ANGEL INVESTMENT – AN EXPLANATION

Coming together is a beginning; keeping together is progress; working together is success.
Henry Ford

Generating returns from inspirational high-growth, startup companies is critical for New Zealand. These companies are our future economic powerhouses.

Investing in these companies is not for the faint hearted but it is enjoyable and a rewarding use of time and capital. It's an extremely high-risk endeavor. On a deal-by-deal basis, an investor in a high-growth startup is more likely to lose their money than not. A portfolio approach is vital.

High-growth startup investment is very different from other more conventional investment. It differs fundamentally from later stage M&A activity, private equity and even most venture capital. When it comes to personal wealth management, it is also a very different investment proposition from real estate, public debt and the stock markets.

The right sized portfolio, managed by focused skilled people, together with the right timing and a dollop of blind good luck, will deliver an IRR of 20-40% or 10-30x their money back to an angel investor. Not to be lightly dismissed, angels are also motivated by the belief that their investment generates social and economic returns; the belief that they are building and inspiring their community's future wealth generators and jobs.

Given the risk profile of this asset class, it is critical the right people are involved both with respect to their personality profile and their skill base. Founders and investors must be creative, optimistic, utterly dedicated and focused. There is a very high level of personal engagement and commitment on the part of founders and investors. These investments are almost completely illiquid and the time frames to liquidity can be long so founders and investors are often working together for a number of years.

The aim is to create value as quickly as possible and set these ventures on a path making them irresistible to potential acquirers or public equity markets. The value is in the demonstration and proof of product/market fit. A deep understanding of capital strategy is required as this impacts directly on the ability to scale value quickly and generate the necessary returns. A high-growth capital strategy is typically agile and deploys capital super efficiently.

Angel investors are committing personal capital to commercialize technology with nascent markets and business models and, more often than not, inexperienced teams. There are no guarantees or templates. There is a resilient faith that it is worth doing for reasons which go beyond the financial returns but which are motivated by those returns.

Why an explanation?

This paper provides a quick, but deeply informative, guide to high-growth startup investment in New Zealand. Its purpose is to explain why it matters and what success looks like if we do it right. It is also important to set out how high-growth startup investment differs so fundamentally from other investment disciplines. These differences are grounded in the extremely risky nature of this endeavor, the degree of faith required, the depth of the relationships and role people personally play in delivering success.

ANGEL ASSOCIATION NEW ZEALAND

Angel investment in New Zealand

As a formally recognized endeavor in New Zealand, early-stage or startup investment in high-growth ventures is about a decade old. The catchall term is “angel investment”. Strictly speaking, an angel is an individual who invests his or her own money but the term ‘angel investment’ is also used to refer to more broadly supported early-stage funds.

The New Zealand Venture Investment Fund (NZVIF) established the Seed Co-Investment Fund (SCIF) in 2006 to catalyse a formal early-stage investment sector. This $50m fund was set up to co-invest alongside accredited clubs and funds on a dollar-for-dollar basis as a passive investor, up to a maximum of $750,000 in any one deal. To date the fund has backed over 400 ventures and, together with its co-investment partners, invested over $650m. The median age of a SCIF portfolio company is just 3 years old and to date only 24 companies have had a positive exit generating an IRR of just over 9%. More active management of this largely nascent portfolio is planned to lift this result.

The Angel Association New Zealand (AANZ) was incorporated in 2008 to promote the growth of angel investment. Today there are 12 angel clubs or networks and half a dozen early-stage or angel funds in New Zealand. The oldest and most established clubs are based in Auckland, Tauranga, Wellington and Nelson. Half a dozen new clubs have been established in recent years and two more are in formation. About 800 angels belong to the AANZ member networks. AANZ’s members also include investor-led tech incubators and two of the most prominent equity crowdfunding platforms in New Zealand, Snowball Effect and Equitise.

Annual investment in high-growth startups has exceeded $50m for the last five years and last year showed an uplift of $24m on 2017’s $87m to reach $111m. A third of this capital is being invested in new deals with the bulk being directed to follow on funding for existing ventures. This is a sign of a maturing market as investors double down on their higher performing portfolio companies.

New Zealand angels have a preference for software (54%) and life sciences (12%) companies. They also have a preference for B2B (business to business) enterprise sales models and companies that target niche markets that have a high value on a global scale.

A typical New Zealand angel invests between $5,000–30,000 per deal; 20% of our community are leading deals and sitting on angel-backed company boards; the average portfolio size is 8 companies (too low) and angels typically commit 29 days a year to mentoring and supporting the ventures they have backed. Angel investors must be accredited investors as defined by the Financial Markets Conduct Act 2014. In terms of deal size and company valuations, on average a New Zealand angel round is circa $900,000 and angels are backing companies valued at around $3.2m. About a fifth of our companies have received offshore investment.

The most high profile exit to date in the New Zealand angel community was a company called PowerByProxi. It was sold to Apple in 2017. Another rewarding exit was GreenButton's sale to Microsoft in 2012. This venture returned 12x to the initial investors. For AngelHQ, the club that led the investment, this exit allowed its members to essentially 'break even' across all of their previous investments through the club. That is, the capital returned to the club, matched the money members had invested to date. In the last two years rewarding outcomes for investors have been generated from ventures such as Engender, SwipedOn, One6One and Publons.

It is estimated the more formal part of the early-stage investment market described above represents only about half of the actual activity taking place in this asset class in New Zealand.

Why it matters and what success looks like

New Zealand's economic and social prosperity depends on new business creation.
Particularly businesses that are being generated from the technology and innovation New Zealanders are advancing today. US based research has shown that new companies generate almost all the net new job growth in an economy.

Those investing in high-growth startups have a clear vision of success.
It is New Zealanders, including those investing, generating wealth from inspirational, globally competitive products and services that had their genesis here in New Zealand.

Generating the returns expected given the level of risk inherent in these ventures requires deft portfolio management.
Recent studies indicate that at 50 investments the risk of getting an IRR of less than 10% falls to 25%. With a portfolio of less than 20 investments, 30% of investors will experience a negative IRR. Active portfolio management improves the odds of success – follow-on where there is traction and divest from non-performers. We know when angel investors 'hit a home run' they will redeploy up to 80% of the capital generated back into more high-growth startups.

We also know from international experience it takes 20–30 years or three horizons, to create a robust, self-sustaining innovation ecosystem.

In the first decade creating the ecosystem is about the generation of inputs – sourcing startups, dollars in, deals closed. New Zealand is one decade in and has done this well. In the second decade angel backed companies will start to generate genuinely visible outputs by way of jobs, export and tax revenue. Only in the third horizon does the eco-system start to really hit its straps and deliver the outcomes to validate this endeavor. It is at this point liquidity events become de rigueur and recycled capital is being fed back into the economy. The social and economic outcomes are being realized.

So what makes this endeavor so different?

It's hard… very hard… why?

- Some individual returns are compelling but the odds are slim. Ninety percent of an early-stage portfolio's returns are generated from just ten percent of the ventures invested.
- Early-stage founders *"don't know what they don't know"* so there is often a great deal of 'heavy lifting' on the part of more experienced directors and advisors who get involved.
- It's incredibly non-linear in terms of growth and the success path. The role of *"the pivot"* is well known.
- It's a deeply personal and often long term engagement on the part of the investor who will be working very closely with the founder. Founders are typically driven, passionate and emotionally dedicated to their ventures.
- It's often hard to find right team and talent who are able to work literally 24/7 for at least four, and up to ten years. There is a real need to manage energy levels carefully to avoid burnout and fatigue on a weekly, monthly and yearly basis.
- It's often hard to find the right informed and aware professional services advice to support founders and this sometimes includes willing but inexperienced investors.
- There is a paucity of experienced governance support for our high-growth ventures.
- There is an element of serendipity in getting the business model right and ensuring the model's relevance to a potential acquirer.
- A lot of travel is required for the founder and lead investor. There is an absolute need to be 'in-market' both for the business and in finessing the exit/return.
- There is always an obsession with running out of cash. New Zealand startup businesses are often under capitalised due to the limited funds in New Zealand.
- It is often challenging to secure alignment with sources of follow-on capital; if you can even find this capital. This is particularly so in New Zealand where there are currently few active VCs.

What do we need?

- The whole country needs to be involved in supporting high-growth companies. Much like raising a child takes a village; scaling ideas to global impact takes a whole country. Like nothing else we've done in New Zealand, scaling high-growth companies has to be *"NZ Inc"* inspired and delivered. Government, private sector, professional service providers and our diaspora all must be involved for the long haul. This needs patience and commitment. It will be ten to twenty years before we see the real impact of this endeavor.
- An appreciation and nation-wide understanding, tolerance and support for the risk takers (investors and founders) is needed by the government, banks, wealth management, media and other commentators.
- Policy stability for funding and delivering programmes for founders and support organizations is vital. Ensuring collaboration between incubators and tech hubs is important too.
- Policy support, such as tax relief for angel investors, would have a big impact.
- Government support to secure follow-on funding domestically and internationally from venture firms, ACC, KiwiSaver and investor migrants would be welcome.
- More institutional and private wealth management engagement and investment is needed.
- A 'NZ Inc' approach to helping startups access the right connections particularly offshore and particularly to acquirers would have a real impact on success.
- New Zealand is small enough to take a national portfolio approach to the seed and early-stage space. This could be tightly or loosely approached. We have a proxy in the NZVIF portfolio and it could (should?) include those who would like to add what they are doing to it. This would be a place to start. Whatever we do next is based on how to support and drive that portfolio to generate the returns expected.

Conclusion

New Zealand is without doubt generating innovation and technology at the forefront of global endeavor. New Zealanders share intrinsic values of openness, curiosity, resilience and a desire to make a difference that prime us to take this innovation to world and make it a better place. Global connectivity is increasing which lowers barriers to entry for startups to customers and capital. Supporting high-growth startup companies is rewarding, inspirational and vital for New Zealand's economic and social well-being. We all have a stake in it being done successfully. It requires a truly NZ Inc approach. Those of us already involved know success in this field requires long-term commitment and a defiant faith that it's worth doing. Get on board. Help us deploy the talent and capital required for this asset class to deliver!