Alarmingly small percentage of angels in organized networks

While I am excited about an increase in the level of angel investment activity, I'm worried that many would-be angels don't adequately appreciate why there is an entire industry dedicated to full-time startup investing.

At $22.5 billion, there has only been an 18 percent increase in angel investments from 2002 to 2011, according to the Center for Venture Research. Meanwhile, there has been a disproportionately larger increase in the number of angel-backed ventures — up 83 percent to 66,000 — during the same period, suggesting that more and more high-net-worth individuals are trying their hands at angel investing. Yet while the number of angel networks in the U.S. has tripled since 1999, only 10,000 to 15,000 of the 225,000 people who made an angel investment in the last two years are in an organized angel network.

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The unfortunate truth about angel investing is that "a majority of all new, angel-backed companies fail completely, so if you invest in only one company, the odds are that you will lose all your money," said David Rose, who is neither a bitter angel nor a competitive venture capitalist, but rather a successful entrepreneur, angel investor and founder of Gust, a global platform for startup funding and early-stage investments.

"It takes investing the same amount of money consistently into at least 20 to 25 companies," Rose said, "before your returns begin to approach the typical return of over 20 percent for professional, active angel investing."

Despite this warning, the majority of angel networks invest in only four new deals per year. The average angel investor would need to be an active angel for five to six years and participate in every deal before he or she would build the kind of portfolio that Rose recommends.

I speak from experience when I say that very few angels do this, but I don't blame those who don't. The startup game is not for the faint of heart, and it demands one's full and often undivided attention.

The term "angel" comes from Broadway, where it was used to describe wealthy individuals who provided money for theatrical productions. Today, angels are wealthy individuals who are often doctors, lawyers, retirees or sometimes people running their own businesses. Their limited bandwidth often demands a more passive approach to investing, even though there's nothing passive about trying to start a successful company.

Many angels believe they will seed a company, the company will achieve a few milestones and then the venture community will fund the company's continued growth. But the data shows a different reality. Since 2007, angels have funded roughly 60,000 new companies every year, while the National Venture Capital Association estimates that each year only 1,000 companies receive venture capital for the first time. In other words, less than 2 percent of angel-backed companies are likely to receive venture capital funding. Furthermore, those companies fortunate enough to receive venture capital may have to self-sustain for quite some time beforehand.

Consider the health care industry, for example. Since 1987, the average time from company formation until exit was about 10 years, according to Dow Jones VentureSource and CB Insights. Yet the average time from a company's first venture capital investment to exit is often four to seven years, depending on sector. This means that entrepreneurs and angels must often carry the day for three to six years before venture capital even becomes an option for health care companies. Considering that it took media darlings Facebook and LinkedIn over eight years to reach an initial public offering, I would guess this dynamic holds true for other industries also.

Fortunately, more experienced angel investors have begun to appreciate the importance of not going it alone. According to the Halo Report, 67 percent of angel networks in the U.S. syndicated a majority of their deals, and 75 percent of those deals involved at least one nonangel investor. I hope this trend continues because the lifeblood of a successful portfolio is not how deals are done, but rather what deals are done.

Surprisingly, an angel recently told me that he isn't worried about access to deal flow because venture capital is retreating to later-stage deals. Not surprisingly, he is not an experienced angel, much less successful. Since the Internet bubble, the proportion of venture capital invested between later and early-stage deals has remained relatively constant, according to the NVCA. However, there has been a 42 percent increase in the proportion of overall deals getting done that are considered early-stage. Venture capitalists have not abandoned their early-stage focus. They are just investing less in more deals and have likely already seen and passed on a majority of the deals that end up seeking investment from angels.

But be they angels or venture capitalists, investors must cultivate a reputation built on credibility and consistency to gain access to the very best deals. This kind of

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Raider Express relies on factoring to cover immediate costs such as fuel.

FACTORING: Also for high-growth

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in making loans, said Mike Perrine, commercial banking president for Capital One Bank in Austin. Factors are able to advance more money and take greater risks, he said, due to conducting in-depth assessments of companies and charging greater premiums. As a result, factors can help companies rebuilding after losses or vulnerable due to concentrated sales to one industry.

Factoring is a great tool for high-growth companies, Perrine said, though he added that it's in such businesses' interests to graduate to commercial banking and significantly lower financing terms. Interest rates average about 7 percent or less for bank loans, he said, compared to the equivalent of about 12 percent or higher for factoring.

Raider's 15 percent growth during the last 12 months would have been difficult to achieve without access to Far West's higher advance rate, Eggleton said.

Raider's increased revenue base initially constrained its cash flow due to the time lag between payouts and receivables. Fuel price hikes exacerbated the problem, spurring the need for cash before increased costs could be passed onto customers. Far West's factoring rate is worth the flexibility it gives Raider to manage such situations, Eggleton said.

CROWDER: Most successful angels actively involved

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reputation comes from adding real value and being present when things go wrong. Managing risk with a hands-on approach early on is critical to driving returns. From business model optimization to customer traction to executive recruiting, successful investors are often actively involved with every aspect of a company's evolution. I fear that many angels fail to appreciate the commitment required to engage in successful early-stage investing, and I would strongly encourage them to seek out more experienced investors to partner with.

Even if an angel is unable to gain access to the network and resources of more established investment firms, he or she should be able to work with local angel networks, like the Central Texas Angel Network, where angels are becoming more disciplined and better educated on what it takes to be a successful investor. I wish them the best of luck because entrepreneurs need as much access to active, smart capital as possible.

RANDALL CROWDER is managing partner of TEXO Ventures, an Austin-based venture capital firm focused on health care companies.

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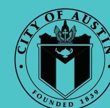

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