies.

AUTHOR

Roger L. Martin is dean of the Joseph L. Rotman School of Management at the University of Toronto. He was appointed to a seven-year term beginning in September 1998. He is also a professor of strategic management at the Rotman School.

A Canadian from Wallenstein, Ontario, Roger was formerly a director of Monitor Company, a global strategy consulting firm based in Cambridge, Massachusetts. During his 13 years with Monitor, he founded and chaired Monitor University, the firm's educational arm, served as co-head of the firm for two years, and founded the Canadian office.

His research interests lie in the areas of global competitiveness, integrative thinking, and organizational learning. He has written *Harvard Business Review* articles in 1993, 2002 and 2003. His first book, *The Responsibility Virus: How Control Freaks, Shrinking Violets - And the Rest of Us — Can Harness The Power of True Partnership* (Basic Books), was published in October 2002. He writes extensively on Canadian competitiveness policy in *The Globe and Mail*, *National Post* and *Time* magazine. He is currently chair of the Ontario Task Force on Competitiveness, Productivity and Economic Progress.

Roger received his AB from Harvard College, with a concentration in economics, in 1979 and his MBA from the Harvard Business School in 1981. He serves as a director for The Thomson Corporation; is on the Advisory Boards of Butterfield & Robinson and Social Capital Partners; is a founder of E-magine; and is a trustee of The Hospital for Sick Children in Toronto.

SUMMARY

Before investing, angels are cautioned to conduct due diligence on five key elements of the company, these being the legal, financial, technology, marketing and human resources aspects. The experience of many investors is that failure in just a few items can easily result in failure overall. The article lists a number of questions to ask with respect to each of these categories and provides six warning signs of a potentially flawed deal. Investors are also advised to understand the core technology and validate the fundamental values of the individuals involved, as this will provide the best index as to whether or not an investment should be made.

CHAPTER 2

DUE DILIGENCE

by Paul LaBarge

INTRODUCTION

There are five key elements that angels should consider before investing in a particular enterprise. These are the legal, financial, technology, marketing and human resources aspects of the company. Each of these areas presents the investor with several fundamental issues, which should be examined and addressed before embarking on an investment. The experience of many investors is that a failure in just a few items can easily result in failure overall. Thus a major challenge for investors is to distinguish between those items that are deficiencies, and can be remedied, and those items which are fundamental flaws.

TECHNOLOGY

There are several factors to consider with technology. For instance, is there a demonstrated demand for the product? Creating a superior rat-trap – or even a wholly new product or technology for which there is little consumer need – will rarely result in a well-trod path to the company's door. A product's success is directly related to its utility.

Secondly, will the technology function reliably under the real-world conditions proposed? To what extent has it been effectively tested?

Does the technology offer benefits that are not available from competing products – such as added functions or features or lower costs – or does it simply duplicate offerings currently available?

Is the technology protected? Are patents in place? To the extent that there is no proprietary technology, what evidence is there of an ability to create a competitive business?

Efforts should also be made to check the employment history of management and to determine whether or not the technology or any part of it was engendered in the course of prior employment. Former employers may have substantial resources dedicated to the enforcement of their patent and technology rights.

An investor is also advised to understand the technology from the bottom up. This often involves talking to the full development team. It's not unusual for senior people to have a limited grasp of the internal workings of the technology.

Finally, it is important to be honest with yourself as an investor. To what extent do you actually understand the technology and how it works? If you do not, it may be advisable to solicit the advice of a third party expert or simply walk away from the opportunity.

HUMAN RESOURCES

As an angel investor, you are betting on the talents of the management team, its ideas and its core values. How well do you know these people? Are their values aligned with yours and can you work closely with them to move the company forward?

What have they achieved in the past and what are their reputations among their colleagues or in their industry? What is their previous history with investors? Unfortunately, there are entrepreneurs who move from one failed venture to another, and seemingly, have no problem raising money from naïve investors.

In considering the management team, ask yourself whether or not they represent a full package. Does the group understand the marketing, financial and intellectual property implications of their venture, or are they just a "one-trick" pony?

Who really contributed the most to the group's innovative ideas? Is that person still with the venture and still participating in a meaningful way?

Credentials are an important part of the assessment process, bearing in mind that they do not necessarily tell the whole story. There are many talented and experienced people with limited or no university backgrounds. Consequently, an assessment of each individual's participation in the development of the technology may yield a more realistic assessment of the team capabilities than would their CVs.

FINANCE

Take time to assess the true value of the investment you are making. During the technology bubble in the late 90s, many angels failed to do this and sometimes lost their entire investment. High valuations usually lead to unrealistic expectations and endanger an angel's investment in the next financing round. Valuations must be based on sound and realistic projections.

A financial spreadsheet is germane only to the extent that the underlying assumptions are realistic or factual. Consequently, investors should focus on the assumptions. In particular, the absence of certain items in the financial material may indicate a lack of understanding or expertise with regard to the overall business operation. Also, pay close attention to indicators that demonstrate whether or not the entrepreneur has the capability to build a successful business. These include such metrics as revenues per employee and sales cycle, and such considerations as adequacy of staffing and the investment infrastructure.

LEGAL

The existence of proper incorporation and the shareholders agreement will tell you a great deal about the sophistication of the people involved. One element that can consume inordinate time is trying to understand the dynamic between the participants in the venture. Shareholder agreements will not, by themselves, adequately protect the investor in the case of ill will. However, the process of negotiating an agreement or reviewing the terms of the existing agreement may yield insight into the ethics and values of the individuals.

In assessing the feasibility of the enterprise, investors should examine the level of fairness within the existing structure. A failure to recognize the contribution of essential participants may be a signal that the enterprise does not have the necessary cohesiveness to succeed. Investors should also be aware that an excessively complicated share structure may become a substantial distraction from the operations of the business. The enterprise is best served when shareholders have a unity of interest.

MARKETING

This often proves the weakest link in a new venture. How realistic are the proposals in the business plan for moving the product into the marketplace? In fact, do the principals even have a business plan? Are they familiar with the channels in their industry and do they have a plan for accessing them? Who, if anyone, among the principals has a track record in marketing – and is that track record in the same industry as the current venture?

WARNING FLAGS

Sometimes, angels are wise to walk away from a potential investment. Here are a few signs that trouble may lie ahead:

1. To the extent that there are inconsistencies in values, or trust is not present, then no investment should be made.

2. If there is resistance to due diligence and if people are defensive in their response, than there are probably buried issues.

3. If the deal has been shopped around, one must ask why others have refused to invest and what negatives are present.

4. Excessive passion for the technology may demonstrate an unwillingness to be flexible in meeting the needs of the marketplace.

5. Evasive responses and lack of market knowledge about competitive technologies and alternate solutions probably indicate that the entrepreneur does not have the requisite competence to justify an angel's participation.

6. And finally, one should be realistic with respect to the likelihood of working productively with the people leading this venture.

CONCLUSION

The lessons of due diligence are two-fold. First, there are a series of questions that every investor should ask and that will provide the analysis necessary to make an appropriate business decision. Secondly, the investor can avoid the potential for analysis paralysis by making the effort to understand the core technology and validate the fundamental values of the individuals involved. This will provide the best index as to whether or not an investment should be made.

AUTHOR

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Paul C. LaBarge is one of the founding partners of the firm of LaBarge Weinstein, a business law firm established in Ottawa in 1997 and concentrating in the technology sector. Prior to founding his current firm, he was a partner with Gowling & Henderson, Lang Michener and later established the Ottawa office of Blake, Cassels & Graydon. He received his BA in Economics from McMaster University, law degree from Osgoode Hall Law School and was called to the Bar in 1976. His practice today concentrates primarily in tax, corporate law and mergers and acquisitions. He has extensive experience in legal and financing transactions not only in the technology sector but also in natural resources, real estate and the privatization of public entities. He is currently a director of a number of publicly-listed and numerous private technology companies.

SUMMARY

By pooling assets, angel investors can share the risks and leverage the expertise of partners. They can also participate in offerings with high-quality private growth companies, which may not be available to the individual angel investor. This article examines two specific types of structures that facilitate group investing – limited partnerships and capital pool companies – and discusses the benefits and disadvantages of each. It also outlines two other structures, which are currently unavailable, but are worth considering for the future.

CHAPTER 3

ANGEL TRANSACTIONS: IN SEARCH OF THE IDEAL STRUCTURE

by Delilah Panio
with input from Kevan Cowan, Warren Dowd, Alain Lambert and Wendy Thompson

INTRODUCTION

In response to current market conditions, angel investors are looking for ways to minimize risk while contributing to the development of new ventures. Clustering or investing in groups has been identified as one means for angel investors to reduce transaction costs while increasing opportunities and returns.

By pooling assets, angel investors can share the risks and leverage the expertise of partners. They can also participate in offerings with high-quality private growth companies, which may not be available to the individual angel investor. This approach also gives investors more negotiating power with respect to the terms of the financing and the direction of the business. And by pooling their money, angel investors can present an attractive value proposition to growth companies that readily competes with formal venture capital dollars.

While there is no "ideal" angel structure, this paper will address two specific types of structures that facilitate group investing: limited partnerships and the Capital Pool Company™ (CPC™) program of TSX Venture Exchange™. It also outlines two other structures, which are currently unavailable, but are worth considering for the future.

LIMITED PARTNERSHIPS

Angels have used limited partnerships for many years as a way to bring together capital and expertise for specific investments. Syndication allows for greater leverage of funds than individual investors can achieve on their own.

HOW LIMITED PARTNERSHIPS WORK

In Canada, a limited partnership is formed between a *general partner,* who is liable to all creditors of the business, and *limited partners,* whose liability is limited to the capital contributed to the partnership. Limited partners are not allowed to participate in the management or operations of the business or they risk losing their limited liability status.

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In Canada, limited partnerships are regulated under provincial legislation.

According to the Ontario Limited Partnerships Act:

> **13.** (1) **Limited partner in control of business. –** A limited partner is not liable as a general partner unless, in addition to exercising rights and powers as a limited partner, the limited partner takes part in the control of the business.
>
> *(Source: Consolidated Ontario Business Corporations Act, Related Statutes and Regulations, 25th Ed., 2002)*

A key issue is determining when a limited partner's activities amount to participation in the management or operations of the company. This issue is further complicated if the limited partner is itself a corporation. If a limited partnership is to be used, qualified legal advice should be obtained.

WHY ANGELS SHOULD CARE

Limited partnerships offer angels several advantages. They allow angels to syndicate on bigger deals than they might otherwise have access to. They distribute the transaction costs, which in turn facilitates comprehensive due diligence and the negotiation of more favourable investment terms. The liability of the limited partner is limited to the size of its investment. And limited partnerships can be structured to allow for investments in single or multiple targets over time. For example, the limited partnership could make calls for additional funds from limited partners for subsequent investments.

There are also disadvantages with limited partnerships, however, and angels should be aware of them. In particular, limited partners cannot be active in the management or operations of the limited partnership or the target company. This will be a negative feature for many angels who like to be actively involved in the businesses in which they invest. As well, establishing the limited partnership can add complication and expense.

CAPITAL POOL COMPANY™ (CPC™) PROGRAM

The Capital Pool Company (CPC) is a product of TSX Venture Exchange and originated with the Junior Capital Pool (JCP) program on the Alberta Stock Exchange in the 1980s. The CPC is an alternative route to the traditional initial public offering (IPO) or reverse take-over (RTO) for taking a company public.

The CPC program is currently available to residents of British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, and Quebec. This means that residents of these jurisdictions can participate in the initial public offering of the CPC.

HOW THE CPC PROGRAM WORKS

The CPC program introduces investors with financial market experience to entrepreneurs with development-stage companies requiring capital and public company management expertise. Unlike a traditional IPO, the CPC program enables seasoned directors to form a Capital Pool Company with

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no commercial operations and no assets other than cash, and then list it on the TSX Venture Exchange and raise a pool of capital through the CPC prospectus. The CPC management team then uses the funds to seek out an investment opportunity in a growing business. Once the CPC has completed its "qualifying transaction" and acquired an operating company which meets Exchange listing requirements, its shares continue trading as a regular listing on the Exchange.

There are two phases in establishing a Capital Pool Company.

Phase I: The Capital Pool Company

Creating the CPC

- Three to six individuals with an appropriate combination of business and public company experience put up a total of between $100,000 and $500,000 in seed capital.
- These founders incorporate a shell company – the CPC – and issue shares priced between $0.075 and $0.15 in exchange for seed capital.
- The CPC and its advisors prepare a prospectus that outlines management's intention to raise between $200,000 and $1,900,000 by selling CPC shares at up to prices between $0.15 and $0.30 and at least twice the issuance price of the seed shares, and to use the proceeds to identify and evaluate potential acquisitions.

Selling the Shares

- The CPC files the prospectus with the appropriate securities commission(s), and applies for listing on TSX Venture Exchange.
- The sponsoring broker sells additional CPC shares to at least 200 arm's length shareholders, each of whom buys at least 1000 shares. No one individual can purchase more than two per cent of the offering, and no one individual together with his or her associates or affiliates, can purchase more than four per cent of the offering.
- Once the distribution has been completed and closed, the CPC is listed for trading on TSX Venture.

Phase II: The Qualifying Transaction

Announcing the Transaction

- Within 18 months, the CPC identifies an appropriate business as its "qualifying transaction" and issues a news release to announce that it has entered an agreement in principle to acquire the business.
- The CPC prepares a draft filing statement or for non-arm's length transactions, an information circular providing prospectus level disclosure on the business that is to be acquired.
- TSX Venture reviews the information and evaluates the business to ensure that it meets minimum listing requirements.

Preparing for the Vote

- For acquisitions with a non-arm's length component, the approved information circular is mailed to the CPC's shareholders, who vote at a shareholders' meeting on whether to approve the qualifying transaction.
- Following shareholder approval, the qualifying transaction closes and the business is acquired.
- Shortly thereafter, the "resulting issuer" – no longer a CPC – begins trading as a regular listing on TSX Venture Exchange.

Maximum Cash Pre-Deal

	Minimum	Maximum
Seed Financing Range	$100,000	$500,000
Prospectus Financing Range	$200,000	$1,900,000
Pre-Listing Gross Cash Maximum	$2,000,000	

Additional financing usually occurs at the time of the qualifying transection through a private placement. There is no limit on the amount of money that can be raised in this "side car" financing.

THINGS TO CONSIDER

There are three sets of criteria to consider when examining the feasibility of the capital pool structure. These are the needs and wants of the private company, the current market conditions and the critical success factors. Understanding and satisfying all three is critical in achieving a successful CPC.

1. **Private Company**

   The private company should want or require the following:
   - Alternative access to capital.
   - To be a public company and understand the benefits and consequences.
   - Greater flexibility in the going public process than is possible with an IPO.
   - Reduced risk and greater certainty than with an IPO.
   - To maintain greater control of company. (In a CPC, only 20 per cent of the float needs to be held by the public).
   - A simple and clean way to go public versus an RTO.
   - Prefer the less restricted terms sometimes offered by venture capitalists.

2. **Market Conditions**

   The following market conditions are likely to be present:
   - Company is at too early a stage or doesn't have the financial history for a broadly distributed IPO.
   - A weak IPO market.
   - VC financing is not viable or management prefers not to use it.

3. **Critical Success Factors**
   Factors critical to success include:
   - The company has progressed beyond the start-up phase.
   - A strong management team with public company and sector experience.
   - Long-term strategy to grow as a public company (i.e., management recognizes that this is just one step in growing a business.)
   - The company has a reasonable valuation, which in turn results in a viable share structure.
   - Long-term investor support.
   - The presence of advisors (lawyer, broker, investment banker) experienced in public venture capital.
   - Management recognizes and accepts the responsibilities of being a public company, including the additional costs, disclosure requirements and the limited liquidity inherent in small-cap stocks.

WHY ANGELS SHOULD CARE

The CPC is simply a mechanism to grow a company. Accordingly, an investor still requires a good deal to be successful. The CPC is not for every company, but in the right instance, it is an excellent growth vehicle, as it allows the company to multi-tier finance and create a structure similar to an IPO with a strong investor base. It may also enable investors to attract money they would not have access to as a private company.

It is also important not to emphasize short-term liquidity, but to concentrate on building a company. The key is to create a like-minded approach with the other angel investors, the broker, counsel, management and the board of directors, focused on creating share holder value. Having a core group of long-term angel investors will definitely give the CPC an advantage.

Here is a summary of some of the “pros” and “cons” of a Capital Pool Company:

PROS:
- It allows the entrepreneur and seed investors to leverage private dollars with public dollars.
- Angels are able to maintain greater control of the company for longer term, especially in structuring and financing.
- Angels face fewer operational restrictions than working with VCs.
- The CPC does not have the complexities of VC term sheets and structures.
- It allows participants to partner with “patient capital” from institutions.
- It provides access to capital, especially for businesses not considered by VCs.
- It creates a recognized market valuation for the company.
- The public shares can be used as currency for M&A activity.
- The shares can be used to attract talented management.
- The company can create stock option and share purchase programs as an incentive for employees.
- Can raise up to $2 million, a significant amount for growth capital.

CONS:

However, the CPC is not for every company.

- Being a public company is onerous on management and financial resources and requires a good board of directors, management team and professional advisors.
- The cost of listing and maintaining the public company are not insignificant.
- Public companies are open to public scrutiny.
- Creating a CPC is not a liquidity event for founders or seed investors.
- CPCs must deal with the liquidity challenges inherent in the small-cap marketplace and will have to work to obtain a following from the financial community in the early years.

OTHER STRUCTURES

Limited Liability Company (LLC)

Limited Liability Companies (LLCs) are similar to limited partnerships from a taxation perspective. However, unlike a limited partnership, LLCs allow the members to participate in the management of the business without losing their limited liability status. As is the case with a limited partnership, investor liability is capped at the amount of the investment.

LLCs are currently available only in the United States. However, the LLC is an investment vehicle that would likely be attractive to Canadian angels who want to consolidate their investment activities. Consideration should be given to lobbying for LLCs to be available under Canadian income tax legislation.

Community Small Business Investment Fund (CSBIF)

The CSBIF is not particularly relevant to angels in its current form, but may be a model to consider adapting for angel investments. It's worth noting that in early 2003, Ontario's provincial budget proposed changes making angel-driven CSBIFs possible. However, at time of publication, these proposals were yet to be approved.

CSBIFs are currently available in Ontario and are often established by labour sponsored funds (LSFs) to assist them in meeting their investment pacing requirements. If an LSF invests in a CSBIF, it receives two credits (i.e. one dollar invested in a CSBIF equals one credit and the second credit is issued to the LSF when the CSBIF invests that dollar in a company).

CSBIFs require sponsorship by a local non-profit organization. Typically, one LSF and one sponsor invest together in a local venture.

There are restrictions on what the CSBIF can invest in. Investments are usually made only in small start-ups. The maximum CSBIF investment in a single business is $1 million.

Investors other than LSFs are entitled to receive a modest 7.5 per cent tax credit for investing up to $500,000 in a CSBIF, resulting in a maximum tax credit of $37,500.

CONCLUSION

When selecting the right structure, it is important to consider the specific deal and circumstances. Realize that each of these mechanisms is just one step in building a successful business. A long-term strategy should be developed to take advantage of opportunities in the present and the future.

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As the Business Development Executive for TSX Venture Exchange, Delilah Panio works with key stakeholder groups to increase awareness, interest and ultimately participation in the public venture capital marketplace. Responsible for the Ontario and Atlantic Canada regions, Ms. Panio develops and executes business development programs to inform target markets of TSX Venture's product and services.

Ms. Panio has been with TSX Venture since July 2000. Prior to that, she completed business development and strategic planning for the city of Calgary's economic development organizations. Ms. Panio has an MBA from the University of Calgary and a BA (English) from the University of Regina.

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Mr. Cowan is responsible for the Ontario operations and the national business development and strategy, of the TSX Venture Exchange. He joined The Canadian Venture Exchange (CDNX), the predecessor of TSX Venture Exchange, in 2000 when it acquired the Canadian Dealing Network (CDN). Prior to that, he joined the Toronto Stock Exchange as general counsel of CDN in 1997 and in 1999 became the director of CDN. Mr. Cowan received an LLB from Osgoode Hall Law School and joined Smith Lyons in 1988. He became partner in 1994 and practiced in the corporate and securities area, with a concentration in finance transactions.

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Warren Dowd is currently president and CEO of Envoy Capital Management Ltd., a private investment firm representing accredited investors. He is also president and CEO of First Capital Management, a private investment firm which has participated in a number of successful transactions utilizing the CPC structure. Mr. Dowd is chairman and founder of Investment Planet, a financial software firm, and is active on a variety of private and public boards. Mr. Dowd is also a founding director of the Calgary Enterprise Forum, a non-profit forum for emerging business.

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Mr. Lambert has been active in the financial community in Canada since 1986, acting as senior investor relations advisor to both small and large cap companies. He has also provided his clients with a wide range of financial, strategic and communications advice as well as making investments in various private and public companies. Prior to 1986, Mr. Lambert was a lawyer with Phillips & Vineberg in Montreal. He has considerable experience with CPCs, acting as director and officer of several CPCs, as director of public companies that originated as a CPC, and as an advisor to companies going public through the CPC process. Mr. Lambert is currently president of One & Company Communications Inc., an investor relations firm with offices in Montreal and Toronto.

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Ms. Thompson's practice emphasizes business acquisitions, private equity and mezzanine financing and structuring of joint ventures, partnerships and shareholder relationships. In addition, Ms. Thompson frequently advises private equity and subordinated debt fund managers on the structuring and creation of new funds. She has extensive experience advising technology businesses in raising financing, developing strategic alliances and protecting their technology. For more than ten years, Ms. Thompson was a director of the Canadian Venture Capital Association, retiring in 2001. She is past chairman of the Board of Governors of Havergal College and currently a member of its Leadership Committee. In addition, Ms. Thompson is a director of several Canadian companies.

SUMMARY

Incubators have emerged over the past two decades as a fundamental instrument of economic growth and company creation. However, the demise of a number of "for profit" dot.com incubators in Canada and elsewhere has been swift and highly visible, and some have questioned their sustainability. Despite this, the basic needs facing new businesses remain constant – the need for resources, skills and financing. As technology start-ups struggle to establish themselves and investors seek new opportunities, incubators retain an important role in facilitating the development of new businesses. Not-for-profit incubators in particular remain a cornerstone of government policy in Canada at all levels and there are plans to create more. This next generation of incubators can fulfill four important functions for angel investors. These are:

- *Supporting and developing their angels investments in early stage companies.*
- *Providing a source of high potential and qualified deal flow.*
- *Facilitating the creation of win-win relationships between angels and entrepreneurs.*
- *Accessing a large community of interested parties who can provide networking opportunities for the new company.*

CHAPTER 4

INCUBATORS: AN ANGEL INVESTOR'S BEST FRIEND?

by John Cook and Carolyn Dewar

I. OVERVIEW

Business incubators were created originally as a way of making use of abandoned industrial space. However, recent events have encouraged incubators to focus on providing true value-added services. According to the National Incubator Association:

"A business incubator is an economic development tool designed to accelerate the growth and success of entrepreneurial companies through an array of business support resources and services. A business incubator's main goal is to produce successful firms that will leave the program financially viable and freestanding.

These incubator "graduates" create jobs, revitalize neighborhoods, commercialize critical new technologies and strengthen local and national economies.

Critical to the definition of an incubator is on-site management, which develops and orchestrates business, marketing and management resources tailored to a company's needs. Incubators usually also provide clients access to appropriate rental space and flexible leases, shared basic office services and equipment, technology support services and assistance in obtaining the financing necessary for company growth."[1]

Business incubators have experienced a tremendous surge in growth over the last two decades, swelling from just 12 in the United States in 1980 to over 900 by 2000, with 3000 in existence around the world.[2] Much of this

[1] Source: National Business Incubator Association (Web site).
[2] National Business Incubator Association, 2000.

growth was fuelled by a desire to find an active way for companies, government and the financial community to stimulate innovation and new business creation. Over 80 per cent of the incubators created in North America were "not for profit," created as a tool of government economic development or linked to research organizations eager to see the benefit of their research work applied to the marketplace.

In the late 1990s, the dot-com boom created what appeared to be a major opportunity for a new generation of incubators in the private sector. Many saw this approach as providing a superior route to business success, as compared to traditional venture capital funding. Unfortunately, this business model was based on the false premise that money ploughed into start-ups in the first 12 months could be returned within 12 months, due to the high valuations that the stock market and acquisitions were placing on these companies. The collapse of market capitalizations for such companies resulted in a reappraisal of this model, not to mention the spectacular collapse of some incubators, such as NRG and Itemus in Toronto. Incubators created by large corporations, such as Nortel or OnX, which were seeking to capitalize on innovation from within their companies, have met similar fates. It has become obvious that current market conditions will not support such enterprises in the private sector.

Given this experience, universities and governments have begun experimenting with new "not for profit" models. These approaches are based on links between a community and a mixed-use incubator, and between a strong research organization, such as a university, and a technology incubator. Each of the new incubators has a different agenda, with different models achieving varying levels of success and sustainability. Today's incubator manager needs to build on the most successful practices of other incubators, while fully engaging the local business community in fostering new enterprises. Angels, too, are making an important contribution to creating regional wealth and, under certain circumstances, facilitating the growth of technology hubs.

The fundamental needs of new businesses remain the same – access to resources and support to help them survive the critical first phase of development. Indeed, the importance of business fundamentals and strong early stage development are being re-emphasized in the post-dot.com world. Incubators can play a critical role, not just as providers of space and equipment, but as a real axis of business advice and services and an environment of mentoring and encouragement.

Incubators can also fulfill four important functions for angel investors:

- Supporting and developing angel investments in early stage companies.
- Providing a source of high-potential, qualified deal flow.
- Facilitating the creation of win-win relationships between angels and entrepreneurs.
- Accessing a large community of interested parties who can provide networking opportunities for the new company.

Each of these roles is examined below.

SUPPORTING AND DEVELOPING AN ANGEL INVESTMENT IN EARLY STAGE COMPANIES

The traditional model of incubators is changing. In addition to offering inexpensive and flexible space, as well as technology infrastructure and support equipment, incubators are also providing start-up companies with many value-added services and a much more comprehensive development process. This includes such help as refining the USP, active mentoring, providing the start-up with training, expertise and new businesses tools, and facilitating access to the financial community and to a range of business services, such as accounting, legal, public relations and recruitment.

Two examples of the training programs available to new business owners are the Ventures Innovation Incubator at the TIME Centre (Simon Fraser University), and the Exceler@tor (University of Toronto). Both programs offer workshops and training sessions for start-ups located in the incubator and for new technology businesses in the wider community. The TIME Centre has also held a one-day workshop focused on board governance for start-ups, designed to forge links between start-ups and the investment community.

One of the ways in which incubators help start-ups is by bringing them in contact with one another and with the wider business community. It is important for new businesses to have face-to-face contact and opportunities to network and share experiences. The Harvard Business Review, in an article entitled *Networked Incubators*, talked about the importance of these interactions in distinguishing successful incubation models[3]. Incubators, whether housing the start-ups in a collective space, or reaching them more remotely, are creating opportunities for new businesses to meet and interact. These interactions help to generate new ideas and encourage business owners to drive their enterprises forward.

The provision of shared physical space and equipment is still a core part of most incubation programs. This is especially critical for specific business sectors, such as biotechnology, which have a protracted pre-revenue development phase and where labs and equipment are very expensive. Incubators providing such facilities include the Laval Biotechnology Incubator, which provides inexpensive space and pools costly equipment so that the start-ups can focus on testing and building their businesses, rather than covering significant capital and operating costs. This is also true in IT incubators such as the Exceler@tor, where sophisticated IT technology infrastructure can be shared by the 25 companies housed in this Toronto facility.

As incubators evolve from sympathetic landlords to a source of significant knowledge and resources, they will dramatically increase the chances that a new company will succeed and grow and that an angel's investment will be rewarded. The incubator will reduce the company's burn rate, both by reducing its operating costs and helping it to secure more flexible financing terms. It will improve access to technology infrastructure and partners. It will allow start-ups to become better prepared to present themselves to the investment community. And it will provide a tightly formed network of colleagues and mentors, while helping enterprises to develop the necessary skills to thrive.

PROVIDING A SOURCE OF HIGH QUALITY DEAL FLOW

Incubators have traditionally set three major requirements for admission: technological innovation, willingness to learn and significant market opportunity. This makes them an ideal source of high quality deal flow for angel investors. In addition to helping turn technology innovations into businesses that are investor-ready, incubators can also prepare the start-up for negotiating a specific deal. The ability of an incubator to facilitate this marriage between new companies and angel investors will greatly increase the deal conversion rates and lead to higher levels of investment success.

3 *"Networked Incubators,"* Harvard Business Review, September 2000.

Incubators, especially those run on or by universities, have unique access to research talent. This opportunity to build relationships with faculty and to raise the profile of business creation on campus often encourages researchers in the lab to create new businesses. This synergy is illustrated by the number of large and successful incubators located adjacent to campuses in Boston, North Carolina, California and elsewhere. Simply being close to the source of the discoveries, and connected with the research community, encourages the creation of new businesses and investment opportunities.

The second way that incubators develop a strong pool of investments is by providing training and resources to make the new businesses "investor ready." Incubators assist start-ups in developing a coherent business plan and offer presentation training, which can transform a lab researcher into an articulate businessperson. In some cases, they will find the right person, other than the inventor, to lead a technology company. Some angel investors say that this preparedness means that they pay more for investments coming out of incubators, as the business owners are more savvy and have thought through the value they bring more clearly. But this training is also reflective of their overall management skills and development, which makes them better deal partners than the average new business owner.

FACILITATING THE CREATION OF WIN-WIN RELATIONSHIPS BETWEEN ANGELS AND ENTREPRENEURS

Incubators serve investors by bringing them together with a hub of pre-screened investments. The creation of this unique "marketplace" facilitates deal flow and allows angel investors to identify investment opportunities that have received and will continue to receive training and support.

The incubator can also provide guidance on technology or market development to angels with limited experience. Many incubators even offer customized presentations, which introduce the angel to a set of potential investments that meet the angel's criteria. This pre-selection allows the angel to achieve a higher deal conversion rate per presentation and makes the deal-making process more efficient. Such synergistic relationships between incubators and angels are just beginning to develop. Both sides can do a lot more to encourage this natural partnership.

ACCESSING A LARGE COMMUNITY OF INTERESTED PARTIES WHO CAN PROVIDE NETWORKING OPPORTUNITIES FOR THE NEW COMPANY

Incubators, given their role as a hub and their linkages to universities and research facilities, are in an excellent position to elicit partnerships with many organizations. For example, the Exceler@tor has strategic partnerships with Microsoft and HP, which enable it to provide more sophisticated technology solutions and a ready partner for early stage commercialization. Such partnerships also allow incubators to help their tenants by arranging for technology evaluations and collaborations and by putting these new companies in touch with prospective partners and even acquirers.

These relationships bring considerable value to the early-stage company, as do the interactions that incubators facilitate with the investment community, potential employees and the academic community. Start-ups operating outside incubators are unlikely to have the same level and number of relationships available to them.

AN EVOLVING MODEL

While incubators have undergone tremendous evolution, there are still important developments underway to better align the interests of incubators, investors and innovative businesses.

In the original, rent-driven business model, incubators had little incentive to push start-ups to develop and outgrow the incubator, as this would truncate revenues. Today's incubator is more likely to incorporate a model that allows for a return of value to the incubator at a subsequent stage, thus providing an incentive to encourage the new company's growth. The Exceler@tor, for example, uses a warrants model to achieve this.

Incubators are also looking at new business models that allow them to generate revenues by providing training and continued access to services for their alumni. This could be done by taking a further equity or royalty position in the new business. Such an approach provides the incubator with much greater incentive to push the start-up to develop, leverage training and resources and grow the business, which in turn aligns the start-ups more closely with the interests of investors.

To attract investors, start-ups should be seen as ready to take on the challenges and realities of the business world. VCs sometimes consider incubators as negative selectors because the comfort of the incubator could prevent the aggressive growth of the business. If start-ups feel that their welcome at the incubator is never-ending, with cheap access to resources, they may become complacent and not push their businesses forward. To this end, incubators must set and enforce ongoing performance expectations and strict exit policies. They should also ensure that start-ups are paying appropriately for the resources they consume and meeting regular payment schedules. In some cases, substantial increases in monthly rent or service charges are advisable.

A specific challenge in university-run incubators is ensuring that decisions are based on business considerations. It is not unusual for a founder to maintain an academic mindset, instead of a competitive, commercial frame of mind. This will inevitably inhibit growth and commercial success. The incubator must ensure this issue is dealt with firmly, otherwise it will create problems for investors trying to instill a returns-driven approach to these businesses.

CONCLUSION

The mission of most "not for profit" technology-based incubators is to increase the survival rate of graduates and foster their acceleration in the commercial market space. Angels with limited technology knowledge and networks can significantly benefit by working with incubator management to:

- identify likely incubator investment opportunities
- rapidly complete the engagement process
- maximize return on the investment, and
- take full benefit of the resources and networking opportunities available through this special resource.

By forging strong partnerships with incubators and by sharing common goals, angels can identify superior opportunities among incubated companies and enjoy higher returns than they would otherwise receive by investing in individual opportunities alone.

AUTHORS

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John Cook brings enthusiasm, a passion for building external and internal relationships, and extensive experience in sales and marketing in the investment management and real estate industries to MaRS leadership. Mr. Cook's expertise with both small, entrepreneurial environments and large, established companies will assist the wide spectrum of organizations expected to benefit from MaRS. He is committed to establishing MaRS as a global address for the commercialization of scientific discovery.

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SUMMARY

For many angel investors whose deals require subsequent financing from venture capitalists, declining valuations, or "down-rounds," have become a major problem that, in some cases, sharply reduce or eliminate angels' original equity stake. Angels can protect themselves against the impact of down-rounds by beginning with a realistic appraisal of the investment, monitoring their investment throughout the process, using such mechanisms as guaranteed payouts and management fees, formulating strong funding and defensive strategies, participating in subsequent financing rounds, and building better relationships with venture capitalists. Most of all, angel investors are advised to understand the motivation and behaviour of venture capitalists and have an exit strategy in place from the very beginning.

Chapter 5

Bridging The Gap: How The Prudent Angel Can Survive The Down-Rounds

by W. Daniel Mothersill

INTRODUCTION

"Down-rounds" have become a critical challenge for angel investors. These are the declining valuations that often accompany the entry of new investors into subsequent financing rounds. In some cases, down-rounds are substantial enough to severely diminish or eliminate entirely the equity stake held by angels and other early investors.

Angel investors are often quick to criticize venture capital investors (VCs) for down-rounds. However, angels who are careful about keeping their eye on the ball are much less likely to suffer heavily in down-rounds. VCs and angels may exhibit differences in approach and may be driven by different prerequisites. Nonetheless, the two have much in common. With better attention to detail and a better understanding of the VC process, angels can make early-stage investing a more congenial and rewarding experience.

How does the prudent angel avoid getting burned in down-rounds? The primary rule of an angel investment – as with any investment — is to plan for one's eventual exit. Angel investors need to consider their exit strategy from the outset, and continue to do so through the entire investment process to payout. Only the naïve will expect later-stage investors to look after their interests.

THE INVESTMENT CLIMATE

By the end of 2002 and into 2003, the environment for early-stage financing had become as discouraging as it has been for the past 25 years. Little money was being invested and fear tended to dominate investment decisions, making negotiations difficult and seriously reducing risktolerance.

This tough environment intensified the inherent conflicts between angels and VCs. While many angels pointed to VCs as the source of their problems, the truth is that both angels and VCs found the investment climate trying, albeit for somewhat different reasons. However, with a little perspective, angels can understand the venture capital process better and thereby improve their own positions.

The prudent angel knows and understands his competitors and his allies.

VCs AND ANGELS ARE BOTH EARLY-STAGE INVESTORS

The earliest investors frequently include the company's founders, the management team, friends and family, and angel investors. Some venture capitalists may enter at this early stage, though this is unusual. It is often a mixed crowd that supports an early-stage venture, but what these investors share is a powerful interest in growing the company. These people are investing in the future, based on what they know about the talents of the management team and its ideas and products.

In contrast, later investors generally have a better sense of the business' prospects, and are investing on the basis of visible results rather than personal knowledge, instinct or experience. These later investors, who are almost exclusively venture capitalists, are interested in making deals that will bring a good return within a specific time frame. While some VCs look at the bigger picture and are comfortable with long-term investments, many prefer to earn a healthy return with a quick turnaround. Liquidity is a key consideration, as venture capital funds must generate a steady return for their investors.

This need for relatively quick returns on investment often push VCs to sell an equity position sooner rather than later. In so doing, they may leave early investors and managers with nothing but bitter experience. Naturally, this is a key source of tension between angels and VCs. However, since this is a well-known element of early-stage investing, it is sensible to plan for the eventual entry of secondary investors. The prudent angel will learn as much as possible about the role and motivations of VCs, and will also attend closely to the start-up's stage of growth and need for new capital injections.

BEGIN WITH A REALISTIC APPRAISAL OF THE INVESTMENT

Entrepreneurs are enthusiasts by nature and will occasionally woo investors with grandiose predictions of how much revenue they can generate over a short period of time. It has not been unheard of for start-ups to boast expected revenues of $5 million or $10 million or more. And yet, a simple review of available statistics quickly reveals how inflated such projections can be. A recent survey ranking the top 100 independent software companies in Canada in 2001 (Branham 100, www.branham.com) noted the following:

- Only 63 of the 100 had revenues of over $10 million a year.
- The companies had, on average, been in business for 15 years.
- The 100th ranked company on the list had revenues of only $2.8 million.

These figures illustrate how risky it is to place one's trust in an entrepreneur's earliest projections. As early-stage investors, angels often get swept up in management's enthusiasm. Instead, they need to put their financing on a more cautious footing and ask themselves: "If these sunny projections don't materialize, how am I going to protect myself when the company goes back to the market for more money?"

MONITOR THE INVESTMENT FROM THE OUTSET

The prudent angel will ask for best and worst-case projections at the outset and assiduously track results against them. Angels need to know when the company's course deviates from expectations, and when it does, be prepared to take the necessary steps. These may include a further personal investment, joining the Board, helping with marketing, finding a purchaser for the investment, writing-off the investment, finding additional angel investors or providing stronger incentives for management to deliver.

THE ENTRY OF THE VENTURE CAPITAL INVESTOR

Let's assume the angel investor has retained his investment. A few years have passed and the early, enthusiastic, hockeystick revenue projections are a distant memory. The company has built a solid foundation and is now attracting interest from venture capitalists. This is great for the company and may help it to realize its goals. However, angel investors must be aware that their situation changes with the entry of the VCs.

Once in, the VCs need to make a quick exit in order to provide a constant flow of income to their investors. They also need to leave some value in the company for managers to ensure the necessary incentives are in place to continue growing the business. However, as noted above, early-stage investors can easily get squeezed out.

Having provided the initial capital for growth, the prudent angel is alert to the ongoing need to protect and build his investment. Fortunately, there are several mechanisms available to help him. These include averaging down, the use of formal debt instruments of various sorts, guaranteed pay-outs, management fees, finders' fees, shotgun clauses triggered by share dilution and representation in the form of directorships, among others.

THE GAP

In truth, new businesses rarely begin generating revenue momentum — or VC interest — until the third or fourth year of operation. This may be too long for many angel investors to wait, as the risk is simply too high. Consequently, there is often a gap between the time when angel investors should or must get out and venture capitalists are ready to come in. The result can be a stalemate in which all parties withdraw from the game — VCs because they can't get the requisite returns within the requisite time frame, companies because they don't like the terms of investment and angels because they don't want to risk more money.

Ideally, the prudent angel identifies the need for more money early on, and works with the investee to pinpoint and attract a venture player whose terms are mutually agreeable. Unfortunately, the reality in today's environment is often rather different and angel investors must be prepared for it.

THE RETURN OF REASONABLE VALUATION

Returns in almost every market, from equities to venture capital, have fallen during the past two years. In hindsight, the real question is not why the fall occurred, but why it did not happen sooner. Valuations between 1998 and 2000 were outrageously high and added to investors' uncertainty about how to assess risk. Amid all the energy and excitement that surrounded the late 1990s, people began using bizarrely high multiples, overly optimistic forecasts, market share projections and other novel methods to estimate potential success. None of these novel methods lasted beyond the bubble.

Thankfully, the past two years have seen a return to the fundamentals. Investors of all kinds are looking at conventional valuations (based on actual earnings, revenue, cash flow, and other tangible indicators) and conservative valuation strategies using lower multiples and more realistic forecasts. Indeed, the pendulum has swung back with a vengeance.

Everybody has been affected. Early-stage companies, financed by angels at the height of the madness, are now being funded at reduced valuations. Of course, this puts a further financial squeeze on angel investors. The prudent angel is just as likely to have been swept up in the madness as everyone else – and just as likely to be looking at lower portfolio valuations.

WHAT CAN ANGELS DO?

The solution lies in formulating strong funding and defensive strategies. Angels must ensure that an investee company has a solid business plan outlining how and when it will deliver promised results. They should also be prepared to supplement this by providing hands-on management and marketing assistance, as required. In portfolio terms, the prudent angel will focus careful attention on the fundamentals, including value propositions, sales channels, competitive advantage, market size and product and service differentiation.

Moreover, angel investors must remain keenly aware of developments affecting their investments. If restructuring is required, then the investor should try and lead it – by contacting management and other stakeholders to arrange for financing. By being the initiator, the angel investor will retain a measure of control and reduce the risk of being squeezed.

PARTICIPATING IN LATER ROUNDS

At some point, there will be a later round of financing. For angels, this can be an opportunity – after all, a down-round is a good time to invest as businesses have reduced their valuations, the inflated sales figures are flapping like torn flags, and management is increasingly eager to negotiate. However, the decisive factor for further investment must be sustainable profitability. Clearly, bubble-type valuations have had a lasting negative impact and investors and managers have become more concerned with building profitability. The prudent angel will have also adopted profitability as the fundamental element in investment valuation.

PREPARE FOR THE FUTURE AND BE READY TO STAY IN THE GAME

Angels who have prepared for the next round of financing will have already determined their course of action. If not, they still have a choice. They can enter the next round, where a better deal is being offered (in essence, averaging down, but retaining some control over the dilution); they can hold tight and watch their investment be diluted (the classic squeeze); they can scramble for leverage and payback (management fees, fees for services, directorships, shot-guns); or they can pull out.

Clearly, early preparation works better than last-minute scrambling, and enables the angel to plan how best to participate in later rounds. For example, if an angel reduces his initial payout, this can leave funds in reserve to enable reinvestment at the next stage. This allows the investor to get in on the ground floor and help build the company, while participating in the terms and benefits that go along with later-round financing. It also gives the angel leverage in new rounds and keeps the door open between the angel and the VCs, which is key to cooperative investing and, in effect, bridges the gap between the first and later rounds.

To reiterate, the prudent angel must be prepared for the next round of financing and has already planned the route that is most workable.

CO-OPERATION CAN PROVIDE MUTUAL BENEFITS

There is great value to be had in today's market. After a couple of years of blight, even big brokerages are beginning to take an interest in small, well-run companies. In one recent deal, management, a national brokerage, VCs and angel investors were all involved at the same time. The company had positive cash flow and money in the bank. The arrangement seems to be working even though the compound annual growth rate isn't quite at 30 per cent, which is something of a concern for the VCs. But the pricing was simply too good for the players to resist.

In this case, all management needed for continued growth was funding. The investors are working together to make sure management has what it needs. None of the participants wanted this company to fall into the angel / VC gap, and took steps to ensure this didn't happen.

The lesson from this example is that the prudent angel welcomes partners who can help the investee.

KEEP YOUR EYE ON TOMORROW

There are two key questions for every early-stage company: "How do we attract money today to build the business now?" and "How do we make this business grow *into the future*?" Angels need to focus on the same questions on behalf of their investees and keep in mind that the past is history. The world has changed, valuations have changed and priorities have changed. An angel cannot change what has already happened. If VCs have already bitten into the investment, the challenge is to find a way to make the most of the flesh that remains.

The prudent angel stays focused on today and tomorrow and leaves yesterday behind.

TAKE ADVANTAGE OF TODAY'S PRICING

Angel investors are better off than they were two years ago, though they may not realize it. The reason is that investees are generally better managed today and more focused on revenues and profitability than ever before. Many of them are showing they can survive with a delayed or even evaporated second round.

Also, as noted above, there is a small resurgence of investor interest in early-stage companies. While not definitive enough to constitute a trend, dollars are slightly more accessible, which will help to close the angel / VC gap, at least for some lucky companies.

The involvement of venture capitalists could hurt if there is a big down-round. However, valuations today are such that many angels will want to stay involved with their companies and participate with later-round investors. They can, in fact, help to reduce VCs' anxiety about valuation by maintaining or building both their presence and their investment in the target company.

The prudent angel talks with VCs about valuations and how to realize intrinsic worth in their investees.

BUILD RELATIONSHIPS BASED ON TRUST

VCs are looking for quality deal flows. For this they need good relationships with those in the business community – including angel investors. Angels can provide access to a world of deals that VCs wouldn't otherwise know about. This change in philosophy has been noticeable in the term sheets turning up recently.

There is no question that some VCs – driven by fear and the need for quick returns – squeezed some early investors unconscionably. There were more than a few very ugly deals. But the good faith required for successful business dealings cannot grow when one side is taking untoward advantage of the other. The ridiculously lopsided terms that were common in the recent past have begun to give way.

The prudent angel will look for mutually rewarding relationships and will not judge all VCs by the actions of a few.

BE PREPARED TO COMPROMISE

The key to a new relationship between angels and VCs is compromise. Relationships take time and both sides have to learn to trust one another and to support one another's objectives. Even when the goals of the parties no longer align, if the relationship is strong, it is possible to get through with grace and dignity.

The benefits of compromise also apply to investment targets. Given the current environment, investors should aim for smaller profits on more deals and greater diversity in their portfolio to spread risk and enhance income. This goes for angels and VCs both.

BUT ARE VCs WILLING TO TAKE LESS INTERNAL RATE OF RETURN?

VCs are beginning to look at things in the longer term. The late 1990s saw an unbalanced market and a very demanding and somewhat unrealistic set of investors. Today, many VCs have learned that, as an early-stage investor, a short-term approach to making money just doesn't work. Many are beginning to realize that the tough provisions inserted in term sheets when valuations were unrealistically high need to be altered now that valuations are more reasonable.

Slowly, the market is changing. At a recent venture fair, several major VCs made it clear that they were not interested in seeing companies project revenues of $100 million within five or seven years of start-up. They even suggested that their earlier demands had resulted in a whole generation of managers making unrealistic projections just to get on the radar screen. Another venture fair conversation featured a VC who had left the industry because he felt that the VC model resulted in too much money coming out of early-stage companies too soon.

The prudent angel encourages companies to provide realistic valuations and projections.

PICK YOUR PARTNERS, BUT….

There are good and bad VCs, and most angels would rather deal with VCs who never participated in the scurrilous squeezes. However, in this changing market, angels must be willing to look past VCs' recent behaviour, because, realistically, there isn't much choice. In tough times, any VC who is willing to get involved in a project and who has money is a good candidate for later round financing.

That being said, however, angels need to look to themselves. Based on their years of experience, relative freedom, and closeness to the investees, it is their responsibility to behave like the professional investors they are. That means building on their knowledge and experience to establish workable term sheets that provide reasonable protection. It means structuring various types of investment arrangements, creating measurable and monitored goals for investments and holding themselves accountable for the performance of their money.

Angel investors cannot sit back and blame management, the VCs, the investment climate, commodity pricing or the telecom upheaval. Instead, they must realize that they have at their fingertips the resources to make good and profitable investments.

What resources? At the very least, they have each other in Canada's increasingly active and organized angel network. And they have the experience of working with their fellow investors – the VCs and the brokerages. They need term sheets. They need regular meetings with management. They need to be kept in the loop and to keep themselves informed. They need metrics. They need to track investments against stated and communicated goals. They need to know how to say "no". They need an understanding of business models, business management techniques and valuation criteria. Because, let's face it — if they had invested as professionals in the first place, it would have been much harder to squeeze them.

The prudent angel treats his or her investments as a business.

As they develop national expertise, angels need to focus on ensuring a better and more business-like working relationship with both investees and other investors. This will go a long way to helping bridge the gap between angel investors and venture capitalists.

AUTHOR

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An angel investor, he holds a minority position in three Canadian technology firms.

Daniel is a director of the National Angel Organization and chair of its Communications Committee. He is also twinned with Ernst & Young in preparing presidents and CEOs of emerging companies to effectively pitch to angel investors and venture capitalists. During the past two years, he has presented to more than 700 entrepreneurs participating in Canada's major venture fairs. His "graduates" have raised $100 million in VC and angel financing over that period.

A frequent guest speaker on communications, Daniel is also coach-in-residence for the Toronto Angel Group, a corporate sponsor of the Toronto Venture Group and a mentor with the Excelerator initiative at the University of Toronto's Innovation's Foundation. He studied at York University, The Wharton School and the Royal Conservatory of Music.

CHAPTER 6

THE SYNERGY BETWEEN ANGEL NETWORKS AND CORPORATE VENTURING

by Bryan Pilsworth

SUMMARY

The growth of a seed company is frequently dependent on the availability of risk capital, often provided by angel investors. Angels fill a necessary gap between "love money" and the professional financing provided by venture capitalists. Unfortunately, the tough economic climate and the challenge of achieving the exceptional investment returns of the recent past have affected the ability of angels to fulfill this role. Angels have been adversely affected by declining valuations, fewer exit opportunities and higher market risk.

In response, angels have formed local and national networks to pool capital, enhance due diligence and diversify investments. While angel networks are achieving new levels of scale, negative market pressures may ultimately force these networks to co-partner with corporate venture capitalists (CVCs) in order to reduce investment risk.

Working with corporate venturing arms enables angel networks to:

- *Obtain insight into growth markets and corporate spending.*
- *Acquire valuable feedback to improve due diligence and help the startup. improve its product in the post-investment period.*
- *Provide additional capital and a path to subsequent financing.*
- *Improve a start-up's credibility through a corporate association.*
- *Leverage corporate sales channels to generate revenue more quickly.*

Despite these benefits, angel networks can still expect to face difficulties in finding common ground with a limited number of corporate venture capitalists in Canada. In particular, angels may find it challenging to find venture arms that focus on seed-stage investments. Among the few CVCs known to the writer that do explore opportunities with seed-stage companies are Bell Mobility's Accelerator Fund, Hydro-Québec CapiTech, BDC Venture Capital and Noram's Technology Incubator.

TOUGH TIMES FOR STARTUPS

The growth of a seed or start-up company is heavily dependent on the availability of risk capital. In early-stage companies, traditional sources of financing come from personal savings, family and friends, and severance packages. This form of financing, sometimes called "love money," is usually sufficient to finance market research and to explore a product concept, but is rarely enough to reach prototype development. At this stage, entrepreneurs must begin looking for new sources of financing. In most cases, venture financing is not appropriate, as venture capitalists are reluctant to examine opportunities where the total financing is less than $1 million. As a result, angel investors, who are typically successful entrepreneurs with seed capital and acumen, help to bridge this financing gap.

When love money has been expended, many start-ups will pursue grants and government funding. In Canada, examples of these funding sources include the Scientific Research and Experimental Development Program (SR&ED) and the National Research Council's Industrial Research Assistance Program (IRAP). Some may choose debt financing in the form of low-interest loans or credit card advances, while others pursue supplier or angel capital. Despite these multiple sources, raising early-stage capital to fill the gap between love money (e.g., $150,000) and professional venture capital financing (e.g., $1 million) is still difficult.

ANGELS FILL THE FUNDING "GAP"

Angel financing is one of the few early-stage "smart money" sources that can fill the early-stage financing gap. As Carleton University professor Allan Riding remarked at the University of Toronto's "Financing Innovative Ventures in Canada" roundtable series: "I have spent considering why it is that angels are important, and the first item, of course is money. Angels fill the gap between "family" and "friends" financing and venture capital." (Riding, Canadian Investment Review June 2000). In the past couple of years, however, this role has been a challenging and difficult one.

TOUGH TIMES FOR PRIVATE EQUITY INVESTORS

Both angels and VCs have been hard hit by the devaluation of technology and telecom companies in North America and a continuing slow economy. As a result, start-ups are facing much higher scrutiny for new financing. Doug Hewson, a partner at Axis Capital in Ottawa noted, "It's an awfully cold environment for angels right now. A lot of them have seen their personal net worth drop considerably." (Hewson, Financial Post, February 2001).

In order for angels to continue the cycle of investing in early-stage companies, they need to generate investment returns. Achieving satisfactory returns in 2002, however, was almost impossible because of the prolonged economic downturn, a poor IPO market and crushing down-round valuations, a phenomenon of declining valuations that occurs when new investors come into subsequent financing rounds. During these periods, earlier investors – typically family, friends and angels – have their equity stake diminished, and sometimes, wiped out completely. Says local Ottawa venture capitalist Pat DiPietro: "I invested in five start-ups as an angel and every one of them has crashed (in terms of price)…angel investing is a tough business." (DiPietro, Ottawa Citizen February 2003).

Similarly, Coralie Lalonde, another Ottawa angel investor with Katsura Investments, states: "Many angels have lost private equity investments because of financing terms that wipe out their ability to achieve a return on their investment, regardless of how well the company does." (Lalonde, Ottawa Citizen February 2003)

Anecdotes about declining valuations are not surprising in light of recent 2001 data on Canadian venture capital and private equity returns. The Canadian Venture Capital Association (CVCA) showed a negative return of 10.7% for all venture capital in 2001. (Note: Recognizing the importance of industry performance data, Macdonald & Associates, in conjunction with CVCA, has begun, for the first time, releasing Canadian investment performance data. 2002 return data was not available as part of the March 5, 2003 press release.)

Canadian Private Equity Performance (As of 12/31/2001)
Percentage IRR

FUND TYPE	**1 Yr**	3 Yr	10 Yr
Early stage	**-7.2**	22.5	17.5
Balanced venture capital	**-12.2**	14.3	12.8
All venture capital	**-10.7**	15.7	13.3
Buyout & Mezzanine	**10.6**	9.2	15.7
All private equity	**-7.9**	14.6	13.7

Source: CVCA, Macdonald & Associates Limited

More recent U.S. 2002 performance data also paints a bleak picture. For the period ending Sept. 30, 2002, one-year returns for U.S. venture capital funds were negative 22.3%. The table below provides evidence of this cold investing environment in 2002 for all U.S. private equity.

U.S. Private Equity Performance (As of 09/30/2002)

FUND TYPE	**1 Yr**	3 Yr	10 Yr
Early stage	**-28.6%**	19.4%	34.2%
All venture	**-22.3**	15.1	26.3
All private equity	**-12.3**	1.0	15.1

Source: Thomson Venture Economics

That being said, the situation in Canada appears to be improving. According to the CVCA, Canada, relative to the U.S., showed positive improvements in the capital deployed (i.e., change from Q3 to Q4, 2002) and the percentage of funds allocated to support early-stage investments (i.e., early stage $ share), that is often follow-on financing to angel-backed investments.

Canada vs. U.S. Venture Capital Activity (As of 12/31/2002)

	Canada	U.S.
$ Invested	**$1.6 B USD**	$21.2 B USD
Drop in $ Invested from 2001	**35%**	49%
Change from Q3 to Q4, 2002	**+51%**	-7%
Early Stage $ Share	**42%**	19%
New Capital Raised	**$2.1 B USD**	$6.9 B USD

Source: CVCA, Macdonald & Associates Ltd.

Nonetheless, disbursements levels in Canada were down 35% from $3.8 billion CDN in 2001. This lower level of activity suggests that venture investors are still being impacted by lower stock market valuations, an uncertain economy, and higher market risk which ultimately lead to fewer exit opportunities. Consequently, Canadian angels are likely to face on-going difficulties, despite the recent signs of improvements, and to remain very cautious with new investments.

ANGEL NETWORKS TO DIVERSIFY AND DE-RISK

If angels are unable to realize necessary returns, they will be unable to fulfill their critical role. For Canadian angels, the pain is real because tax laws prohibit them from writing off the investment without disposing of the equity stake. With the appropriate change in government policy, Canadian angels could at least write off capital losses during down-rounds.

Consequently, angels need to explore other ways to improve the opportunity for returns in the current economic climate. In particular, they must guard against excessive dilution, additional down-round valuations and high-risk bets. If, however, angels can focus on investment diversification through networking amongst themselves, their investment risk may be reduced.

Small local angel networks in Canada, such as Ottawa's Band of Scoundrels and the Purple Angels, and larger groups, including the recently established National Angel Organization, have emerged to provide a framework for simplifying, diversifying and reducing the risks inherent in early-stage investment opportunities.

California's Band of Angels is a popular and oft-cited example of a long-running and successful angel group. The group consists of about 150 semi-retired Silicon Valley executives and is regarded as the benchmark for such organizations. Since its founding in 1995, the Band has invested an estimated $75 million of its members' money in over 100 companies.

Angel networks can achieve scale and benefits that couldn't possibly be achieved by a single angel. That being said, negative market pressures may still force nascent angel networks to co-partner with venture capitalists, and in particular, corporate venture capitalists.

NEW SYNERGY BETWEEN ANGELS AND CORPORATE VENTURE CAPITALISTS (CVCs)

There are major advantages to angel networks in partnering with corporate venture organizations.

First, angels can obtain insight into growth markets and corporate spending, which is especially important in periods of reduced capital expenditure. Angel networks must have insight into growth markets and corporate spending to make better investment decisions. This is particularly true in the current economic cycle of reduced capital expenditures, with investors tending to favour traditional technology suppliers over start-ups, due to the latters' questionable long-term viability.

Corporate venture capitalists, in particular, are in a unique position to see where demand will materialize, since they are familiar with their firm's two-to-three year technology capital expenditure roadmap. Consequently, a CVC can anticipate where real demand will occur and what problems can be solved by a start-up versus a current supplier. By partnering with a CVC, angels can make better investment choices because they will better understand time-to-revenue considerations and potential competitive threats.

Second, Angels can obtain customer feedback to improve their due diligence before an investment and product development insight after an investment. Because of the strong links to its parent company, a CVC can solicit feedback from the parent's technical and product development personnel. While CVCs don't do this frequently, the angel investors that do obtain feedback through their CVC partner can benefit tremendously from improved due diligence (pre-investment) and greater customer involvement during product development (post-investment). The start-up can also improve product development through the corporation's involvement and better identify product issues and deficiencies.

Third, angels can employ "other people's money" to co-invest and gain another source of follow-on financing. Partnering with a CVC can also create additional opportunities to attract further funding. For example, an angel network could create a seed fund and accept external venture capital financing. The California-based Band of Angels has created a fund that co-invests in deals that are subscribed by its members. Not only does this provide additional financing, it acts as a bridge to subsequent follow-on financing. In some instances, the angel network can also leverage non-equity project financing offered by some CVCs. For example, in Canada, Bell Mobility's Accelerator Fund offers start-ups project financing for compelling wireless concepts.

Fourth, angel networks can improve a start-up's credibility through a CVC and corporate association. The angel network and CVC partnership can lend a start-up a higher degree of credibility than it could otherwise achieve. In particular, start-ups co-funded by a CVC and angels have more credibility when approaching larger clients. An example is Telus Ventures' backing of Spotnik Mobile, a Toronto Wi-Fi service provider. This backing helped Spotnik to compete for many contract opportunities such as Toronto's Pearson International Airport. Spotnik's advisory board includes senior Telus Mobility management.

Finally, the start-up company can leverage sales channels and generate sales more quickly. Through its relationship to a larger corporation, the start-up can sometimes obtain an immediate sales channel to distribute its product. This channel relationship may also extend to other vendors and partnerships, allowing the start-up to leverage a larger company's sales force to obtain revenue and sales. This is very important because follow-on investors are looking for tangible signs of market demand in the form of revenue.

FINDING COMMON GROUND

Given the foregoing advantages, it would seem natural for angel networks to want to work more closely with CVCs to mitigate risk, diversify and accelerate early-stage angel investments. However, finding common ground between angel networks and CVCs may be challenging given the small number of active CVCs in Canada and their limited interest in seed-stage funding. In addition, the strategic terms demanded by CVCs may detract from the start-up's focus.

In Canada, the potential for CVC angel network partnering is limited. There are only a handful of companies that have formal or informal venture arms and they tend to focus on three sectors: telecom, energy and financial services.

Canadian corporations involved with venturing activities

Sector	Canadian corporations
Telecom	• Bell Mobility • CGI Inc. • Rogers Communications • Telesystems (Microcell) • Telus Ventures
Energy	• Hydro-Québec CapiTech • Mitsubishi Canada • Noram Engineering • OPG Ventures (Ontario Power Generation)
Financial Services	• e-Scotia Acquisitions • RBC Technology Ventures

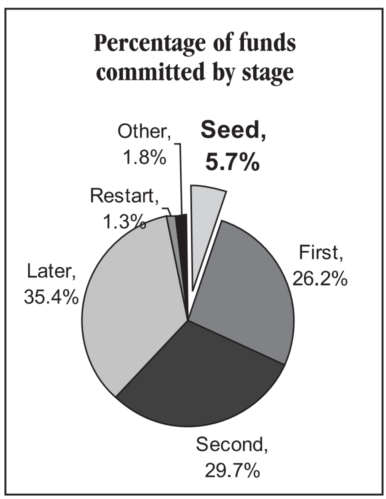
Source: Bell Mobility Research

In addition, the amount of CVC capital committed to seed rounds, in which angels would participate, is likely very small. In Canada, few of the venture arms focus on early-stage seed financing opportunities. From the above list, Bell Mobility's Accelerator Fund, Hydro-Québec CapiTech, and Noram's Technology Incubator are venture arms that explore opportunities with seed stage companies. This situation is much the same in the U.S. Ernst & Young revealed in a recent survey (Ernst & Young Corporate Venture Capital Report, Fall 2002), that American CVCs committed only six per cent of available funds in the seed stage round. The results of the survey are illustrated in the graph shown below.

CVC INVESTING IN VC-BACKED COMPANIES BY ROUND (FALL 2002)

CVCs have also been criticized for having a negative impact on a start-up's ability to pursue business opportunities. Sometimes a CVC will require local market product exclusivity to differentiate the parent from the competition. Or perhaps a CVC's ownership may limit others from using the start-up's product or service. These are valid concerns. A CVC with an equity investment will, however, attempt to balance strategic terms, such as exclusivity, with a suitable return on investment.

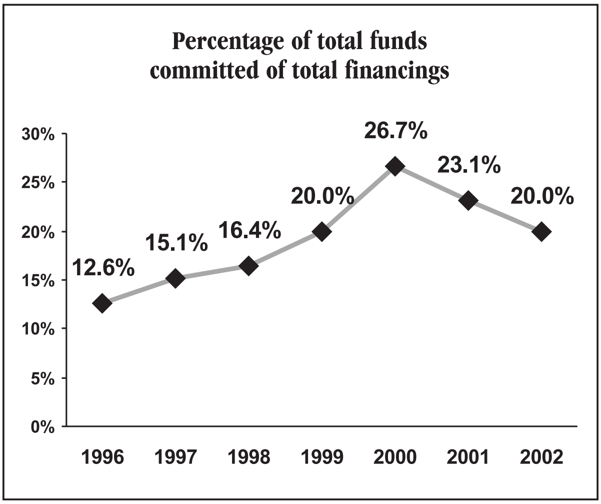
Finally, critics argue that CVCs might be temporary investors and not committed to the longer term. For example, in 2000, there were 400 corporations worldwide involved with corporate venturing, whereas two years later, the number had dropped to 300. While this evidence supports the



Source: Ernst & Young Corporate Venture Capital Report, Venture Capital Advisory Group, Fall 2002.

claim, it is worth noting that corporate venture capital as a percentage of total venture capital financing participation has not declined dramatically. U.S. data provided by Ernst & Young's Corporate Venture Capital Report shows that CVCs continue to participate in 20 per cent of equity investments compared with 27 per cent in 2000. Consequently, it seems premature to discount the CVC as temporary investors.

U.S. EQUITY INVESTMENTS WITH CVC PARTICIPATION (FALL 2002)



Source: Ernst & Young Corporate Venture Capital Report, Venture Capital Advisory Group, Fall 2002

Despite these challenges, there can be real value for angels working with innovative CVCs. Within Canada, angel networks can benefit from a unique CVC vehicle that focuses on early-stage developments.

CONCLUSION

As angel networks look to mitigate risk and diversify their future seed/start-up investments, they can benefit tremendously from closer working relationships with corporate venture capital organizations. Simply put, angel-backed start-ups with CVC support can succeed with better product development, new channels to sales and greater credibility. The key challenge in achieving the benefits of partnering with CVCs is identifying a mutually aligned CVC that participates in seed-stage investing.

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SUMMARY

Canada is falling behind developments in other industrialized countries and using outmoded means, including a low dollar and a reliance on base commodities, to maintain its competitive position. Meanwhile, we face major environmental challenges, including that of meeting our Kyoto Accord commitments. However, in developing technological innovation to deal effectively with environmental challenges, Canada faces gaps in funding intensity. Sustainable Development Technology Canada (SDTC) has been formed to bridge these gaps and provide funding continuity. There is a great opportunity for angel investors and SDTC to work together as agents of change to share risks and enhance returns in the sustainable development technology area.

CHAPTER 7

CREATING INVESTMENT OPPORTUNITIES THROUGH THE SDTC

by Dr. Vicky Sharpe

INTRODUCTION

As we move into the millennium, Canada is faced with two enormous challenges. The first is a significant decline in our nation's prosperity relative to other industrialized countries. And the second is the need to meet our increasing environmental responsibilities. Both challenges are critical to the well-being of future generations. Our success in tackling them will be affected by how well we develop and employ innovative approaches to common problems.

This paper examines some of the key forces shaping our economic future and the nature of the investment climate for new technologies. It also proposes ways in which Sustainable Development Technology Canada can partner with the angel investor community to take advantage of emerging opportunities.

THE FUTURE PROSPERITY OF CANADA

There is growing evidence to suggest that Canada is failing to keep pace with developments in other countries, especially the United States. According to the latest ***Global Competitiveness Report*** published by The World Economic Forum, Canada now ranks 11th in the *Current Competitiveness Index*, far behind Finland, Australia, the United States, and Singapore (Ref [1]). The report also describes the way in which countries maintain their competitive position. One indicator, the *Nature of Competitive Advantage,* ascribes a value to *how* countries maintain their competitiveness. Countries at the top of this ranking are considered creative, innovative and effective. Conversely, a low ranking indicates that a country clings to outmoded and ineffective means to maintain its competitive position. Canada ranks 23rd out of 58.

[1] ***Global Competitiveness Report: Competitiveness and Stages of Economic Development.*** Michael E. Porter, Jeffrey D. Sachs and John W. McArthur. World Economic Forum and Harvard Business School. October 2001.

- **Reliance on a Low Dollar:** Canada continues to rely on a devalued dollar and low labour and raw material costs to remain competitive, rather than on unique and high value products and processes. According to a 2001 Industry Canada study, 91 per cent of the increase in trade with the United States in the 1990s was the result of the low dollar and the U.S. economic boom. Relying on a devalued dollar dulls the incentive for innovation. It also increases the cost of upgrading our outdated equipment, as approximately 70 per cent of Canada's installed machinery is imported, and most of that is from the United States (Ref [2]).

- **Reliance on Base Commodities:** The *Commodity Price Index* has been steadily declining at about 0.6 per cent per year for the past 200 years and the developing countries are beginning to dominate base commodities through ultra-low pricing structures. The developed world, on the other hand, is moving away from price-based commodities and toward value-based goods and services in order to remain competitive. Finland, for example, is ranked the number one competitive country in the world. It exports more consumer electronics (e.g. Nokia) than wood products, which was the traditional mainstay of its economy (Ref [3]).

The Canadian government has responded to these international realities by launching the ***Innovation Agenda*** (Ref [4]), which is designed to strengthen technology development. It underscores the need for large and deliberate investments to support research infrastructure and new and developing technologies. While this is a positive step forward, there are many barriers that must be overcome before Canada can secure strong future growth.

CANADA AND THE ENVIRONMENT

The second major challenge facing Canadians is the environment. There are a number of important issues that need to be addressed, but the largest one – and the one that affects our economy the most – is climate change.

In December 2002, the federal government ratified the Kyoto Protocol, which commits Canada to reducing its greenhouse gases to 6 per cent below 1990 levels by 2012. The national debate over whether or not to ratify the agreement put the issue of climate change into stark relief for many Canadians and prompted some industry observers to come to three main conclusions:

- The economic impact of climate change is significant.
- Canada needs technological innovation.
- If Canada doesn't meet the innovation challenge, others will.

The economic impacts of climate change are significant.

Estimates for meeting Kyoto range from \$3.3 billion (federal government) to \$23-\$40 billion (government of Alberta). The final amount, while still far from certain, will undoubtedly be considerable.

[2] ***Canadian Competitiveness: A Decade After the Crossroads.*** Roger L. Martin and Michael E. Porter. C.D. Howe Institute. Working Paper 2001-1.

[3] ***OECD in Figures.*** 2001 Edition. Statistics on the Member Countries. OECD Observer. May 2001.

[4] ***Canada's Innovation Strategy***: http://www.innovationstrategy.gc.ca/cmb/innovation.nsf/pages/Menu-e

However, the costs of *not* meeting the climate change challenge are equally as high. The insurance industry, for example, estimates that the worldwide direct economic losses from natural disasters, primarily weather-related, have risen from US$1 billion per year in the 1960s to more than $50 billion per year in the 1990s. This is a fifteen-fold increase when adjusted for inflation. Indeed, Canada saw three of its worst natural disasters ever in the 1990s: the 1996 Saguenay flood, the 1997 Red River Basin flood and the 1998 ice storm in Quebec and eastern Ontario. Each caused more than $1 billion in damages and untold human tragedy (Ref [5]).

Canada needs technological innovation.

According to the OECD, the Canadian economy represents about 2 per cent of the global gross domestic product and produces about 2 per cent of the world's greenhouse gases (GHGs). However, Canada produces the second highest *per capita* rate of GHG emissions in the world (22.7 tonnes/person). The national emissions rate is disproportionate to Canada's economic productivity, and even accounting for geography and climate, suggests that Canada needs to dramatically improve its industrial practices.

The emission levels have continued to increase steadily from 601 million tonnes (MT) in 1996 to a projected 810 MT by the year 2010. If Canada is to meet its Kyoto commitment of a six percent reduction from 1990 levels, or 565 MT, it must actually reduce about 33 per cent, or 245 MT, from 2010 levels (Fig. 1). This gap poses an enormous challenge for the entire economy, one that can best be met by technological improvements in all industrial sectors, as well as a shift in the values and behaviours of Canadian society.

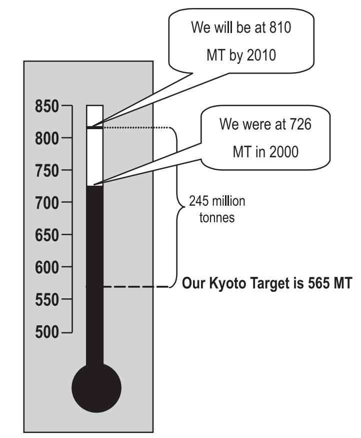

Figure 1: Canada's Emissions Gap

If Canada doesn't meet the innovation challenge, others will.

Countries such as the United States, the Netherlands and the United Kingdom are aggressively developing technologies to meet the climate change challenge, while at the same time increasing their productivity. The United States, for example, spends 14 times more money on R&D than does Canada, but obtains 49 times more revenue from licensing and royalties.

Canada currently stands in last place among the G7 countries in terms of R&D investment relative to GDP. But the investment picture looks equally disappointing in the private sector. It invested a total of $18.6 billion in ventures throughout Canada between January 1996 and July 2002 (Ref [6]). Of that, approximately 2.6 per cent, or $488 million, was for energy and environment related projects. This is well below the North American average of four per cent for private investment in clean technologies (Ref [7]).

5 Institute for Catastrophic Loss Reduction. University of Western Ontario. http://www.uwo.ca/wnews/issues/2001/apr26/centre/index.htm

6 Ventures West. Report on the Canadian Venture Capital Industry. Files.

7 ***Investment Monitor Q1/Q2 2002***. Cleantech Venture Network.

TECHNOLOGY DEVELOPMENT PROCESS

In order to determine how to improve technological developments here in Canada, it is important to first understand the technology development process and isolate the areas of greatest concern. There are five distinct stages that an emerging technology must pass through before it is ready to enter the market (see Figure 2). Typically, emerging technologies face three basic types of risks: developmental, financial and market.

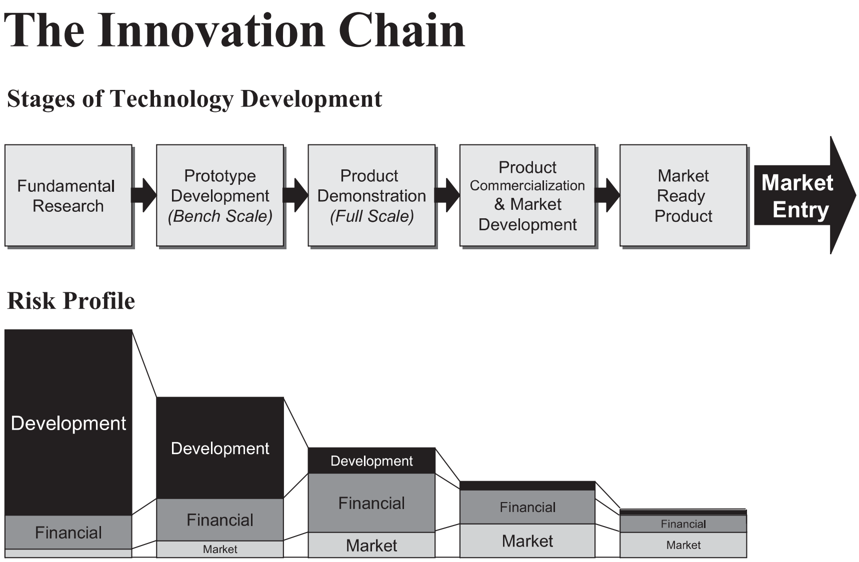

Figure 2

DEVELOPMENTAL RISK

Early in the process, developmental risk is high; it is simply not known whether the technology will work or not. During these early stages of fundamental research and prototype development, federal and provincial governments provide sporadic but substantial funding support.

FINANCIAL RISK

As the technology matures, the proportion of financial risk increases as concern shifts to the financial viability of the product.

MARKET RISK

At the same time, market risk increases as concerns arise over whether there is a ready market for the product and whether there is sufficient marketing infrastructure to support it.

While the individual risks vary at each stage, the overall risk declines as the product approaches market readiness. At each stage of the process, there are key players who get involved, depending on the level of risks involved.

In the early stages, when overall risk is highest, public funding for basic research is provided by federal and provincial government agencies to universities and colleges. As the technology progresses from bench-scale tests to larger-scale prototype tests and demonstration, overall risk continues to decline but financial risk increases. Early private equity - in the form of seed venture capital or individual angel investors - is a source of finance for fledgling companies prior to the venture capital stage.

Formal financing through venture capital typically picks up at the seed capital stage where products have been prototyped and demonstrated, but are not manufactured in volume, and certainly not generating revenue. Venture capitalists fund individual companies through these commercialization stages and frequently exit when banks become involved or as the company reaches the IPO stage. Industry, often in the form of manufacturers or major technology users, will invest through the venture and market-entry stage, as their individual interests and economic ability allow. Individual industrial companies typically invest in their own form of technology innovation, usually to meet individual market needs or increase corporate competitiveness. Consequently, they cannot be relied upon as a consistent source of funding in this stage.

Finally, large financial institutions take over as the technology enters the market. Public fund placements through pension funds are important players who generally invest in known companies or technologies already in the marketplace.

FUNDING GAPS

Throughout the process, it is clear that there are some distinct gaps in the funding cycle. The dotted line, *Funding Intensity*, shows the continuum of financial investment through the various stages of development (see Figure 3). The gaps in funding intensity are evident and are the result of a lack of product maturity, risk aversion within the financial sector and a fragmentation and lack of communication among key players in Canada.

The first gap is referred to as the "*pre-VC gap*" and typically occurs between the latter portion of government investment stage and early part of the private investment stage. This gap is perhaps the single-largest barrier to companies and entrepreneurs trying to bring their innovations to market. With the recent decline in activity among venture capitalists, there has been an even greater withdrawal of capital placements from the pre-VC stage, as venture capitalists continue to hold portfolios in cash or fund existing initiatives and work with organizations they are comfortable with. This has increased the pre-VC gap, as money has become increasingly scarce. The second gap, referred to as the "*pre-IPO gap,*" occurs just prior to the product going to a market offering and large-scale investment. These two gaps are an excellent illustration of how the lack of integration can cause substantial breaks in the development chain.

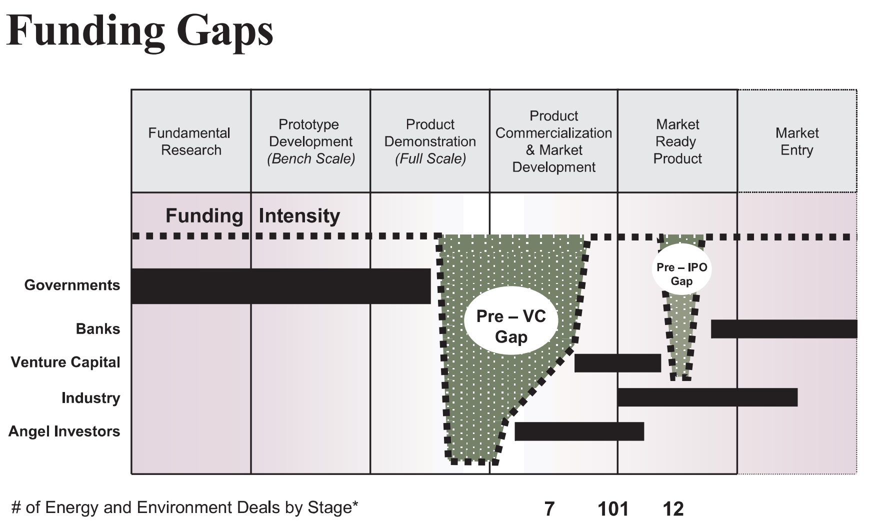

Figure 3

* Source: MacDonald & Associates, Oct 2002

It can be argued that Canadian scientists and engineers possess some of the greatest skills and expertise in the world, but tend to work in isolation of commercial markets. This can lead to a "disconnect" between what they develop and what the market wants. Without a strong market demand for a new technology, there is very little chance of creating a commercial success. The financial institutions, sensing this lack of coordination, avoid opportunities that are perceived to be high risk. These gaps pose the greatest threats to technology development.

A CASE IN POINT

Natural gas vehicle technology is clearly able to reduce air emissions from cars and trucks. However, it's difficult for consumers to buy natural gas for their cars (distribution), the tanks take up usable space in the trunk (consumer preference), and retailers have to install expensive safety mechanisms (regulation and control). For these reasons, there has been only limited interest in natural gas vehicle technology, despite its benefits and the time and expense involved in developing the core technology.

SUSTAINABLE DEVELOPMENT TECHNOLOGY CANADA

Sustainable Development Technology Canada has been formed to bridge these gaps and provide funding continuity. It is a funding organization that increases access to market and the rate of market entry for the commercialization of innovative technologies that address climate change and air quality. SDTC focuses on four main priorities:

- **Creating Integrated Networks:** SDTC acts as the central body that orchestrates the efforts of all the players in the innovation network. It does so by managing financial relationships and by building consortia of marketers, researchers, financiers, technology manufacturers, distributors and end users. Together, this creates "go to market" partnerships with a high likelihood of successful market entry.

- **Managing Risk:** SDTC shares developmental and financial risk and acts as a common information source for its partners. By involving the complete range of innovation players early in the process and throughout development, the probability of product success is substantially higher. The lower levels of risk can prompt potential investors to reduce overall financing costs. SDTC does not take equity and, therefore, does not dilute the commercial arrangement; nor does it seek to own intellectual property, but does require dissemination of the results.

- **Providing Funding Continuity:** SDTC manages a $350 million investment fund that leverages matched funding from private investors, governments and research institutions.

- **Providing Follow-Through Support:** SDTC maintains contact with all high potential developers, even if they initially fail to get funding support. Not all projects will be an immediate success and it may take a few attempts to "get it right". Typically, after an initial failure, entrepreneurs are faced with having to figure out what went wrong, make the corrections and launch another attempt at support. In most cases, there is very little constructive feedback and no mechanism for connecting developers with the right technical advisors. SDTC, however, continues to help proponents strengthen their capabilities. Once it has funded a project, SDTC stays in the picture, helping entrepreneurs promote their high quality, risk-reduced opportunities to the financial sector. This provides investors with pre-qualified deal flow, while reducing the time to market for innovators.

SDTC focuses on the oil and gas, power production, transportation, forestry, agriculture, building/construction and the energy utilization sectors. These sectors are vital to Canada's economy, but have historically faced greater difficulty obtaining funding as they typically require longer time to market and are more capital-intensive. Consequently, the VC community to date has invested very little in these areas (2.6 per cent vs. 59 per cent for IT and 18 per cent for biotechnology). Therefore, these technologies often face difficulty in attracting funding, despite the fact that they are increasingly attractive targets for investors because of their inherent stability and the essential role they will play in Canada's future prosperity.

To date, SDTC has reviewed over 500 consortia funding applications, representing more than 2000 companies and institutions. These consortia applied for $876 million in funding, which, when leveraged with matched funding, represents a total of $2.8 billion in project costs. Of these, eight projects (totaling $6.61 million) have been approved for funding, and another 24 are currently under review. The applicants' calculations indicate that the total emission reduction potential of implementing all the technologies is 165 MT of greenhouse gases per year (approximately 65 per cent of Canada's annual reduction target); the approved projects represent 11.2 MT.

While this data helps to quantify the pre-VC gap, it also demonstrates that there is significant untapped capacity and demand for funding sustainable development innovation in Canada. But this potential will remain untapped - and the opportunity lost - if the gaps in the innovation chain are not closed.

ENERGY AND ENVIRONMENT IS A GROWTH SECTOR

In the past, there has often been a difference between environmental responsibility and economic performance. However, progressive companies today are beginning to see that the "environmental dividend" is helping to make them more competitive, while improving their image with shareholders and the public. While the energy and environment sector has traditionally been a small market for private investors, there is growing evidence that this is changing.

Private investments in the life sciences, IT and traditional sectors have all declined dramatically since the year 2000 (Fig. 4). Investments in the IT sector alone dropped by $2.1 billion between 2000 and 2002 (Ref [8]). The dotted line in Figure 4 conservatively assumes there is *no further decline* in the major sectors in 2003.

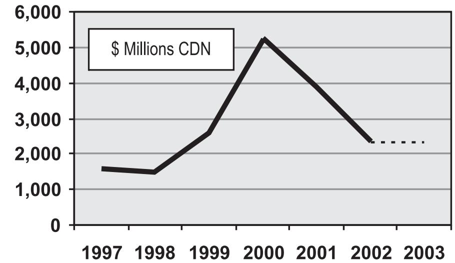

Figure 4: All Sectors

The only sector gaining ground is energy and environment, which is poised for substantial growth over the next five years (Fig. 5). The February 2003 federal budget earmarked $2 billion for the environment and an additional $1 billion for municipalities, of which a large portion is for improvements to the environment. This is within the context of a global market for environmental products, which is estimated to be worth $800 billion per year. Analysts predict that it is expected to exceed $1 trillion when climate change and urban infrastructure improvements come on line. By contrast, the Canadian environmental market is currently about $30 billion, or 2.2 per cent of the Canadian GDP, of which about $12 billion is for technology products and services. This is 1.5 per cent of the current global market (Ref [9]).

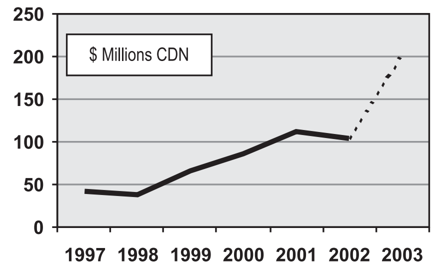

Figure 5 Energy and Environment Sector

This small market share, combined with the government imperative to improve the environment, indicates that there are substantial growth opportunities for this sector. This could provide sufficient inducement for private Canadian investors to take advantage of the new opportunities. To appreciate the potential for this sector, simply consider that if only 20 per cent of the 2003 environment budget, which is $2 billion over five years, were to be applied to technology development for environmental products, this would translate into an additional $80 million per year for development. This is reasonable given the fact that this budget increased SDTC funds from $100 million to an additional $250 million over five years or by $50 million per year. If private investors fund at roughly the same level as government, there would be an additional $80 million in market activity above existing investment levels (dotted line in Figure 5).

[8] MacDonald and Associates. Project files. February 26, 2003.

[9] ***Hi-Technology: The Heart of Canadian Innovation.*** Canadian Advanced Technology Alliance. Special supplement, Globe and Mail, November 8, 2002.

OPPORTUNITY FOR ANGEL INVESTORS

Angel investors are often independent entrepreneurs with a tremendous amount of expertise that can help companies improve financial performance and protect their investments. They typically operate in the pre-VC stage, where there is a moderate level of investment risk. Although they have tended to operate as individuals, these investors are now beginning to create networks as a means of harnessing their collective talents and financial resources. Efforts to coalesce this pool of investment talent has recently culminated in the creation of the National Angel Organization (NAO) which seeks to maximize the value of this group - and of Canada - by bringing entrepreneurs together.

There is an opportunity for SDTC and the angel investor community to work together for their mutual benefit. Angel investors need qualified deal flow; SDTC needs sound industry and financial expertise in the pre-VC area; and both work with the same groups of entrepreneurs. Each project that goes through the SDTC process is thoroughly screened for its technical, financial and market merit, resulting in a short-list of highly qualified projects. This pre-screening means that individual investors are in a better position to be aware of promising new technologies, which helps them make more financially sound and potentially more lucrative investment choices.

Angel investors do not have the resources to assess the opportunities and conduct due diligence with the same rigour as SDTC, making this a significant value-add provided by SDTC. Further, because of its national scope and process for attracting entrepreneurs, SDTC has a “cross-country snapshot” of the multiple opportunities in Canada, enabling comparisons in and between technology groups. This is unique to SDTC and provides a particularly well-balanced and diversified set of opportunities for angel investors to consider.

Although the exact means of collaboration have not been fully quantified, NAO and SDTC are clearly working together as agents of change to share risks and increase returns in the sustainable development technology arena. By combining their efforts and expertise, angel investors and SDTC will be able to enhance the likelihood of successful technology commercialization. This will go a long way to helping secure a strong economic future for Canada, while meeting environmental imperatives through sustainable development. SD technology is the emerging “best opportunity” for investors looking for new frontiers.

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Dr. Vicky Sharpe is president and CEO of Sustainable Development Technology Canada. Previously, she was president of GRI Canada and Astral Group where she demonstrated leadership and vision in the use of innovative technologies in the energy sector. Dr. Sharpe has over fifteen years experience in the energy industry and over the course of her multifaceted career, she has successfully integrated sustainable development into business practices. She built an international business in the areas of energy efficiency and the environment, while serving as vice president of Ontario Hydro International. Prior to this, she was responsible for leading edge marketing, business development and technology innovation in the industrial sector, serving in various management positions at Ontario Hydro.

A recipient of the inaugural National Energy Conservation Association's "Energy Efficiency Award" for outstanding contributions to the energy industry, Dr. Sharpe has served as an international advisor and representative on sustainability issues and represented the Canadian energy sector on the Asia-Pacific Economic Cooperation (APEC) Business Forum. Dr. Sharpe has chaired several Boards, including the National Advisory Board on Energy, Science and Technology, Clean Air Canada Inc. and co-chaired the City of Toronto's Sustainability Roundtable.

Dr. Sharpe holds a BSc Honours in Applied Biology (Co-op Program) from Bath University, U.K. She earned her PhD in Microbiology and Chemistry from Trent University, U.K. where she spent 5 years as a Doctoral Researcher and Lecturer.

SUMMARY

Angels often invest as groups in order to access higher quality deal flow, share due diligence and diversify investments and reduce risk. This article profiles four Canadian angel groups - the Kingston Angel Network, the Vancouver Angel Network, Ottawa's Band of Scoundrels and the London Angel Network. The practices of these four groups illustrate that there are common features to most angel groups as well as different ways in which angel groups approach the challenge of early-stage investing.

CHAPTER 8

BUILDING AN ANGEL GROUP

by Brad Ross
with input from Ian Campbell, Joe Dales, Tony Farrow, and Mike Volker

INTRODUCTION

Angel investors often work in groups for three key reasons:

- To access more and higher quality deal flow than can be found by working alone.
- To reduce individual effort by dividing up the work.
- To reduce risk by tapping into the group's varied experience.

Group participation also allows individual investors to spread their capital across more deals, resulting in better diversification and reducing risk.

Less than 20 local angel groups have been formally established in Canada, compared with more than 300 in the U.S. While each network is uniquely designed to serve the interests of its members, these groups have many characteristics in common, such as the investment screening process, and many that vary, such as organizational structure. Four groups are profiled in this chapter.

KINGSTON ANGEL NETWORK

The Kingston Angel Network was launched in November 2001 with an informal dinner hosted by the Kingston Economic Development Corporation (KEDCO). This was in response to interest expressed by recent arrivals to the community with angel investing experience. Using the personal networks of business people in the community, organizers invited approximately 20 people to discuss the need and opportunities for angel investing in Kingston.

The guests identified a clear gap in the availability of seed capital below the thresholds of venture capitalists. Companies requiring investments of over $1 million were able to tap into venture capital funds to meet their needs. However, small businesses needing investments of less than $1 million had few sources of funding and there were very few deals. Consequently, many of the area's prospective entrepreneurs were moving to larger centres such as Toronto, Montreal and Ottawa where they stood a better chance of attracting the financing needed to bring their ideas to fruition.

Following that first dinner, 12 investors, with the support of KEDCO, formed an ad hoc group and began meeting monthly as the Kingston Angel Network. They were motivated as much by the need to assist the economic development of the community as by the goal of achieving superior financial returns. The group quickly ruled out pooled investments, as no one wanted to be responsible for investing someone else's money. Instead, the group decided to cooperate on uncovering deal flow and evaluating opportunities, and then to invest as individuals where appropriate.

Finding and evaluating deals

KEDCO provides the public interface for the angel group through its Web site and offices. Entrepreneurs fill in a one-page summary, which can be downloaded from the KEDCO Web site, for screening and coaching by KEDCO staff. This also provides a coarse filter to ensure that proposals sent to the angel group meet its basic requirements.

Following this initial screen, applications are passed onto the members of the network. If a member expresses interest in the proposal, the entrepreneur will be scheduled to present at an upcoming meeting. If not, the proposal will receive one final review at the next monthly meeting. Presenters are typically allotted 20 minutes, with an additional 20 minutes for questions. Investors interested in pursuing the opportunity create an ad hoc committee to pursue due diligence and negotiations. If there is no interest in the proposal, the entrepreneur is given feedback on the reasons, and if possible, the names of contacts who may be able to help.

In its first year, the Kingston Angel Network considered 24 proposals and closed one deal. At 4 per cent on this albeit small sample set, the close rate is close to the range of one to three per cent typically found in angel investing. While membership of the group has fluctuated, there remain 12 members, including six who are active on a regular basis. Four of these individuals participated in the lone deal to be closed.

Investment Strategy

Investments don't necessary have to be made at early stages or in any particular industry. Any proposal that represents a sound business opportunity, while fulfilling community objectives, is looked at seriously.

VANCOUVER ANGEL NETWORK

The Vancouver Angel Network was created by a small group of like-minded investors in 1999. The group began as a casual meeting of approximately 20 people. These were individuals who had been successful in running their own businesses and who were looking to be active participants in the businesses they invested in.

From these informal meetings a more formal structure evolved. Today, there are over 200 members, with 40 or 50 attending the network's monthly breakfast meetings. The philosophy of the group is simple. People are there to make evaluations of serious proposals brought forth by the local business community. The group meetings also provide the investors with the opportunity to get to know each other and trade stories and experiences about what they are currently working on.

Finding and evaluating deals

Deals are brought to the attention of the membership through a structured, if somewhat informal, process. An angel member must sponsor a prospective business in order to bring it in front of the group. To be a sponsor, the investor must work with the network and be interested in making a personal investment in that company. By making an individual member do this initial due diligence, the group avoids having to deal with a formal application and screening process.

Approximately one in four presentations made to the group receive capital. The investments range from as low as $25,000 to as high as $4 million. The group has a definite technology focus and only looks at applications from local Vancouver businesses.

Three or four companies are brought before the group at each monthly meeting. The meetings begin at 7:30 a.m. and typically last two hours. Each presentation is restricted to 15 minutes; the presenters have ten minutes to present to the group, with five minutes reserved for questions. The presentations are not intended to spark a detailed discussion, but to gauge general interest among the group.

Generally speaking, presenters do not listen to other presentations. At the end of the meeting, each business' sponsor leads a discussion on the presentation, without the presenter in the room. Gauging interest is normally a simple process, with people just speaking their minds. Often it becomes clear very quickly who, if anyone, is interested in the opportunity.

A nominal annual fee is used to defray the minimal administrative costs and to provide coffee and muffins for the breakfast meetings. No presenters or investors are charged for attending the seminars.

OTTAWA ANGEL NETWORK - BAND OF SCOUNDRELS

The Band of Scoundrels, formed in 2001 by several individuals to facilitate investing in the Ottawa community, is a general partnership consisting of eight individuals and two corporations. It is structured as a pooled interest with a formal process for selecting investments. Rather than providing a forum for individual investors to select targets, the Band pools the members' funds and decides as a group on a per investment basis. Decisions are made by voting, with a 70 per cent vote carrying the day.

Finding and evaluating deals

Band members nominate candidates to present to the group; however two members of the Band must examine the deal before agreeing to hear the presentation. The champion or sponsor is responsible for ensuring the necessary information is presented.

While each member of the organization shares equally in the financial risk, workload varies among the members depending upon availability.

The Band meets on the first Monday of each month over dinner and companies are given one hour to make their presentation. Following the presentation, the candidate is asked to leave. The members of the Band then go around the table to vote "yes", "no" or "yes but." "Yes but" requires the company to provide further information; if satisfactory, the vote becomes a "yes." As soon as four "no's" have been registered, the deal is dead. Once a decision is made to pursue an investment, the major conditions of a term sheet, such as valuation, are considered.

Follow up discussions to resolve the "yes buts" are performed by phone and e-mail. If the e-mail message has not been responded to within five business days, then the recipient is deemed to be in agreement with the e-mail.

The Band actively works with other syndicates or early venture capital groups to raise larger amounts of money for potential investments. In its first 18 months, the Band invested in four deals with another two in progress. Four other opportunities, which had been approved by the group, fell through during negotiations and final due diligence. Decisions as to valuations are made at the group level, where parameters are set defining minimum or maximum values. It is then up to the champion to negotiate the specific terms with the company.

LONDON ANGEL NETWORK - THE TECH ALLIANCE VENTURE GROUP

London is home to many leading institutions, including University of Western Ontario, Fanshawe College, and major hospitals and research centres. Many residents and graduates have started innovative companies in the life sciences, information technology and advanced manufacturing sectors. Recognizing that these start-ups and early-stage companies require capital, a number of angel investors and other stakeholders have formed a network with the goal of bridging gaps in early stage financing and promoting small business growth in London.

Over the years, the London Venture group has taken advantage of several government programs to assist network angel investors and innovative businesses. The group has also attracted a significant number of volunteer members who provide support to high potential companies at no cost. Over time, a list of investors has been compiled that is used to contact angels regarding investment opportunities.

There is no pooling of funds and decisions regarding investments are left to individuals. That being said, investors have followed each other on deals after other members have completed the background research and due diligence.

The London Venture Group joined the TechAlliance to share resources and to expand the number of volunteers and angels available to assist in the growth and success of innovative companies. The TechAlliance Venture group offers acceleration services to the businesses and angel education services for potential angels. These are discussed below.

Finding and evaluating deals

The Venture Group Acceleration encourages companies, which are looking for financing, to present a business plan for review and follow up. When a potential business seems promising, the group assigns two or three of its members to act as advisors to that business. These advisors spend several months getting to know the people and the company. They attend regular meetings with the company and assist in developing the presentation that will be made to the rest of the group members. Once the advisors are satisfied that the business is worth investing in, the principals will be allowed to present to the other angels.

If the presentation sparks interest, the members of the group will match prospective investors with the capital requirements of the company. A major benefit of this approach is that individuals can invest smaller amounts in a number of businesses, thereby diversifying their portfolios and spreading risk.

The angel investor education services include peer-to-peer network meetings where information and learning is shared. Keynote speakers cover topics that will help angel investors make better investment decisions and encourage more investments.

CONCLUSIONS

While there are many models for structuring an angel investor group, there are also a number of critical success factors common to each. Successful groups begin with a core of investors who have experience and share a commitment to angel investing. They select a process that quickly connects entrepreneurs with interested investors or provides constructive feedback to entrepreneurs as well as leverage to other sources of funding and support.

These examples show that angel investors will easily find a structure and process that works for them and quickly develop templates and tools to evaluate deal flow. Cultivating the network for deal flow and attracting new investor membership are the ongoing activities that determine the sustainability of the angel investor group.

AUTHOR

Brad Ross is a private investor and the former President of Entrust Technologies Europe. To foster entrepreneurial activity in Kingston, Mr. Ross is leading efforts to establish a local network of angel investors and launching a business plan competition (www.firstcapitalchallenge.com). He serves as chairman of the board of trustees for the High Performance Computing Virtual Laboratory, on the boards of the Student Technology Venture Challenge and Esponsive Communications Corporation, and on the R&D committee of Kingston General Hospital. After completing studies in Mathematics and Engineering at Queen's University (B.Sc. '80, M.Sc. '82), Mr. Ross worked at Bell-Northern Research in software development and R&D management. In 1988, Mr. Ross won a Nortel scholarship to study management science at the Massachusetts Institute of Technology (S.M. '90). With this foundation in technology, business and team leadership, Mr. Ross co-founded Entrust in 1993, Northern Telecom's most successful intrapreneurial start-up, growing the business through to spin-out and eventual IPO.

__This article had significant input from several angel investors who live across Canada: Ian Campbell, Joe Dales, Tony Farrow, and Mike Volker.__

CHAPTER 9

BUILDING A NATIONAL ANGEL ORGANIZATION

by Henry Vehovec

SUMMARY

The National Angel Organization (NAO), formed in October 2002, is a non-profit group that represents angel investors in Canada. Its mission is to improve the success of angel investors through networking and education and by providing a collective voice. NAO has already performed pioneering research work with the Rotman School of Management, Industry Canada, and is in discussions to conduct broader-based work with other economic stakeholders. Among its first priorities, the NAO is examining the nature of the venture capital gap and the determinants of success for angels seeking to fill it. The article also focuses on the demographic compositon of angels in Canada and outlines the governance structure for the new NAO.

INTRODUCTION

Angel investors address the gap between love money and venture capital or more sophisticated sources of downstream capital. Generally considered the weakest segment of the financing services spectrum, angel investors must address higher risk, uncertain liquidity, long investment horizons, management gaps and a wide range of other industry-specific issues. Historically, angel investing has been carried out primarily by individual private investors; disciplined investment managers rarely invest at the angel level.

Relatively little has been known about angel practices and how they might be improved. Indeed, relatively little has been known generally about the angel investing "sector." It is unclear, for example, how many angels there actually are in Canada. Oddly, many angels do not even recognize themselves as angel investors; they might not even be familiar with the term. Yet, the reality is that angels invest more than five times in early stage businesses as the entire venture capital industry combined.

Since 2000, more than 300 angels have participated in loosely organized grass roots events that have grown in sophistication and ambition. At the second Angel Investor Summit in October 2002, it was decided to create the National Angel Organization (NAO), a non-profit organization that would, among other goals, provide continuity for the enthusiasm and optimism that has characterized angel activities to date.

ISSUES AND CONSIDERATIONS IN CREATING NAO

In the discussions leading to the creation of NAO, the participants articulated various challenges to be addressed by a national organization of angels, including the creation of distinct value propositions for a wide variety of angel needs and requirements. Specific needs were expressed based on geography, local clusters and maturity of existing angel organizations. Discussion also focussed on defining deliverables, benefits of membership, funding models, governance structure and organizational considerations. At the conclusion of the meeting, the group voted in favour of creating a Founding 100 Members group of the NAO in order to set the founding board, select an Executive Director, incorporate the organization and set the agenda for Angel Investor Summit 2003 to be held in Montreal on October 30, 2003. The Founders are set to reconvene in Montreal for the AGM on the evening of October 29, 2003.

NAO AND PROGRESS TO DATE

The NAO seeks to engender an environment of confidence and trust that will allow the angels to communicate openly with each other. By establishing and cultivating such an environment, many angels are willing to participate in broader research, particularly when they see the genuine interest of policymakers as well as educational benefits for themselves.

NAO has already performed pioneering research work with the Rotman School of Management and is in discussions to conduct broader based work with leading researchers at Queen's Centre for Economic Development (QCED), the Richard Ivey School of Business and the Haskayne School of Business. By acting as an independent hub that respects the angels' right to privacy, the NAO should be able to provide aggregate information that has been unavailable to date. The federal government through Industry Canada, as well as the provinces of Ontario, Manitoba, Alberta and PEI, have also expressed interests in working with the NAO to produce more effective public policy that will encourage economic growth. In the summer of 2003, the NAO will begin a cross-country fact-finding tour to discover the gaps and impediments to early-stage financing in Canada. The findings from this tour will be shared with angels, policymakers and other stakeholders.

ANGEL INVESTMENT AND THE VENTURE CAPITAL GAP

Among its first priorities, the NAO is examining the nature of the venture capital gap and the determinants of success for angels seeking to fill it.

NAO research indicates that the venture capital gap is actually finite and methods exist to quantify the gap. Furthermore, the actual funding gap for quality projects represents an amount that is less than 2 per cent of the cumulative net worth of the high net worth individuals in the country. Critics of the VC gap notion often suggest that there actually is no funding gap, rather, there is a quality gap. The suggestion is that if the emerging companies were of high enough quality there would be more than sufficient money waiting to invest.

By any name, there is a gap that leaves junior companies seeking funds. There could also be cultural, structural and educational gaps that prevent much of the available wealth in the country from investing in early stage private equity.

DETERMINANTS OF ANGEL INVESTING SUCCESS

The Angel Investor Summit 2001 co-chaired with Roger Martin, Dean of the Rotman School of Management, University of Toronto, concluded that there were both macroeconomic and microeconomic determinants for angel investing success. At the microeconomic level, angels can improve their returns on investment through networking, diversification, investing in groups and adopting best practices. Further, it was determined that there are many cluster specific barriers, practices and determinants that must be considered by angels. The NAO can help to build awareness, education and facilitate activities and programs addressing these microeconomic issues.

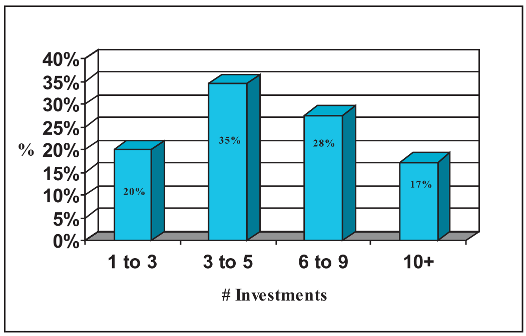
Furthermore, angels have never had a collective voice with respect to macroeconomic issues, let alone a mechanism to survey, study, analyze and make recommendations on larger policy issues affecting them. The NAO can and will facilitate the study of issues relevant to angel investor success.

NAO MEMBER PROFILES

The majority of angel investors among the early founders of NAO have invested in five or more angel investments, average 49 years of age and are very much interested in making more angel investments in their lifetime. Their typical deal size would be less than $1 million, with several angels grouping together to each invest $50,000 to $250,000.

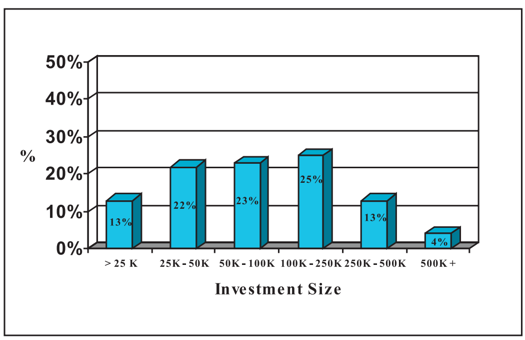
NAO organizers recognize that there is a cadre of super angels that has so far been largely unrepresented at the NAO. These individuals often have their own support organizations and may make their investments through agents, junior angel partners or subsidiary corporations. The NAO will seek to engage and include super angels in the Founding 100 as well as in the general membership.

NAO members - Number of investments made



The NAO encourages senior as well as beginner angels to become members. Angel groups often enter deals combining active and passive investors. Boards often like to have several generations represented while also having cross-functional expertise. The NAO needs to be inclusive if it is to harvest cross-pollination benefits.

Size of investment



There is also a wide range of sophistication of angel groups across Canada. Many angels tend to be private and reclusive. The NAO is firm in its intentions of maintaining the strictest confidentiality policies that will allow the most private of angel investors to engage with others in the angel community.

To be an effective collective national voice for angels, the organization must represent and encourage membership of angels transcending considerations of geography, local clusters, age, investment type, size and angel investment styles. With this in mind, the Angel Summit in 2002 hosted participants from seven provinces, representing themselves or local angel groups. There were budding angels interested in building groups in communities of less than 50,000 as well as angels from the country's major centers. The challenge for the NAO is to create a value proposition that is appealing to this wide cross-section of potential angel members.

NAO SERVICES & VALUE PROPOSITION

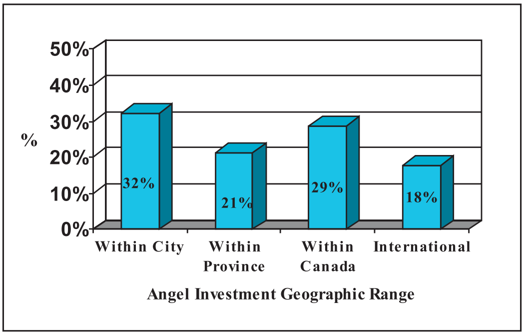
Prior to the formation of NAO, angels were asked to assign preferences to the following list of services and potential NAO benefits: Angel Investor Summit, Angel Investor Charity Golf Tournament, What's Hot Breakfast, Deal Flow, Confidential Angel Roster, Public Policy Advocacy, Angel Forum Groups, Industry Trends Information, Best Practices in Deal Structure and Angel Investment Fund. The top three deliverables desired by the survey population were access to the confidential angel roster, participation in the angel summit and current information regarding best practices. The potential bias of this sample was that many of the respondents had been to the previous year's summit and may have been consequently predisposed to ranking the summit and roster access higher than items that had yet to be delivered.

Some of the younger or smaller angel groups were very interested in the potential educational benefits of NAO, and strongly supported the creation of an angel investor fundamentals curriculum. The junior groups were often less enthusiastic about sharing deal flow or their roster. The senior angels were excited about the prospects for exposing their regions and local deals to the rest of the country and other investors.

There was also strong support during discussions for public policy advocacy. Although there were differences in vision with respect to the most needed benefits by the various angels, the group was uniform in wanting to have a collective voice that might be heard on important topics relevant to economic development at all three levels of government.

ANGEL INVESTOR HABITS BY GEOGRAPHY

Angel investors tend to invest close to home. An angel might say that he would only invest in companies that he could drive to and from in an afternoon. Although the largest portion of angel investors still invest within their own home cities, a surprising number were willing to venture outside their province and even outside the country.



This statistic could be attributed to increasing globalization and also an interest by angels in focusing their investments in domains of expertise regardless of geography. NAO hopes to track these and similar characteristics within the angel community and identify trends.

GOVERNANCE MODEL

The group has chosen a non-profit organization structure as a model. Angel investors must meet strict admission criteria. The members elect a board of directors and the board appoints an executive director and staff as needed.

The organization is structured as a hybrid of several models, thus allowing angels to interact and be represented in a way that is not available in other organizations and professional development groups. Many of the founding members also maintain relationships with other groups such as the Canadian Advanced Technology Association (CATA), Canadian Association of Family Enterprise (CAFE), Canadian Venture Capital Association (CVCA), Conference for Advanced Life Underwriting (CALU), World Economic Forum (WEF), Young Presidents' Organization (YPO) and others. None of these groups represent the unique and important interests of angel investors. The NAO will seek to create alliances or relationships with these and other business, academic and government groups as appropriate.

CONCLUSION

Since NAO's founding in October 2002, it has emerged as the voice of angel investors in Canada, with a mission to improve the success of angel investors through networking and education. Studies indicate that Canadian competitiveness and resultant standard of living has fallen in the last ten years. By improving the probability of success and returns of angel investments in Canada, benefits accrue to the economy and society in general. NAO is founded on the premise that angels fund innovation by investing in young companies and that innovation leads to improved productivity, prosperity and consequently a higher standard of living.

AUTHOR

Henry Vehovec was the founder of the Angel Investor Summit and network that ultimately created the National Angel Organization (NAO) of which he is the first Executive Director.

Along with a career in technology, sales and management, Mr. Vehovec himself has invested in several early stage companies in life sciences, telecommunications and software services. Through Mindfirst Inc., Mr. Vehovec currently provides strategic consulting, financial advisory and technology outsourcing services to growing businesses and projects.

Mr. Vehovec chairs the CHIN UP Fund (www.chinup.org) for nerve research at Toronto's Hospital for Sick Children and is currently a member of the investment committee of the Foundation for Sustainable Innovation (www.sdtc.ca). In 1996, he completed the Owner/President Management (OPM) Program at the Harvard Business School, holds an MBA from the Richard Ivey School of Business at the University of Western Ontario, a P.Eng designation, and BASc from the University of Toronto.

SUMMARY

The following is a summary of the NAO's recommendation that the Canadian Ministry of Finance establish an Innovation and Productivity Tax Credit ("IPTC") for Canadian small business.

A full copy of the paper is available at http://www.angelinvestor.ca/library/docs/NAOWhitePapeFinalFeb2004.pdf.

CHAPTER 10

THE INNOVATION AND PRODUCTIVITY TAX CREDIT – A RECOMMENDATION FOR CANADA

RECOMMENDATION

For the past 30 years, there has been a fundamental change in the drivers of the Canadian economy from natural resources to technology and innovation. Some 85% of Canada's GDP is presently being generated by small and medium-sized enterprises (SMEs). They are without dispute this country's economic engine. The launch of an overwhelming number of SMEs has depended upon capital invested by angel investors who assume significant risk in funding these emerging Canadian companies and nurturing their success. As integral components of the success of SMEs and the economic health of our communities, there is public policy value in further encouraging angel investments in Canadian SMEs. Nevertheless, the current tax regime provides little recognition of the risks assumed by angels and does not provide maximum incentive for continued investment and risk-taking by angel investors in Canadian SMEs.

To recognize and encourage investment in Canadian SMEs and reap potential benefits of employment and community prosperity, we recommend federal and provincial governments provide qualified and eligible investors (individual and corporate) with a combined 30% Innovation and Productivity Tax Credit (IPTC). **We recommend the IPTC be provided for investments in an Eligible Business Corporation ("EBC") thus dramatically increasing funding for these ventures.** **(**The IPTC program should be modeled after an existing program that is working effectively in the province of British Columbia.)

DISCUSSION AND SUPPORT

Federal and provincial economic policymakers alike recognize the need to encourage innovation in order to ensure economic growth and prosperity. Canada has an abundance of seed and start-up business development opportunities, based on technology and innovation. Net new economic growth is generated primarily by SMEs. It's imperative that Canada's policymakers support and encourage angel investment in our emerging enterprises. Policies that allow emerging enterprises to capitalize on the management and financial resources provided by angel investors improve the likelihood that such companies will succeed, leading to more jobs and long-term economic strength.

Historically, individual investors have been the primary source of capital for seed and start-up companies. As noted in a recent paper by the U.S. Community Development Venture Capital organization:

- In the U.S., Jeffrey Sohl, a professor at the University of New Hampshire estimated that in 2002 approximately 200,000 private individuals invested $15 billion into 36,000 entrepreneurial ventures.
- Individuals invest at a critical stage generally when the entrepreneur's family and friends' money (otherwise known as "love money") has run out and prior to venture capital money.
- Only 2% of venture capital money is invested in seed and early stage companies.

Angels are some of the most important (though least understood) players in our entrepreneurial landscape today. In the U.S., *angels fund 30 to 40 times as many entrepreneurial firms as the formal venture capital industry, although their total capital commitment may be less because of the stage of the investment*. Angels as a class, <u>bring BOTH money and a unique strategic guidance to early stage concepts</u> - seeking to become a business.

Canada must encourage more entrepreneurial companies in order to achieve its economic goals. SME's are the single most important driver of economic growth and job generation in this country.

There is a critical shortage of seed and start-up investment in Canada. This shortage, referred to as <u>the Funding Gap in the Innovation Chain, is in the order of $5 billion</u>. Since 2000, there has been an increase in direct research funding of over $4 billion. However, at the same time, early stage funding has decreased by $1.6 billion. Much of Canada's potential future innovation will not be commercialized, due to these current funding trends and the existing funding gap in the innovation chain, unless something is done.

Canadian governments need to focus resources on this Funding Gap (the Pre-VC stage of business development). Without governments' help, innovation stalls and does not progress to a later stage, where venture capitalists will invest. (See page 56 for further information on the Funding Gap). More distressing is that the failure to better facilitate investments in the early stages of companies could prompt an exodus of Canadians and their enterprises to other jurisdictions with more capital-friendly structures.

Seed and start-up investing is a very risky business, but the rewards can be very high for several stakeholders beyond angel investors: owners, employees and their communities benefit when SMEs succeed. There is a need for governments to incent everyday Canadian angels to take the risks necessary to invest in Innovation.

Angels help entrepreneurs deal with the inherent execution risk of business development, in a very efficient manner. They operate with low overhead, do not charge for their time and have the patience to wait for a payoff many years hence. Entrepreneurs often refer to angels' value to their business as being "priceless".

Investments in seed and start-up companies have a huge multiplier effect (8 to 10 times) for the Canadian economy, attract later stage follow on investments (4 to 5 times) and are virtually self-financing for the government portion of the funding (within a two-year period). Labour Sponsored Investment Funds (LSIF) tax credits have been very successful in attracting large pools of capital for private equity investment. The LSIF (and British Columbia) tax credit needs to be extended to angel investments. **The NAO is seeking a tax credit program for qualified investments that recognizes the potential value and prosperity these activities can create.**

The NAO recommends public policy planners make it an overarching objective for governments to seek out and leverage the strategic value of angels' funds in our national innovation chain. This should be a motherhood priority.

ANGEL INVESTOR LINKS

Below are links to organizations whose members have participated in NAO events and initiatives. NAO does not make angel investments itself; however, many of the listed groups match entrepreneurs with angel funds. Entrepreneurs seeking funds should review this list for angel groups with profiles most closely matching their needs. Links are listed in alphabetical order by organization name.

Atlantic Venture Networking Group (AVNG) - Fredericton, NB
www.avng.org

BC Angel Forum - Vancouver, BC
www.angelforum.org

Calgary Enterprise Forum - Calgary, AB
www.calgaryforum.com

Cleantech Venture Network
www.cleantechventure.com

Golden Horseshoe Venture Group
www.ghvf.org

Innocentre Alberta - Calgary, AB
www.innocentrealberta.com

Kingston Angel Network
www.business.kingstoncanada.com/angelnetwork.cfm

Montreal - CEIM.org
CEIM

National Angel Organization – Toronto, ON
www.angelinvestor.ca/

Ottawa Capital Network - Ottawa, ON
www.ottawacapitalnetwork.com

Purple Angel - Ottawa, ON
www.purple-angel.com

Toronto Angel Group (TAG) - Toronto, ON
www.tvg.org/tag

Vancouver Enterprise Forum (VEF) - Vancouver, BC
www.vef.org

Angel investor groups or organizations with angel investor resources that want their website listed on the NAO website are asked to send their request with their website address to info@angelinvestor.ca.