FINANCIAL POST

Angels need some common ground

Lone wolves hinder set-up of capital pools

Brad Cherniak, Financial Post Published: Monday, April 12, 2010

The angel world is, pardon the pun, devilishly hard to analyze as a capital source. One thing is certain, though, the aggregate numbers are huge.

In the United States, angels invested US$9.1-billion in the first half of 2009. This would equate to about US$18-billion on an annualized basis, a fairly steep drop from the roughly US$30-billion of annual aggregate investment in recent years. The average angel investment was about US$370,000.

Canadian data is sketchy but in 2004, angels are estimated to have invested $2.2-billion. It is hard to say if this was a representative year for investment volume and activity, but it is the most recent "hard" number available. My sense is angel activity has fallen materially in the past few years, but remains substantial. A very rough estimate of the average Canadian angel investment is $150,000.

By way of comparison to venture capital, VCs in the United States invested US$21.4-billion in 2009, and their average investment was US$8.6 million, much higher than the average angel investment. Canadian VCs invested about $1-billion in 2009, with an average investment of $3-million.

These estimates come largely from the following industry organizations: National Angel Capital Organization (NACO), Canadian Venture Capitalization Association (CVCA), National Venture Capitalization Association (NVCA) in the United States and the Center for Venture Research at the University of New Hampshire.

However, the structure of the industry is even more important for companies looking to tap into angel financing. There are about 30 active groups across Canada, with between 20 and 100 active angels in each. These groups are estimated to represent about 5% to 10% of all angels, which, with rough extrapolation, suggests there are about 20,000 individual angels in Canada, versus 350,000 in the United States. Perhaps a third of these are active at any given time.

Angel groups are largely not-for-profit organizations run with skeleton staff and resources. At the top of the pyramid is NACO -- the national body tasked with angel community development and dissemination of best practices, as well as directing some deal flow.

They do an excellent job of getting the word out and increasing sectoral knowledge, all with a $2.5-million government grant and small amounts of private funding.

Bryan Watson, executive director of the organization, characterizes the structure of the angel world in Canada as a mesh network. There is no formal hierarchy or system of interaction between groups, yet alone individual angels.

The groups barely scratch the surface of angel activity in their local markets, although they are increasingly seen by individual angels as resources for deal flow, collaboration with other angels who have complementary skill sets to their own, and have collectively deeper pockets behind their investee companies and spread the risk.

Nonetheless, with individual angels resistant to committing to a group, particularly to agreeing to preset annual investment activity or paying annual dues, it's hard for these groups to function efficiently as capital pools.

Angels, for the most part, still function as lone wolves, with vague investment styles and criteria. Even the groups lack focus in this regard, although there are some fairly specialized ones. The quality and value-add of angels varies widely, although I would suggest that is also true for VCs. Personal interactions and serendipity still drive risk capital markets, although the more you know, the more likely you are to be lucky.

Angels tend to respond to the same investment factors as VCs. For example, in the United States in the first half of 2009, only 27% of angel investments were for seed and startup capital, a full 19-point drop from a year earlier, and a multi-year low. The notion of the wealthy individual who will drop a couple of hundred grand into a garage technology at the drop of a hat is largely a myth. Angels, like everyone else, are risk averse.

Here are a few of my conclusions on angel, or independent venture capital:

- The loss of this segment of the capital market would have disastrous consequences for small-to mid-sized businesses and by extension the North American economy.

- It will continue to be an obscure and inefficient segment to access, and average deal sizes will remain small for the foreseeable future.

- Governments need to ramp up funding for angel organizations, which represent an exceedingly low-cost way to facilitate the flow of capital to SMBs and boost the economy -- but they must not regulate the industry or get directly involved in the process.

- The baffling heterogeneity and opacity of the angel world is actually its key strength. It is not prone to the "hot" trends, group think and hubris that have infected the VC world.

- There are lots of trends emerging and exciting new developments to come. We still have plenty to learn.

- Brad Cherniak has spent more than 20 years as a principal, advisor to and investor in private companies. He is co-founder of Sapient Capital Partners, a Toronto-based advisory firm to companies from early stage to $50-million in revenues. He can be reached at brad@sapientcap.com