Industry Canada Industrie Canada

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Angel's Touch !!!

An Entrepreneur's Guide to Informal Investment

Canada

Many great business successes like Bell, Bombardier and Nortel have one crucial thing in common: They began with a good idea and a handful of people with the cash and the confidence to get them started.

For as long as there has been commercial enterprise, there have been private investors willing to inject their own money into promising new ventures. Long before a business captures the attention of professional capital providers, it is the private, informal sources of risk capital that plant the seeds of success.

This document aims at providing background information on "angel investors", these elusive individuals who are wealthy, have good business acumen and many business contacts. They are an important source of equity financing for small businesses but they are difficult to get at. Who are they? Where are they? How can they be identified? How can you get them to invest in your business? In this paper, we will demystify these questions.

Indeed, given the high level of financial risk inherent in small and medium-sized enterprises (SMEs) in their early stages, informal investors, also called business angels, are very often the only source of seed and start-up equity capital.

In Canada, there is no shortage of angel investment funds. The challenge lies in readying SMEs to approach investors, and linking willing investors with able entrepreneurs. And, with the importance of SMEs to the Canadian economy, the Government of Canada has an intense interest in promoting that relationship.

That is why, under the *Canada Community Investment Plan* (CCIP), Industry Canada supported 22 demonstration projects that explored how communities could pull together to facilitate access by entrepreneurs to informal early-stage investment in small and medium-sized businesses.

Small but powerful**:** The Government of Canada has a profound stake in supporting small and medium-sized enterprises, the most dynamic engines of economic growth in all sectors. Comprising 99% of all Canadian businesses, SMEs with up to 500 employees account for almost 90% of total employment in Canada.

These projects generated some practical approaches for communities interested in developing investment facilitation services to match entrepreneurs with angels. The collective experience of these projects are embodied in a document, ***The Winning Formula*****,** a guide describing how to launch an investment facilitation service in a community.

For a summary of the CCIP, please refer to page 8. For a full description of the CCIP, please visit http://ccip.ic.gc.ca. At this web site, you can also find *The Winning Formula*, a how-to guide on establishing an investment facilitation service in a community, as well as *The Winning Formula at Work*, a collection of 15 best practices gleaned from the CCIP demonstration projects.

Paper copies of both *The Winning Formula* and *The Winning Formula at Work* may be obtained at the Information Distribution Centre, Communications Branch, Industry Canada, (613) 947-7466, or through the Strategis hotline at 1-800-328-6189.

The key elements of the CCIP program, its successes, lessons learned and best practices will be shared at the **Bridging the Information Gap** conference, June 13-14, 2001.

This paper is intended to give you, the entrepreneur, more insight into angel investors.

The Face of an Angel

What is an angel investor?

"Angel" is the term that is commonly used as a short form for the "informal private investor." Angels invest their personal funds (and usually their time, energy, know-how and enthusiasm as well) in new or expanding small businesses started and operated by somebody else. In return, they normally take an equity stake in the company, and most often, also a board seat.

While very young companies can experience high growth, they also stand a good chance of failure. As such, angel investments are risky but potentially rewarding.

How do angels differ from other types of investors?

The formal **equity** investment community consists of venture capitalists and the public equity (or stock) market. While angels share with venture capitalists an involvement in riskier businesses that the traditional financial institutions won't touch, the main difference is that angels use their own money, while venture capitalists invest somebody else's.

Unconditional love: Most new businesses are very familiar with the concept of "love money" – cash injected in a new venture by friends and family. Love money tends to be invested for long periods, with lower expectations of returns.

What sort of people become angels?

With thousands of angels active in the Canadian economy, there are also thousands of answers to that question. In general, however, angels tend to have post-secondary education and incomes that are higher than average (i.e. $100,00 to $250,000 per year). Typically, they are businessmen in their mid- to late-40s with an interest in helping start-up companies develop and thrive. Most have had previous investment experience and are attracted to investments that offer an elevated potential for a high rate of return and capital appreciation. Many angels are immigrants who become leaders in their communities.

Frequent flyers: While some research indicates that about 40% of angels are one-time investors (often known as 'novices' or 'virgin angels'), many invest more than once – some dozens of times – earning the title of 'habitual' or 'serial' investors.
Source: A. Ellen Farrell (2000) Angel Activity in Atlantic Canada: A Year-2000 Review

While most are activist 'doers,' who want to be engaged in the company and have little time for bureaucracy, a few prefer to limit their participation to writing a cheque.

Why do they invest?

Again, all angels have their own reasons for risking their personal financial resources in somebody else's idea. Some are motivated by the prospect of large economic gains if the idea takes off in popularity. Others have altruistic purposes, including helping out start-up entrepreneurs, promoting community development and job growth, and supporting socially useful inventions such as environmental technologies. Another popular category are called "hedonistic" investors: They are attracted by the joy of creating a new concept and the thrill of risk-taking.[1]

There are, however, some common threads. Most angels have an abiding interest in the sectors in which they want to invest. They also tend to share a yearning to be involved in a hot new idea and a dynamic young company.

How much money are we talking about?

Canadian research has found a wide range of investments, although they are typically between $25,000 and $250,000.

As to the overall impact of angel activity on the Canadian economy, estimates vary from about $500 million per year to an amount roughly equal to total investments by the formal venture capital industry. In 2000, that was $6.3 billion.

Adding value: It's not just about money. In fact, one of the key strengths of angels is their capacity to add value to their investment, by advising the new company's managers, helping to recruit top managerial and board talent, developing contacts and raising the company's profile, and helping to shape a long-term vision and strategies for success.

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[1] The three categories of business angels – economic, altruistic and hedonistic – were first described by M. K. Sullivan and A. Miller in the *Journal of Business Research* (1996).

Where do angels invest?

A research study from Atlantic Canada found that one in six newly formed companies had received some form of angel capital. Half of them had more than one investor.

While venture capitalists tend to focus on high-technology industries, angels are found in a variety of sectors, including retail, business services, manufacturing and processing, hospitality, health care, real estate and agriculture. The vast majority of angels invest close to their home or office.

Flying United: There are some 'solo' or 'independent' angels, who prefer to invest entirely on their own. Many, however, operate in informal networks or syndicates, where they can pool resources and share their investment risk. Networks are often headed by more activist leaders, known as 'archangels.'

What do angels expect in return for their investment?

Angels generally opt for a minority equity ownership stake in a company, with the precise size of their share depending on factors such as the experience of the angel and the entrepreneur in negotiating such agreements and how many angels are investing simultaneously in the company. In general, all investors together take no more than 60% of the company, leaving at least 40% to the entrepreneurs.

While equity is the preferred choice of more than half of angels, about a fifth of angels choose to extend loans to the start-up firm; another fifth prefer a combination of debt and equity. [2]

Angelic patience: Angels tend to be a patient and risk-tolerant lot. Research shows they will invest in riskier enterprises than conventional venture capitalists and many hang on to their investment for longer periods. In Farrell's study, one-third lost their investment altogether.

In the United States, research suggests that three of 10 investments are winners, three are losers and the rest are somewhere in between, invested in companies that neither fail nor produce a payoff for investors.

[2] A. Ellen Farrell (2000) Angel Activity in Atlantic Canada: A Year-2000 Review

Why do we need angels?

At the early stages of a business's life, angels could well be the only investors willing to put up some outside equity. Banks and other financial institutions offer debt financing, which requires collateral, a prior revenue history and cash flow – requirements most early-stage companies cannot meet.

The professional venture capital market, meanwhile, is usually only interested in more mature enterprises, particularly those at the expansion stage with stronger prospects for exponential growth. Their investments tend to be much bigger, closer to $1 million.

And the public equity or stock markets are for established companies with an identified product or service to sell to a potentially large market. Getting listed on a stock exchange is a costly and complex process, typically aimed at raising at least $10 million in an initial public offering (IPO).

One of the most important advantages that angels bring to a business is their personal touch. Because of their experience, interest, know-how and contact networks, they are in a unique position to create a special kind of success.

What is the "Investment Gap"?

While many new entrepreneurs worry about raising start-up funds, the reality is that there are plenty of prospective angel investors, with lots of ready cash.

And yet, paradoxically, angels report being frustrated by the shortage of good investment prospects. This disconnect is often referred to as an "investment gap." The solution is to help prepare entrepreneurs to approach willing angels, to locate the angels, and then to find ways to win the angel's support.

Winning support, however, demands a compelling business case, because angels typically reject at least three-quarters of all approaches – sight unseen.

Finding your Angel

Perfect angels rarely land fully formed from the sky. You need to find them, persuade them to take an interest in your project, then develop a strong long-term relationship and work hard to retain their trust.

All this can be challenging for a number of reasons – the first being that angels are generally a pretty private bunch. And not without reason: Advertising their willingness to part with substantial sums of money can draw all kinds of unwanted attention.

In Canada, the angel community tends to be rather fragmented, although it's becoming more common for friends and former associates with a mutual interest in investing to build informal networks and share tips on investment opportunities.

Some of these networks are becoming more formal, with business names, incorporated status and web sites. **Capital Connexion**, also known as **Carrefour Capital**, is one example of a service that helps link entrepreneurs with angels and other business supports. This free service was developed as one of the CCIP pilot projects. For more information, please see page 9, or visit their web site at http://www.capital-connexion.com. For more links to Canadian angel networks, please see page 14.

While such on-line databases and directories could help get you started, they don't need to limit your search. There are plenty of angels who aren't yet part of a network. And, of course, there are many successful business-people who could be persuaded to become angels – but don't yet know it.

Other worldly networks: Online angel networks, which are starting to form in Canada, are already commonplace in the United States. In the U.S. too, there are published directories of for-profit and non-profit matchmaking organizations, and the *Wall Street Journal* runs ads for matchmakers who specialize in linking entrepreneurs with angels. Even the U.S. government gets involved through the Angel Capital Electronic Network (https://ace-net.sr.unh.edu), a nationwide Internet-based listing service sponsored by the Small Business Administration (www.sba.gov). ACE-Net, announced in 1996, provides information to angel investors about small, dynamic business that are seeking investments in the range of $250,000 to $5 million. Angel networks are also becoming more accessible elsewhere: Business Angels Pty. Ltd. (www.businessangels.com.au) is a central resource in Australia, while BusinessAngels.com (www.businessangels.com) is a European on-line marketplace for entrepreneurs and investors.

Perseverance pays off

The trick is perseverance and a knack for networking. Talk to business associates, customers and suppliers, and other professionals such as lawyers and accountants. Your local economic development authorities or community business development corporations are good sources for contacts.

Always push for an opportunity to present your case in face-to-face meetings. And if one angel isn't a good fit, ask for a referral to another.

But, when it comes to helping entrepreneurs find informal investors, Canadians have learned a lot in recent years, thanks in large part to an important initiative sponsored by the Government of Canada.

The Canada Community Investment Plan**:** In the 1990s, it was becoming increasingly apparent that growth-oriented start-up companies, especially those located outside Canada's main financial centres, were having trouble attracting equity financing.

And so, in 1995–96, Industry Canada developed the *Canada Community Investment Plan* (CCIP), a program designed to facilitate access to equity finance for growth-oriented small businesses. Through 22 demonstration projects across the country, the program helped entrepreneurs prepare effective investment proposals, identify potential investment opportunities, and match qualified entrepreneurs with local, regional or national sources of capital.

Each one of those 22 communities developed unique "investment facilitation services." The role of these services, devised and refined by local businesspeople according to their identified local needs, was to come up with local solutions that would enable the community's budding entrepreneurs to find financing.

Through investment seminars, coaching, publications and other activities, the investment facilitation services helped entrepreneurs better understand the needs of investors, thereby making themselves "investor-ready."

CCIP Communities

The 22 cities and towns that participated in the CCIP are:

- Burlington, Ont.
- Canmore, Alta.
- Fredericton, N.B.
- Halifax, N.S.
- Kitchener-Waterloo, Ont.
- London, Ont.
- Medicine Hat, Alta.
- Moncton, N.B.
- Mount Pearl, Nfld.
- Niagara, Ont.
- North Bay, Ont.
- Okanagan, B.C.
- Saint-Hyacinthe, Que.
- Sarnia-Lambton, Ont.
- Sault Ste. Marie, Ont.
- Shawinigan, Que.
- Sherbrooke, Que.
- Swift Current, Sask.
- Thérèse-de-Blainville, Que.
- Victoria, B.C.
- Wendake, Que.
- Whitehorse, Yukon

Best practices

Helping small business attract risk capital was a prime objective of the investment facilitation services established in the project, but other benefits emerged along the way.

For instance, the project spawned a network of communities eager to share their experiences and best practices. Many of the SMEs that were coached by community investment facilitators so improved their performance that they were able to obtain both conventional and risk financing. All became better, stronger, more informed businesses.

All communities interested in exploring the possibility of establishing their own community investment facilitation service have access to the experience of this network and the information tools used by the demonstration projects. *The Winning Formula at Work* would be a very prominent document for which it is a collection of 15 best practices gleaned from the CCIP demonstration projects.

In Canada too, thanks chiefly to the experience of the CCIP, more and more people are turning to the Internet for business information. Many independent brokers have created web sites featuring directories of business opportunities. Local economic development offices also use the Internet to position their region and provide investors with a description of business opportunities in their communities. Some create their own sites; others choose to join a group of related sites such as the Carrefour Capital network.

Capital Connexion

Capital Connexion, also known as Carrefour Capital, is a continuously updated database of proposals from SME's looking for capital financing, along with a list of angels searching for business projects in which to invest. The web site was created and maintained by the CCIP pilot project in Thérèse-De Blainville, Que.

Like any good marketplace, Capital Connexion helps manage the supply and demand of private venture capital to support job-creating companies across Canada.

Investors and entrepreneurs are invited to register for the free service. Certified regional administrators, called "gatekeepers," are responsible for managing the registrations to ensure the quality and legitimacy of postings. An investor or entrepreneur who indicates an interest in a potential partner receives a telephone call from the area administrator, to begin talks on a possible linkage.

While basic information about investors and investment prospects are, of course, made public on the web site, gatekeepers (who are usually associated with local economic development organizations) are also charged with preserving the privacy of individuals and businesses.

For more information, please visit http://www.capital-connexion.com

Getting Ready

Experience from the CCIP projects underlines the importance of being "investor ready." That means thinking through your business processes to increase your chances of obtaining risk capital. Toward that end, Industry Canada has developed a comprehensive, self-administered online program called *Steps to Growth Capital*.

Be prepared: Raising capital funds requires effective planning, which can be done in a sequence of nine steps. *Steps to Growth Capital*, accessible online at http://growth.ic.gc.ca, provides you with all the tools and information needed to answer the following questions:

1. What are your financial needs, i.e., how much money will you require to launch your investment opportunity?
2. Have you examined all your financing options, including internal and external sources and risk capital?
3. How will you demonstrate your project's financial potential to attract investor attention?
4. How will you show that your management team is well-balanced and capable of making your company a real success?
5. How should you write and structure your investment proposal to communicate your ideas as effectively as possible to investors?
6. How will you identify potential investors?
7. What strategy should you adopt to impress investors?
8. What steps should you take and what issues should you raise with your investors to ensure a successful final agreement?
9. What must you do to close the deal, complete the due diligence review and , ensure the consummation of a successful business relationship?

For more information, visit the Steps to Growth Capital web site at **http://growth.ic.gc.ca**. *See in particular Step No. 6.4 "Identify Potential Investors."*

Attracting an Angel

Once you've located an angel, you have to persuade him or her to see your opportunity in a favourable light. Angels, as a rule, embrace risk more readily than traditional investors. They don't, however, like to throw away their money.

In fact, since research suggests that informal investors reject 97 percent of all advances, successfully landing an angel requires an astute and targeted marketing strategy.

That begins with a compelling business plan.

Customizing the pitch: Like any other form of business marketing, you have to be prepared to approach many potential investors. But, once you've spotted your target, tailor your approach to the particular interests, needs and motivations of each prospective angel. For instance, if you're angling for an economic investor, emphasize the potential financial returns of your project. A hedonistic investor might be attracted by the possibility of making new contacts or accepting a new challenge, while the positive benefits for the community could be a selling point for the altruistic investor.

Pleading the business case

For risk capital investors, like angels, a business plan must be a strategic document that conveys your vision for the company. Because angels want to build and create, stress the exciting and creative elements of your project. Don't try to cover up weakness; show how angels can actually round out the team. Your plan must be 'yours' and not something developed by a consultant. It should be a living plan to which everyone on the management team is committed and on which they focus their time and resources.

The business plan should also contain information on your market and customers, details of your product or service, an overview of trends, solid financials and an exit strategy that shows how investors will emerge from your deal in better shape than they went in.

More than anything else, however, angels want to see evidence that your firm is headed by competent and trustworthy managers. Because investors are investing in people, they need to know that the people in charge are reliable, knowledgeable and primed for success.

Investment facilitation services, like those established under the CCIP, can teach entrepreneurs how to assess their skills, understand their strengths and weaknesses and fill the gaps in their management teams.

As an entrepreneur looking for risk capital, your challenge is to assemble the best possible management team. You may need to include incentives such as stock options to attract the high-calibre leadership you need.

It's also a good idea to hire an experienced lawyer or accountant to check the credibility and effectiveness of your business plan. Practise your verbal skills to better communicate your vision to a potential investor.

Consciously clear

It's also crucial to be upfront so that all parties understand their roles and their rights. While some investors are content to linger quietly in the background, many prefer to roll up their sleeves and get involved.

Most angels today will expect a formal shareholders' agreement which sets out the nature of the investment and the return. Many will expect frequent updates on the progress of the company, as well as a say on big decisions.

Deal-makers: In selling the merits of your company to a prospective angel, bear in mind that the four primary needs of risk capital investors are:

- a strong management team capable of executing the strategic plan and managing growth
- a rate of return that is high enough to reward the level of assumed risk
- the ability to be actively involved in monitoring, influencing and controlling their investment
- a viable exit strategy to provide liquidity.

For more information, visit Step 3.2 ("Show Your Investment Potential – What Investors Want") on the Steps to Growth Capital web site at http://growth.ic.gc.ca

And, because it's your company that's at stake, you too should be clear about the expectations you have about your angel investor. Are you looking just for cash, or could you benefit from mentoring, coaching, contacts and support?

Keeping it going

Once you have secured your angel investment, it is important to sustain the relationship.

Many angels tie their investments to specific achievement milestones and objectives, so it pays to keep your investor informed. In fact, communication is key to building a solid relationship. An angel that has faith in your abilities and appreciates the potential of your company is more likely to be there to help out if you run into a cash flow problem or other temporary trouble.

There are a number of exit strategies that angels use to reap a return on their investment. Because the vast majority opt for an equity

Loyal to the end: While angels are undeniable attracted by the potential for a high rate of return on their investment, an intriguing little truth is that most of them are satisfied with paper gains. A survey of Atlantic Canadian businesses found that about three-quarters of angel investors had not sold their investment after the firm got on its feet. Indeed, the vast majority of those reported never having even *tried* to sell an investment.

stake, the sale of shares to the company's principals or other equity partners are common ways out. The sale or merger of the company allows debt-holding investors to recover their investment.

Sophisticated angels, who recognize the inherently illiquid nature of their high-risk investment, may ask for convertible preferred stock or convertible debt to protect their investment if the company is acquired or is listed on a public stock exchange through an initial public offering (IPO).

For more information…

Here are some sources and links to help you find out more about angels, angel financing and other useful information for small- and medium-sized enterprises:

- Industry Canada's Strategis web site will get you to several helpful sites, including:

  - The Sources of Financing http://strategis.ic.gc.ca/sources
  - Steps to Growth Capital http://growth.ic.gc.ca
  - The *Canada Community Investment Plan* (CCIP) http://ccip.ic.gc.ca
  - Capital Connexion www.capital-connexion.com

- www.BusinessGateway.ca
- The Canadian Association of Business Incubators, (CABI) www.cabi.ca
- Business Development Bank of Canada http://bdc.ca
- Canadian Seed Capital Inc. www.seedcapital.ca
- eKernel Inc. www.ekernel.ca

Information for this publication was extracted in part from the following research papers, prepared for Industry Canada and ACOA:

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- *Informal Venture Capital Investment in Atlantic Canada: A Representative View of 'Angels,"* A. Ellen Farrell, Saint Mary's University, Halifax, N.S. (1998)
- *Angel Activity in Atlantic Canada: A Year-2000 Review*, A. Ellen Farrell, Saint Mary's University, Halifax, N.S. (2000)
- *Equity Financing Alternatives for Small Business: A Review of Best Practices in the United States*, T&S Heidrick Ltd. (2000)
- *Practices and Patterns of Informal Investment*, Equinox Management Consultants Ltd., (2001)
- *Value Added by Informal Investors: Findings from a Preliminary Study*, Equinox Management Consultants Ltd. (2001).