AN OVERVIEW OF ANGEL INVESTORS IN CANADA

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Summary:

- Angel investors are wealthy individuals who invest their personal funds into early-stage firms. In addition to funding, they tend to contribute industry and managerial expertise to the entrepreneur.
- In Canada, a typical angel investment is $100,000 with an average holding period of five to eight years and an expected after-tax return of 30-40% annually.
- By some estimates, the current outstanding stock of angel capital could be more than $12 billion and the annual disbursement could be more than $3 billion in 1999.
- Major problems facing angels include the shortage of *quality* investment opportunities, difficulties in finding co-investors, high taxes and restrictive security regulations.
- Studying the size and characteristics of the angel market may help better understand the credit channel of the monetary transmission mechanism.

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1.0 Introduction

The success of many young fast-growing firms, especially those in the high-tech industries, has drawn attention to the sources of capital in financing their growth. Most of these firms obtain their earliest stage financing from founders, family and friends (called “love money”). However, these sources of funds are usually exhausted long before the company can develop into the sustainable stage where saleable products exist. Traditional bank financing is mostly collateral-based, and thus is out-of-reach for many young entrepreneurs. An alternative source is venture capital funds interested in taking an equity position in early-stage firms. Nevertheless, the costs of evaluating and monitoring a venture capital investment often militate against small investments valued under $1 million.

Consequently, a market for informal private investors, or “angels”, emerges to bridge the gap between love money and venture capital financing, or the “angel gap”. Angels are typically high net worth individuals who invest their personal funds into early-stage companies. In addition to providing capital, these investors also tend to contribute management and industry expertise to the start-up firms. Unofficial estimates suggest that the size of the angel financing market in Canada may have exceeded that of conventional venture capital funds. In the U.S., angels may invest about five times as much as institutional venture capitalists.[1]

Given their importance in developing the “new economy”, this article provides an overview of angel investors and their investment characteristics. It also addresses the problems angels face and the improvements they suggest. The final section presents the implications of a growing angel capital market for the monetary policy in Canada.

2.0 Characteristics of angel investors

2.1 An overview

The scale of the Canadian angel investment market is considerable. According to Riding, there are approximately 200,000 potential angels in Canada.[2] Some of them are active investors who regularly invest in start-up businesses; some are potential investors who have the resource and interest to invest but have not yet done so.

In terms of the volume of investment, Short and Riding (1988) estimate that the annual flow of angel investment in Canada was between $200 and $400 million in 1988. Dal Cin et al. (1993) arrive at similar estimates five years later. Although no estimates are available for recent years, experts in the field believe that the size of the angel market has exceeded that of the venture capital market.[3]

1. See Doyle (1999).
2. Prof. Al Riding from Carleton University has been studying angels for more than 10 years and published extensively on the topic. This article is heavily based on his work and a personal interview with him.

If this is valid, the new funds provided by angels could be more than $3 billion in 1999 and the outstanding stock could be more than $12 billion. Compared to the $166 billion outstanding business loans provided by banks, the size of the angel market is approximately 7% of the bank business lending market.[4]

Considering that an angel investment is typically smaller in size than a venture capital investment, this implies that more start-up businesses depend on angel financing than on venture capital financing. In 1995, the Canadian Labour Market and Productivity Centre (Riding, 1998) estimates that angel investments have financed approximately twice as many firms as any other form of external equity investment, including institutional venture capital.

2.2 A profile of angels

Riding (1998) describes a typical angel investor as a wealthy and educated individual wishing to invest between $50,000 and $250,000 in a field he or she is familiar with.[5]

3. According to statistics from the Canadian Venture Capital Association, the pool of venture capital under management accumulated to $12.1 billion by the end of1999 and the disbursement of venture capital was $2.7 billion in 1999.
4. May 2000 figure, including charter banks and other financial institutions. In comparison, there were $156 billion bonds and $246 billion equity outstanding by June 2000.
5. Most angels are university graduates and a high proportion have advanced degrees. They report annual incomes that average more than $150,000 and personal net worth more than $1 million.

The average angel is 50 years old and 99% of them are male. They may be current or previous small business owners, professionals, or recent entrepreneurial immigrants. Often, angels also provide the company with their experience and managerial expertise. Thus, they usually invest close to home so that they can actively monitor the firms and advise them on various matters.[6]

2.3 Differences between angels and venture capitalists

Angels differ from venture capitalists primarily in five aspects:

- **Size.** Usually, individual angels make investments below $1 million; venture capital funds invest in deals over $1 million.

- **Access.** Venture capital funds are pools of private investment capital that make investment decisions for their investors, thus investors have less control over their investment decisions. In contrast, angels make independent investments directly to the firms they choose.

- **Participation.** While many angels contribute to the companies as mentors and consultants, venture capital investors usually do not participate

6. Dal Cin (1993) reports about 70% of the investments are made within 50 miles from the investor’s home.

directly in the company's decision making process.[7]

•**Ownership.** Venture capital funds often acquire a large ownership stake in the firm, whereas angels usually take a smaller stake.

•**Institutions.** Unlike venture capital investments, angel investments are classified as personal small business investments, which are subject to various tax advantages as will be discussed later. Also, angel investors are not subject to disclosure regulations as rigorously as those required for venture capitalists.

3.0 Investment characteristics

Relatively few studies have investigated angel activities across Canada, mainly due to the inherent difficulty of obtaining a reliable sample. This article bases its analysis mostly on the 1998 survey conducted by the Ottawa Economic Development (OED) corporation and two surveys supervised by Riding in 1998 and 2000 (denoted AR).[8] These surveys are regional and thus may not be statistically representative for Canada. Given the relatively high level of angel activities in these regions, however, their results can be considered as useful indicators of the angel investment characteristics in Canada.

3.1 Investment preference

•**Sectors of interest**. From 1993-1997, 73% of the angel investment deals in Ottawa were in the computer software, hardware, and telecommunication sectors (OED). These sectors continue to generate by far the greatest interests among angel investors.

•**Investment size.** The average investment made by Canadian angels is about $100,000, with 77% of the investors preferring investment size of less than $150,000 (OED).

•**Frequency.** About 50% of the surveyed angels invest once a year and the other 50% once every 2-3 years (AR).

•**Stage of company.** A majority of the private investors are interested in the earlier stages of development of a company. From the OED survey, 48% of angels have investment in seed (concept) stage companies, compared to 72% that have invested in start-up (at/or near market ready) stage firms.[9]

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7. However, venture capital fund managers take an active role in monitoring and advising firms.
8. The OED survey is based on the interviews with 50 private investors living in the Ottawa region. In the 1998 AR survey, 24 survey respondents are from Alberta and 179 are from Ontario. In 2000, 31 Alberta investors were surveyed, compared to 18 in Ontario.
9. A company's development is usually divided into six stages: seed (concept), start-up (at/or near market ready), 1st stage (initial sales), 2nd stage (expansion), turnaround (turnaround financing) and flexible.

•Syndication preference. Investors tend to syndicate. 90% of the investors surveyed by OED prefer to co-invest with other private investors.

3.2 Investment process

•Length of investment process. Angels are likely to be quick investors. Most investors learn about an investment opportunity through trusted sources, such as business associates and professionals. They then typically spend less than twenty days to investigate and review the proposed business. The whole process of completing an investment transaction usually takes no more than six weeks (OED).

•Rejection rate. Angels also tend to reject investment proposals based on overall first impression of the merits (or otherwise) of the business plan. 72.6% of opportunities are rejected at first glance, with an additional 15.9% rejected at the generic screen stage (AR).

•Selection criteria. The two most important criteria that these investors seek are financial returns (the likelihood and amount of financial gains) and principles (the abilities of the entrepreneurs to succeed). Unrealistic entrepreneur's valuation, weak management and under capitalization are quoted as the most common factors that lead to the rejection of a proposed investment (AR).

3.3 Investment expectations

•Return. Most angel investors expect an after-tax annualized return of 30-40%. Compared to the typical 17-19% Return on Equity (ROE) expected by banks, this level of expected return reflects the high risk nature of angel investments.

•Involvement. 54% of the investors surveyed by OED prefer to be involved in the management of the investee's company. Among them, 34% expect to take a seat on the Board of Directors and 29% on the company's Board of Advisors.

•Exit horizon. Most of the angels expect to hold their investment for five to eight years. The preferred method of exit is either an Initial Public Offering or an acquisition by another company.

•Risk reduction. Diversification is commonly used to reduce risks. On average, Canadian angels hold investments in two to three industries (AR) in their portfolio.[10] In addition, the involvement in the venture's decision making process and the use of long-term hold strategy are also considered

10. This also reflects a need for syndication, as investors rely on the knowledge of co-investors in areas they are not familiar with.

to be risk-reducing methods (Dal Cin, 1993).

4.0 Problems and suggestions

The recent boom of the technology industry has created a large pool of high-tech millionaires with hands-on experience. Thus the supply of angel funds, according to Riding, is sufficient and sustainable. On the other hand, there are many young entrepreneurs with valuable skills and ideas who need funding and industry expertise from these angels. However, the current level of angel investment activity is far from its potential because of the market barriers discussed below.

4.1 Quality of investment opportunities

The quality of investment opportunities seems to be the biggest obstacle that limits the growth of angel investment activities. Many surveyed angels cite that the extremely high rejection ratio of investment proposals is largely caused by the entrepreneurs' unrealistic valuations of their companies and their lack of product and market knowledge.

Addressing this problem, 96% of the investors in the OED survey call for community initiatives to help sourcing quality investment opportunities. In particular, they suggest efforts be made to provide expert evaluation of start-up firms, to educate entrepreneurs on the preferences and expectations of private investors, and to improve their knowledge of the early-stage capital raising process, such as writing an attractive business plan.

4.2A Networking

The lack of networking facilities between individual investors is another concern facing potential angels. As previously discussed, angels prefer to syndicate with other investors to reduce risk and liabilities. Current networking functions do not seem to meet this need. 97% of the respondents in the OED survey indicate that they need help to identify potential co-investors.

On the other hand, investors seem to worry much less about networking with potential entrepreneurs. On average, they are presented with 8-10 investment opportunities per year. However, they do admit that it is very hard to find *quality* start-up firms who are also willing to give up ownership and management rights to angels.

4.2B Angel networks

Angel networks are agencies that bring entrepreneurs and potential angels together electronically and/or face-to-face. Typically, an angel network website lists investment proposals from start-ups and allows their registered member angels to browse, evaluate and choose their investment opportunities. Many networks also provide services to help members screen and evaluate these opportunities.

In Canada, there are over one hundred such private agencies offering "dating" services to investors across the country. In addition, the Economic Development Organization (EDO) and Chamber of Commerce of each region also try to promote the networking between angels and small businesses. For example, the OED launched a program called Ottawa Capital Network which is targeted towards encouraging angel activities in the region. The federal government also initiated the Canadian Community Investment Program (CCIP) in 1996 to subsidize local governments or institutions that form facilities for investor-entrepreneur matchmaking.

However, the success of these angel networks, especially those that are internet-based, has not been evident. Only a small portion (7% in the OED survey) of angels prefer finding an investment opportunity from business organizations or networks. Because of the high risk nature of start-up investments and the local and personal nature of the angel market, very few angels are willing to "blind date" entrepreneurs at the national level. Instead, most of them prefer sourcing their investment opportunities from business associates or professionals, such as lawyers and accountants.

4.3 Tax laws[11]

Higher taxes in Canada are often quoted as the biggest factor that causes Canadian angels to fall behind their American counterparts in start-up business investment. The following are the major differences between the tax laws of the two countries regarding personal investment in small businesses.

- **Capital gain tax rate.** In the U.S., there is a 50% reduction in personal capital gains from investing in a qualified small business (QSB) if the shares are held for five years.[12] In Canada, the taxable portion for any capital gain is 66.67%, which was reduced from 75% in the 2000 federal budget. There is no special treatment for gains from a small business.

- **Capital gain exemption.** A Canadian investor may enjoy a one-time capital gains exemption of up to $500,000 in respect of qualified small business corporation shares. Under the U.S. tax regime, this exclusion many amount to $10 million U.S. per family.[13]

- **Deferral provisions.** For a personal

11. The discussion in this section is partially drawn from Cleveland (2000).
12. Section 1202 of the Internal Revenue Code. QSB is defined in Internal Revenue Code Section 1022c, which exclude farming, operating a hotel or restaurant, banking, insurance, financing, leasing and investing.
13. Section 1202 of the Internal Revenue Code.

investor in the U.S., tax on the gains from the sale of QSBs can be deferred, provided the proceeds are reinvested in QSBs within the 60 days of the day of sale.[14] The gain ultimately realized becomes taxable when a sale occurs and proceeds are not reinvested.

The Department of Finance introduced a similar tax-deferral program in the 2000 federal budget. However, the rules in Canada differ from those in the U.S. mainly in three ways. First, the maximum reinvestment in one business to qualify for the rollover is $500,000 in Canada, while there is no upper limit for the U.S. investors. Second, in Canada only an angel investing personally can take advantage of the provisions. In the U.S., on the other hand, such reinvestment can be made through a syndicate or corporate structure. Third, unlike in the U.S., there is no restriction on the type of small businesses that qualify for the provision in Canada.

As shown from the above comparisons, angels in the U.S. seem to face more favourable tax regimes than Canadian angels. Although the Canadian government has made efforts to improve its tax environment, some restrictions of the provision might still hinder the growth of angel investment activities. As previously discussed, for example, most angels prefer to co-invest or join a certain syndication, but the new tax rollover does not apply to personal investment made through a corporate structure, say, a side fund in a venture capital investment.[15] In addition, the reinvestment limit of $500,000 may be binding for some "bigger size" angels.

14. Section 1245 of the Internal Revenue Code.

4.4 Security legislations

Current security rules are another barrier in the angel market. They are accused to discourage angel investments by creating obstacles against firms from raising angel capital. Under of the regulations of the Ontario Securities Commission (OSC), for example, a new enterprise wishing to raise money has to file a prospectus *except* under the following circumstances:[16]

(1) The investment has to be a minimum of $150,000. The buyer must be a sole buyer and not a syndicate.

(2) A "seed capital exemption" is available once in the lifetime of a company. But the deal may not be solicited to more than 50 investors and cannot be sold to more than 25 investors.

(3) An issue may be sold to "friends of the entrepreneur". Angels who have just met the entrepreneur would not qualify.

15. in the U.S., some venture capital funds allow individuals to invest alongside with the formal fund. Their investment amounts are usually limited to below $100,000.

16. Information on the regulations of other provincial security commissions is not available due to the time constraint in the preparation for this article. Further efforts are warranted to provide a better comparison across provinces.

According to Riding (1998), most of these conditions contradict with the investment patterns of angel investors. Thus many new firms try to avoid the costly process of filing a prospectus by issuing an offering memo instead, which is usually allowed by OSC with the accompany of an investment agreement. However, the preparation for an offering memo costs $30,000-$80,000, an amount that would almost exhaust the entire investment by a typical angel.

In comparison, firms in the U.S. are more encouraged to adopt angel capital. The Securities and Exchange Commission (SEC) allows small businesses to raise capital without issuing a prospectus if the shares are sold to an "accredited investor". A maximum of $500,000 can be raised from a "sophisticated" individual with a net worth of over $1 million U.S. and an annual net income over $150,000 U.S.[17]

5.0 Implications for monetary policy

The rapid development of the angel investment market may have important implications for monetary policy makers. According to the credit view of the monetary transmission mechanism, monetary policy actions affect output through the credit channel.[18] When the central bank tightens (loosens) the credit market by raising (lowering) the overnight interest rate, financial institutions also raise (lower) interest rates on deposits. As deposit interest rates reflect the cost of bank loans, the supply of traditional bank credit then contracts (expands), resulting in a slowdown (increase) of economic activities.

In contrast, changes in the risk-free interest rate are likely to have little *direct* effect on the supply of angel funds, as these funds mostly come from an investor's cash accounts instead of bank loans. Rather, short-term interest rate changes are likely to affect the supply of angel funds through two *indirect* channels:

- First, interest rate changes may affect the portfolio wealth of an angel (and thus the supply of angel capital) through their impact on financial markets.

- Second, if stock market prices are affected, the risk premia in expected equity returns are likely to fluctuate, resulting in changes in the supply of angel capital. Thus, angel investment activities may be more sensitive to financial market crises and uncertainties than traditional bank lending, because of the high risk premium associated with investing in start-up firms.

Given the growing importance of angel capital in the business credit market, it is

17. To qualify as a "sophisticated" investor, an individual has to meet certain requirements in terms of investment experience.

18. see e.g. Thurlow (1993).

crucial to understand the timing and magnitude of these indirect effects.

6.0 Conclusion

Canadian angel investors are playing an active and important role in financing early-stage firms, especially in the high-tech sector. The level of their activities can be further increased if certain market barriers are cleared. These include insufficient networking between investors, hefty taxes, unfavourable security regulations and a shortage of quality start-ups who are also willing to give up equity and management rights in exchange for angel funds. Thus, there may be a need for government and community efforts to improve the regulatory environments and the quality of investment opportunities.

Studying angel activities has important implications for the efficient allocation of private capital and the success of many new small businesses. Moreover, knowing the size and properties of the angel market could help monetary authorities better understand the credit channel of the monetary transmission mechanism. Unfortunately, the current literature on angels is limited and regional. Future efforts should be devoted to a more comprehensive study of angel investors across the country.

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