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Angel Investing: High Risk, Potentially High Return

By Hazel Becker

If you are thinking of becoming an "angel" investor – putting money into early-stage, high-growth companies even before venture capitalists are involved – you have a lot to learn. One way to learn much of what you need to know is to join an angel investment group.

In the investment context, angels are people who invest in start-up companies or provide financial resources to entrepreneurs who are looking to start a company. Such investments are extremely high-risk, and to compensate for that risk, they come with the potential for very high returns. Much of the private capital invested this way comes from family or friends of the new business owner. Frequently, people who invest money in their family members' or friends' ventures don't understand the risk they are taking, and they miss out on the opportunity to share business expertise and learn from other members of a group.

According to the Angel Capital Association, a trade association with 164 member groups, the number of angel groups has grown significantly in the last decade, and they now exist in nearly all American states and Canadian provinces. The Center for Venture Research at the University of New Hampshire says angels invested in 55,480 entrepreneurial ventures in 2008 – a 2.9 percent decline from the number funded in 2007. To Brian Hill, managing director of Profit Dynamics Inc. and author of *Attracting Capital from Angels* (John Wiley & Sons), the data indicate that "angels have a lot of faith in the continued vitality of the American economy and were willing to take significant risk even when the stock market and the real estate market both were down."

Generally, the group process works this way. A panel or subset of an angel group will review applications from entrepreneurs seeking funding to weed out those that don't meet the group's investment profile or minimum requirements. The panel will invite the remaining applicants to a screening session – often a lively meeting with a lot of give and take, in which angel group members offer feedback, advice, and networking opportunities to the entrepreneurs. The screening panel then decides which applicants will be invited to present their projects to the entire group. Projects that pass muster at the group's investment meeting are then subjected to "due diligence," in which potential investors or others with specialized expertise research the project and the entrepreneur, validate the concept, and decide whether to draw up a "term sheet" that becomes the basis for an investment in the company.

As with investment clubs, which generally make more traditional investments in stocks and bonds, some angel groups pool funds so that individuals can invest collectively, while others pool members' expertise and facilitate individual investments but don't invest as a group. Investing with a group allows members to share the financial risk of their decisions, while angels who invest as individuals bear the entire risk of their decision to invest in a project.

How High Is High?

Speaking of risk, this is the first thing you need to understand about angel investing: it is a high-risk business.

"The metrics of angel investing are sobering – it is not a game for the faint of heart," according to David S. Rose, managing principal of the Rose Tech Ventures Team and a member of the New York Angels. "Of every 10 deals you make, five crash, two return even money, and two give you two to three times your money. It takes that last one company, a mega-hit," to get the high return most angel investors are looking for, he said.

Because of the high level of risk, angel groups generally have fairly strict entry requirements. Most groups accept as members only individuals who are "qualified" or "accredited" investors, which the Securities and Exchange Commission defines as a couple or individual with net worth of at least $1 million or a couple/person with at least $300,000/$200,000 in annual income. Some angel groups set the bar even higher, and some – particularly those that invest collectively – require members to pledge a minimum investment over a set time period. Some groups also set a maximum percentage of a member's net worth or investable assets that can be invested in private equity or put into the fund.

On the flip side, angel investing has the potential for high returns. The long-term internal rate of return on an angel portfolio can be 25 percent to 30 percent, Rose said. If done correctly, "this is a very good way to leverage a portfolio with alternative assets," he said. "The caveat is that you have to do it right; you can't just drop in and take your 10 percent and put it in one company." Rose said the typical angel has 10 or more deals in a portfolio, allowing for enough ventures to diversify his/her holdings.

Rewards Not Just in Dollars

Financial gains are not the only reward of angel investing, and for some individuals, it is not the primary reason for joining an angel group. Seattle businessman John Merrill wanted to join forces with other investors to tap their business acumen, expertise, and judgment in the due diligence process and structuring deals. Because angel investing is so risky, he said, it "can be a daunting experience without the expertise and support of an angel group … I joined Northwest Energy Angels because I had experiences where I didn't understand how to analyze a project, or the risks – or how to structure the investment intelligently. I was looking for mentoring from more experienced angels," a stated goal of the Northwest Energy Angels, he said. Merrill also wanted to join forces with like-minded individuals to invest specifically in alternative energy and clean technology projects.

Learning from others was also a strong motivator for Steve Saunders, a Boston intellectual property lawyer who belongs to Hub Angels. "You are combining your talents and being able to make better decisions," Saunders said, noting that "there might be someone in the group who understands different industries, who would be able to parse the business better, or might know someone the business can bring on board" to give it a better chance of succeeding.

Saunders said he originally joined the Hub Angels because he saw an opportunity to network with entrepreneurs and build his client base. The educational process has been important to him. “It’s like getting a master’s degree in business,” he said. “I’m learning things that will let me help my clients, who are small businesses, develop their IP portfolios.” He believes the knowledge he has gained from his participation “makes me better than other patent attorneys who aren’t doing this and gives me an edge in the marketplace.”

How to Decide

If you are thinking of becoming an angel investor, here are some questions you should ask yourself.

Do you have enough capital to devote to this kind of investment? According to David Rose, the “typical” angel invests between $25,000 and $100,000 in private equity. You may find a way to invest only $10,000, but you are not likely to do so with a diversified portfolio – unless you find a fund with lots of members and a low commitment. On the other hand, investing through an angel group’s investment fund might allow you to leverage your money and diversify your holdings adequately to mitigate the risk you are taking by choosing this investment vehicle.

Do you have the time to devote to helping your investment pay off? Brian Hill noted that angel investing “isn’t necessarily passive. In fact, some of the best angels are the ones that add more to the company than just money. They bring their contacts, their expertise, and often their ‘been-there-done-that’ experience in building their own companies.” While this requires a commitment of time and energy, he said, “angel investors get involved in this in part for the joy of watching another company succeed partially due to their contribution. They are in it not just for the potential return, but also the psychic returns of being involved in a successful venture. They enjoy passing on their experience to others.”

Can you leave your money in the investment for a long time? Angel investing is “not a get-rich-quick scheme,” Rose said, noting that venture capitalists tend to in a business for about five years and angels’ commitments are frequently much longer. An angel investment is “extremely illiquid. You can’t sell it if you suddenly run out of cash,” he said.

Can you afford to lose your entire investment? Very few angel investments are wildly successful, and not every portfolio will give the 25 percent to 30 percent returns some investors are chasing. Considering that half of all angel investments fail and only one or two in 10 can be expected to be “home runs,” Rose said, “it’s a ‘hits’ business, and you have to kiss a lot of frogs to get a chance at the one big deal.”

If you are interested in finding out more about angel investing and looking for angel groups in your area, the Angel Capital Association provides a directory of its members on its Web site. Even more groups are listed at angelsoft.net/investor-tools/group-finder.