Submission
Seed Co-Investment Evaluation

Angel Association of New Zealand

January 2013

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"If we want more and better jobs for New Zealanders we need to encourage more businesses to be based here. That means making it easier for businesses and companies to access innovative ideas, markets, capital, skilled workers, resources, and the supporting public infrastructure."

Hon Steven Joyce, Minister of Economic Development

Announcing the establishment of the Ministry of Business, Innovation and Employment.

15 March 2012

1.0 Executive Summary

The Angel Association of New Zealand (Angel Association) welcomes the opportunity to contribute to the evaluation of the Seed Co-Investment Fund (SCIF).

As the industry representative body the Angel Association is an informed, if not necessarily objective observer and we acknowledge that even without SCIF New Zealand would still have an angel community. However, in all likelihood it would be smaller, less organised and less professional. The angel community would therefore be making a significantly smaller contribution to New Zealand's economic development. As New Zealand's angel community is in its early stages of development we contend that ongoing Government support is highly desirable.

Our members have been canvassed for their suggestions for improvements to the Fund. They have suggested five key improvements. Each is explained in greater depth within the paper:

- SCIF provides more resource for professional development;
- SCIF provides administrative support for the industry;
- SCIF has a more nimble investment mandate;
- SCIF has higher cap on funding per investment; and
- SCIF acts as a more truly passive investor.

By international standards the New Zealand angel community is still relatively young. It began in earnest no more than six or seven years ago. Prior to this time angel investment was taking place, but it tended not to be labelled as such and was undertaken by a few individuals and one or two funds.

Among the first formal angel practitioners were the Movac and Sparkbox Funds and the Ice Angels network. Movac was formed following the successful Trade Me exit. Henry Duff and Andrew Tait founded Sparkbox in 2001. The Ice Angels network was set up at the instigation of the Ice House to meet the funding needs of its incubator residents.

Today the industry is made up of over a dozen funds and formal networks where membership stands at around 350 angels. Between 80 to 100 deals are done every year, most of which are now accessing SCIF funding.

Angel investing is gaining an increasing profile and is in good heart but it has the potential to be making a much greater contribution to New Zealand's innovation, commercialisation and early-stage, high-growth sectors. The Angel Association is therefore strongly supportive of the SCIF.

Acknowledging the challenges economic development initiatives such as SCIF have to connect the output (SCIF) with the outcomes (more angels, stronger networks and more professional angels), there is no doubt that New Zealand's angel community is more viable, more professional and has more participants as a result of SCIF. Network managers can attest to the lift in interest in club membership, enquiries from entrepreneurs, and increased professionalism on the part of both angels and entrepreneurs following SCIF accreditation.

SCIF provides a longer runway of capital for ventures thereby improving the prospects of success. This in turn enhances the appeal of this highly risky end of the capital markets attracting more angels to the industry. The existence of SCIF also supports syndication and national collaboration both of which improve the prospects of accessing relevant skills, networks and increased capital being raised and further rounds of capital being brought to the venture.

2.0 The Overall Market for Angel Investment

How has angel investment evolved in the last 6 years? And what specifically has changed particularly in terms of leadership, competency and capability?

2.1 Internationally

The value of angel investing in economic development is being increasingly recognized internationally. In many jurisdictions governments are intervening in a variety of ways to stimulate interest in angel investment. The European Union has promoted policies to develop angel investing since the early 2000s. The World Bank and Inter-America Development Bank also actively promote angel investment.

In some places angel investing is having a greater impact than others. Where angel investment is growing, local and central government and others with an interest in the innovation eco-system recognize it is good practice to support both the supply and the demand sides for early-stage funding. Programmes have been put in place to help high-growth ventures become investment-ready, as have initiatives to promote angel investment.

Public sector involvement does face a number of challenges. The two key challenges are the perception that intervening to support angel investment is "helping rich people become richer" and identifying which levers deliver the biggest impact. The first challenge can be met through information dissemination. Once it is understood only one in ten investments delivers a return commensurate with the risk and that on a deal-by-deal basis there is a better than even chance of loosing the capital invested, the rationale for government intervention to support high-growth ventures is more appealing; politically and from an economic development perspective.

In terms of which levers are most powerful, there is a great deal of focus on what happens in Silicon Valley. While there is much we can learn from Silicon Valley, as with any assessment of what works elsewhere, it is important to be aware of New Zealand's own unique circumstances - a small country with a small domestic population and without the same access to wealth or markets. Silicon Valley is a unique and inspirational eco-system and differs markedly from other areas in the US, barring Boston. New Zealand's entrepreneurs and lead investors need to understand how Silicon Valley and other parts of the US, UK and East Asia work and be able to compete effectively for the capital, skills and networks these places offer.

It is important to recognise angel investing is fundamentally different in motivation and execution from venture capital investing. Angels invest their own personal money to make money but also to "give back" and make a real difference to their city, region or country; imparting skills, networks and experience to entrepreneurs and businesses in their community.

There have been a number of evolutionally changes in the most effective angel communities; that is those in the USA, Canada, Scotland, Australia and New Zealand. According to Nelson Gray, from LINC Scotland, these countries share characteristics of angel activity and learning not seen elsewhere. Angels in these countries have, largely without realising it, organised themselves into “groups” or “clubs”. These entities are different from the more commonly found “Business Angel Networks” (BANs) in Europe. The distinction is that the group or club acts to find, screen, invest and support companies over the long term. Their objective is to do great deals, run by angels, for angels.

Co-funding initiatives are one lever the government can use to encourage investment and improve the prospects of venture success.   Other levers include government grants to start-ups and tax incentives. Ideally all three are in place to maximize investment and the prospects of success for early-stage, high-growth ventures. The Angel Association is working on material to promote the benefits of tax incentives to angel investment growth. Tax breaks have been shown to be particularly effective in the United Kingdom.

2.1 In New Zealand

In 2006 when SCIF was founded the Angel Association did not exist, there were two or three angel ‘funds’ in operation and one or two budding angel networks. The Angel Association was founded in 2008.

The New Zealand angel industry has been fortunate to have consistent leadership from a small group of passionate leaders. Andy Hamilton, Phil McCaw, Greg Sitters and Dean Tilyard have been true champions for the asset class and remain engaged.

The Angel Association has had three chairs since its inception; Andy Hamilton, Phil McCaw and this year, Ray Thomson who assumed the role in May. Colin McKinnon has held the post of Executive Director and Suse Reynolds took up the role in July. The Angel Association has been fortunate to secure $340,000 of sponsorship in the last year, largely from government but also from the private sector and has an extensive programme of projects planned through to December 2013. This programme is focused on generating more angels and improving the capability of those already investing.

Angel networks and funds are currently operating in Otago, Christchurch, Nelson, Wellington, Palmerston North, Tauranga and Auckland.

Otago – The Otago Angel network, was formed with a similar imperative to that of the Ice Angels; to help fund the growth of Upstart Incubator companies. Its members are primarily Dunedin based and the Otago Angel network sources funds from Queenstown based members. It currently has 81 members.

Christchurch – The Christchurch angel fraternity is primarily represented by PowerHouse Ventures established seven years ago. PowerHouse invests using managed funds and co-investment. The primary source of funds is locally based high-net-worth investors. A fund is raised every year and typically targets six investments in the range of $100,000 to $1,000,000. PowerHouse employees managing and mentoring the ventures also contribute capital.

Nelson – Venture Accelerator has been operational since 2007 and became a SCIF partner in 2008. It is a small but effective angel network of around 12-16 members and has actively worked with other networks to syndicate and source deal flow since its inception.

Wellington – Four angel funds and one angel network operate out of Wellington.

The Movac directors founded their first venture, AMR Consulting in 1998. A management buyout was facilitated in 2005 and the company was rebranded Maven to provide business and information technology consulting services. At about the same time Movac was established to invest in high-growth companies. The directors have raised three funds and invested in over a dozen ventures. The first two funds are fully invested and the third fund, Movac Fund 3, is an early-stage expansion fund, investing between $1m and $5m in high-growth companies.

Sam Morgan's Jasmine Investments has been investing in angel ventures for the last six years. Dave Moskovitz's Webfund has been making investments for a similar period into digital and new media ventures. Simon Holdsworth's Evander Capital was established in 2008. Angel HQ began as a business unit of the local economic development agency, Grow Wellington. It started with 10 members in 2008 and today has over 30. It is currently working to expand membership through promotion of angel investment in Kapiti alongside the clean-tech incubator. Since its inception Angel HQ has processed over 300 applications for funding, over 50 companies have presented and 15 have been funded.

Palmerston North – The Manawatu Investment Group (MIG) was established in 2007 to provide funding for Manawatu start-ups. The group has evolved from a loose collection of interested individuals, who made several investments in local companies, to a sophisticated group of 30 angel investors. In 2011, MIG Fund 1 began investing. MIG Fund 1 is a million dollar angel investment fund raised from MIG members. The fund allows MIG Angels to syndicate efficiently with the national angel network and provides the opportunity to co-invest alongside SCIF. The MIG Fund 1 Investment Committee meets monthly to review propositions on behalf of the fund. The wider group meets quarterly for investment evenings. Local deal flow is predominately provided by the Bio-Commerce Centre, which also provide management services for both MIG Angels and MIG Fund 1.

The Bio-Commerce Centre is also working with a number of wealthy individuals in Hawkes Bay to establish an angel group. This group is very much in the early stages of creation, but aims to begin making investments in 2013.

Tauranga – Enterprise Angels started in 2008 as a fluctuating collection of 15 to 20 members for the first two and a half years. US angel, Bill Payne's visit in 2011 provided a catalyst for Enterprise Angels' growth. He was guest speaker at a targeted dinner for the region's wealthy business leaders. The event attracted a large number of new members who continue to promote angel investment to their colleagues and friends. Enterprise Angels now has 90 members and 9 corporate members or sponsors. New Zealand Trade and Enterprise's support for international expert visits often provides a draw card for new members.

Auckland – Auckland is the base for three funds and the country's largest and oldest angel network. Ice Angels has over 110 members and was founded in 2003. Since its establishment Ice Angels has invested over $32 million into 37 companies over 70 investment rounds.

Sparkbox Venture Group has been investing in early-stage ventures since 2001 and has invested in more than 30 companies. Its preference is for high-tech companies and it will invest up to $150,000 per round up to a maximum of $2,000,000 over the life of a company.

In recent years Sparkbox Seed and Sparkbox Ignite have been launched offering funding for earlier and later stage angel opportunities.

KOneWOne is owned by Sir Stephen Tindall. It has invested over $100m in seed and venture funding in a large number of start-up and early-stage ventures.

Cure Kids Ventures is a wholly owned subsidiary of the Child Health Research Foundation charity known as Cure Kids. Its investment focus is on research, seed, early-stage and expansion ventures with high-growth potential and with products capable of improving health outcomes, particularly for children.

In the next year the Angel Association has a programme of work supporting its members to grow angel numbers from new networks or from 'feeder' regions in Kapiti, Hamilton, Auckland's North Shore, Southland, Oamaru and the Hawkes Bay.

2.3 Syndication and Exits

Since 2009 there has been an increasing focus on syndicating deals amongst the wider angel communities. This has had a positive impact on competence and capability as it gives angels the opportunity to invest together, to continue to provide funding to growing companies, to aggregate capital so companies get sufficient funding and importantly to share skills and experience between angel groups and investee companies. In New Zealand the proportion of deals syndicated has grown steadily and today over 70% of deals are syndicated.

Another change in recent years has been the increased focus on exits. This has been in part the result of the publication in 2009 of three books by Basil Peters, Dr Tom McKaskill and Scott Shane. Increasingly angels are looking at capital efficiency and the realities of exits and exit multiples and valuations. This focus on exits should support the creation of more sustainable, realistic start-ups, provide confidence around demonstrable returns to angels and attract more individuals to consider the asset class, with the consequent creation of entrepreneurial wealth and skills.

2.4 Capability and Competency

In the last few years the emergence of a number of individuals who are recognised globally as "educators" has seen a greater willingness on the part of angels to seek training and professional development opportunities. This needs to be nurtured and supported by government to build a skilled base of investors who then can attract more individuals to the asset class, and who in turn help create more successful entrepreneurs.

Building angel capability and competency is done largely through experience; that is "on the job" by investing in, and assisting ventures. This further underpins the importance of supporting networks that provide support and opportunities for angels to invest together and share learnings, contacts and experience.

Professional development for New Zealand angels has largely been at two levels. At one extreme are one-day, formal seminars drawing on material and expert trainers from overseas such as the Kaufman Foundation and Bill Payne. At the other extreme are ad-hoc, short sessions which form part of a network event where local experts or experienced angels give a presentation on a particular aspect of angel investment such as valuation, governance or due diligence.

A survey on professional development preferences run by the Angel Association recently told us 90% of respondents were interested in professional development and that they would like these sessions to run for half a day (90%) and would prefer the sessions to be exclusively for angels (84%).

In descending order of preference respondents asked that these cover valuation, "going global", due diligence, term sheets, portfolio management and an introduction to angel investment. Other suggestions for courses included the role of the lead investor, market assessment, governance, and how to use Gust (the online software platform used by angel networks around the world).

There are a number of challenges to building angel competency;

- The lack of experienced angels with the time and training to be able to train other angels,
- The difficulty on the part of both existing and potential angels, who are almost always busy people, to find the time to attend education sessions,
- As a rule angels do not enjoy a classroom/seminar settings, and
- Angels are unwilling to pay much more than a couple of hundred dollars for education sessions.

The Angel Association has a project planned to address these challenges. This will see angels "practice" or "learn by doing" on live ventures. An entrepreneur with a fledgling deal will pitch to a group of investors who will afterwards segment into different groups to gain experience in putting a deal together. This will involve arriving at an agreed term sheet and shareholders agreement and will entail the involvement of experienced local or offshore angels and include securing support from accounting, legal and IP expertise.

2.5 The relationship between venture capital and angel investment

The relationship between venture capital firms and angels is challenging. It is however, not a challenge the majority of angel-backed companies have to grapple with as most never seek or receive venture capital funding.

For a number reasons, as set out in Basil Peters book "Early Exits", there is a growing realisation that for many entrepreneurs and angel investors taking venture capital is not an option simply because it is not available and even when it is, it can actually be harmful given the different approach venture capital fund managers often take to value creation and exits, particularly early exits. The key point is that where angels might for the sake of example, look to take a start-up from $2m to $15m, a venture capitalist will want to take that company from $15m to $100m. This involves a great deal of extra risk as well as diluting any early angel investors almost out of the picture.

At the 2010 American Angel Capital Association conference a survey indicated 26% of angels said they never looked at deal that would require venture capital funding at any time and 48% said they "sometimes" looked at deals requiring venture capital.

In Scotland, Nelson Gray has noted he will not look at a deal that is likely to require venture capital funding prior to an exit given there is little local venture capital. Scottish angels have, in the main, developed strategies and policies to support start-up growth without venture capital.

In New Zealand the venture capital industry is also struggling but some are successfully raising venture capital and follow-on funds. The vast majority of New Zealand based, angel backed companies do not however receive venture capital funding even if they need it and are therefore not seeking it.

3.0 The Role of Seed Co-Investment Funds in the NZ Angel Market

3.1 Selecting investment partners

While recognizing the political and professional imperative for selecting co-investment partners dictates the need for a high degree of compliance and rigor, there are some within the industry who feel there are aspects of the SCIF due diligence on key personnel in angel networks which impinge unnecessarily on privacy and are not relevant to the integrity of the partnership and the Seed Co-investment Fund.

We recognize the New Zealand angel industry is still in its infancy and that the selection of investment partners and degree of rigor required depends to a high degree on the level of development in the local market. The degree of rigor in selecting co-fund investment partners also has an impact on the degree to which the government might manage the fund with more or less oversight.

As a comparison, the Scottish co-fund selects the “group” not the individual. The English co-fund and the European Investment Fund co-fund assess individuals because they have no groups to select from.

Should co-investment funds be active or passive?

Some Angel Association members view SCIF as too active in investment decision-making, especially as it is promoted as a passive investor meaning that the Fund will follow the investment decision of its partner so long as the investment meets previously agreed criteria.

As noted above, we recognize the degree to which SCIF is passive or active will depend on the competency and experience of the partner. In Scotland, the co-fund, operational since 2004 is passive although since 2009 a “monitoring unit” has been in place taking a more active role in decisions regarding follow-on funding. The English and Northern Ireland funds are relatively active; reviewing due diligence and having active investment panels.

In our view the aim should be to move from an active to a more passive fund. This supports greater efficiency, leads to more deals and reduced overhead costs for the co-investment fund, the angel networks, funds and entrepreneurs. It does however inherently recognize that SCIF must have confidence in the competence and capability of each of their appointed partners for this to be achieved.

It is also important to acknowledge that those employed by SCIF are skilled professionals with a great deal of useful and relevant knowledge. The right processes and incentives must be in place to ensure these people continue to share this knowledge with investors – and entrepreneurs.

3.3 Do funds have other roles – such as developing particular sectors?

In the Angel Association's view co-funds should not have a role in promoting particular sectors. Venture success relies heavily on the experience of the angels investing so should be left to these individuals and their respective networks to determine. Promoting deals in sectors where there is little regional or national experience is inadvisable.

SCIF can and should be used to promote best practice and data. This will have a much greater impact on venture success than developing or supporting specific sectors. The Angel Association supports the role SCIF has played to promote standard documents. This has contributed to significant savings in terms of cost and time when progressing and closing angel deals.

4.0 The Impacts of Angel Investment and Angel Investors

4.1 What form does support for portfolio companies take?

New Zealand's angel networks strongly encourage their members to be actively involved in their portfolio companies – as board members, mentors, and in-market channel and development support. These are skills that need to be developed and learned. It is rare for an angel network member not to be on the board to represent fellow investor interests, to call on other group members for help and introductions, to be involved in strategy and recruitment, to challenge the CEO, and if the time comes to help deal with non-performing founders. This role is typically non-executive and unlike more conventional companies, the line between governance and operations is often blurred.

There is an ongoing discussion among New Zealand networks about the role of the network administrator in supporting portfolio companies. Network managers cannot promote deals without risking legal action downstream and yet, if they limit their involvement to "facilitation" and securing the involvement of a lead investor, the deals run the risk of failure. The risk of legal action can be mitigated with the right estoppel clause in the angel network membership form.

There are very real issues in getting good directors for start-ups given that the skills required are quite different to those of corporate directorships and because liability is increased through the frequent lack of company process/governance. These shortcomings are hard to avoid given start-ups inherently have limited resources – financial and personnel. A project is underway to potentially assist in this area.

4.2 The main challenges faced by angels working with their portfolio companies

Key challenges include not being close enough to the company from its inception to ensure its structure, strategy and IP management are optimal, not keeping objectives constantly aligned to growth and value creation, not taking action quickly enough when things start to go wrong, not planning effectively for future rounds of funding and dealing with the consequent dilution effects and not having a proper understanding the realities of an exit. Other 'softer' challenges are managing founder and staff expectations and relationships internally and with investors.

4.3 What proportion will be successful and how?

The answer to what proportion of companies will be successful depends of course on how "success" is defined. How many will become $100m companies trading on a global basis? The answer is probably not many, because globally, this is the reality. However once this is recognised and angel venturing starts to create multiple companies worth between $10m and $50m the industry will be responsible, with further angel and co-fund money, for creating genuine entrepreneurial wealth and jobs with the consequent economic growth.

5.0 The Functioning of Angel Networks

5.1 What sort of structures do angel networks adopt?

In New Zealand no two networks or fund share the same structure. They are variously incorporated societies, private companies, limited partnerships and wholly owned subsidiaries of organizations funded by a variety of local stakeholders.

Angel HQ is an incorporated society with five people on the Board. Upstart Incubator underwrites Otago Angels with 100% deal fee recovery to offset the costs of running the network. Without this support the network would not exist. Enterprise Angels is an incorporated society with a five-person board and with a charitable purpose that would see all assets and funds returned to the community should the network be wound up. In practice Ice Angels operates as a joint venture between by the investor members of the angel club and the Ice House. The Ice House is 100% owned by a registered charitable trust. The Trust's purpose is to enable economic growth through small to medium enterprises and start-ups for the benefit of New Zealand.

MIG and PowerHouse both largely operate as funds with their angel investors able to co-invest alongside the fund.

Nelson Gray points out that in Scotland he works with nineteen angel groups, with three in formation and that there are twenty-two different structures. They are all adapted to the needs and desires of the individuals running the groups.

It is in generally true to say that angel networks are 'member clubs' so the members decide how the club is run. The structures and rules change with time as the networks develop. Those running networks say unequivocally that it is very difficult to make a living running a group commercially.

5.2 What makes networks successful or not?

Without doubt a network must have a champion individual or individuals to start it and attract founding members. Founding members must be like-minded people who have similar attitudes to risk. They need to like and trust each other as they will do deals together and be involved with each other for a number of years. A solid core of people is needed; people who have the time to help run the network, including to support and promote deal flow and to help hold and run events. There is little space for "tire-kickers" and consultants given the expectation that club members have joined to *invest* in companies.

Networks need well-documented and supported processes and procedures and a common investment strategy. The absolute bottom line is that networks must have a steady stream of quality deals and invest in companies. This is what will hold the group together.

5.3 Where do angels look for ventures?

In the past angels, fund managers and network managers have had to "shake the trees" for deals. They have relied on incubators, early-stage investment bankers, the now defunct NZTE Escalator programme, professional service providers, some of the banks, economic development agencies and word-of-mouth to source deals.

In more recent times, given improving awareness of angel investment, network managers and angel funds in New Zealand can increasingly rely on entrepreneurs coming to them. Entrepreneurs will have a better chance of a good hearing if they are referred from trusted and educated sources; particularly fund managers such as Movac and Sparkbox, the incubators and the better tech-transfer offices in Crown Research Institutes and Universities.

Most New Zealand networks use GUST and will not entertain a conversation with an entrepreneur until he or she has filled in the GUST application form. While the standard of applications has improved and entrepreneurs now have a much better idea of what investors are looking for, there is still a real need for support to get ventures 'investment ready'.

The Angel Association surveyed angels about their deal preferences recently including the source of angel opportunities. When asked about their preferred source of deals 88% of respondents told the Angel Association they had no preference – "a good deal is a good deal". Where angels did have a preference, in descending order they identified incubators, "garage or front room", research institutions and economic development agencies. One respondent noted that it was not the source of deals that was relevant but the caliber of the people running the company.

5.4 Do they tend to focus on sectors or take a broad approach?

Whether or not an angel will focus on a particular sector very much depends on the individual's background. Every angel is different. Some angels focus on sectors where they have an interest or expertise, some take a broad approach based on their assessment of the market and business model the entrepreneur is presenting.

The Angel Association asked about sector preferences in its deal preferences survey. This revealed New Zealand angels have a preference for web-based software and services, followed closely by technology hardware and equipment, biotech and life-sciences, fast moving consumer goods, clean tech and agriculture.

At present there are very few "cashed-out" or "exited" entrepreneurs who are now business angels. Most business angels have made cash in traditional businesses. They tend to be willing to make generalist investments and rely on others to provide experience in the vertical or industry in which the venture operates. Nelson Gray points out that the biggest life science investors in Scotland started out in property and frozen food businesses.

There is a high degree of emotional engagement involved in angel investment decisions. Angel investing is not a rational economic activity. Angel investment is not financially lucrative for the majority of participants. The positive investment returns, when they come, are not evenly distributed. A recent Rob Wiltbank, multi-year survey of angel investor returns showed 90% of returns came from just 10% of angel investments. With each individual investment there is a better than even chance the investor will lose his or her money. Angels are therefore looking to help local people and local companies and are driven by a range of other motivations, not just investment returns.

6.0 The Rationale for Public Sector Support

6.1 What gives rise to the need for public sector support?

The founding premise to this discussion is acknowledging angel investment is desirable. After family and close associates, angel investors fund most high-growth, IP-rich businesses; not banks or venture capitalists. Public sector support is required for three reasons; lack of funds, the need for more angels and the need to develop capability.

It is important that the Government recognises that SCIF funding provides:

- private sector investment leverage,
- job creation,
- export earnings, and
- wealth creation for reinvestment.

However, as mentioned already angel investing from a pure financial return, perspective is not a rational allocation of wealth or time. There is presently no conclusive evidence that, as an asset class in New Zealand angel investment provides a satisfactory return on investment, let alone one in proportion to the risk, for the typical angel investor.

In "Siding with the Angels", Robert Wiltbank shows that, on average, angels can achieve a 22% IRR (http://www.nesta.org.uk/publications/reports/assets/features/siding_with_the_angels). However some argue the sample size was small and the IRR was calculated inappropriately. Data is available at a group level. For example, the Tech Coast Angels, based in the US, calculate a return on their entire exit portfolio, cash on cash of about 23%. But again some argue this result is misleading as it is generated from one of the most sophisticated angel groups in the world, and the results are unlikely to be reflected at the individual angel investor level. Most angels do not get their money back. This is particularly so if they do not take a portfolio approach to investment and spread their risk over a number of companies.

So why do wealthy, intelligent people become angels? Aside from seeing a financial return as noted above, people become angels for other philanthropic reasons; to "give back" to their community, to help budding entrepreneurs and for the thrill of "being in business". Angels invest to make money but are "doing good" and getting satisfaction out of helping entrepreneurs at the same time.

Therefore the primary public sector intervention requirement is to persuade individuals to divert some of their net wealth to this class. This inducement to become involved is not an "easy sell" when the evidence of financial reward is thin, particularly in New Zealand where the industry is still relatively young. More resource needs to be applied to persuade more individuals that it is a good thing to do and that there are benefits beyond financial reward.

The current SCIF programme has only very limited capacity to assist in this process and a key lesson for the whole industry over the last six years has been that the rate of recruitment of new angels has been consistently small and relatively static. At the moment the industry is simply not attracting new angel investors at a high enough rate. To effectively meet the future capital needs of our burgeoning innovation economy we need to get more "hands to the pump" and spread the risk and rewards of angel investing across a significantly larger base of angel investors.

Intervention is required to support the establishment and running of angel groups. Groups provide a supportive and collegial environment for new angel recruits and peer pressure to invest but in New Zealand they are typically run with significant fiscal and human resource constraints.

Scottish Enterprise has for many years funded the development of angel groups through LINC Scotland. A United Kingdom government review credits this as significantly increasing angel investing in Scotland compared to England. Scotland and England have the same tax system and fundamentally the same legal system. The big difference is the way the angels are organized. With 8% of the United Kingdom population, Scotland has 25% of identifiable angel investing.

A further reason for government intervention is for educative purposes. Angel investing requires specialist skills. It is economically and financially desirable to have deals properly structured and priced. Failing to educate investors will result in fewer deals, and deals structured in ways that limit potential growth opportunities. More professional development is likely to lead to higher investment returns, reinforcing the message that it is "good to be an angel". Angel education needs to be seen not just as a benefit to the angel, but society as a whole as more successful companies are produced as a result, fewer bad deals will be done and fewer resources, both capital and intellectual will be wasted.

Intervention through co-funding provides additional financial capacity. Once angels are recruited, organised, educated and active, the additional firepower co-funds provide improves the odds of business growing over the long term. As noted earlier, most companies do not get venture capital funding.

So government sponsored co-funding provides a number of benefits:

- It funds companies through growth periods creating more jobs,
- It enables more companies to be funded and as angels do more deals and gain more experience the odds of success are improved,
- Angels are better able to spread their risk and reducing the risk makes the asset class more attractive,
- It sends a clear message that being an angel is a good thing to do,
- It reduces reliance on venture capital, which is increasingly coming from offshore so local ventures are more likely to grow to critical mass in New Zealand rather than move (typically to the US),
- It allows the government to have some influence on the early-stage, innovation and commercialisation sectors which is often difficult in such an informal market,
- Requiring compliance with co-fund rules and expectations improves skill levels, sets ethical standards notably with respect to fee setting, improves efficiency by providing common legal documents and facilitates data collection (deals done, valuations etc) and thereby creates a more informed and cohesive market.

The United Kingdom government sites the Scottish co-fund as an additional reason why angel investing is so much higher in Scotland than the rest of the United Kingdom. Angels can support companies for longer, ensuring they set deep roots in Scotland, reducing the likelihood of job and wealth transfer over the medium to long term.

7.0 What is working well and what isn't?

We asked our members what was working well and what was not and received the following responses.

7.1 Working well

SCIF is run by a professional team and has an efficient system of determining funding eligibility.

SCIF funds are transferred efficiently.

The very fact matching funding is available to top up ventures and to provide confidence is beneficial.

Deal documentation and templates, together with Simpson Grierson interface and legal assistance and support around the release of funds provides useful support.

SCIF processes deliver prompt decisions and SCIF manager's respond promptly and take a practical approach to deals.

SCIF investor education initiatives primarily around sponsoring expert visits are invaluable. Offshore presenters are always attractive to local investors.

7.2 Not working so well

Angel industry data is very "SCIF-focused" so there is inadequate visibility of non-SCIF deals and angel venturing. There is a need for a wider and more detailed set of data on angel deals and profiles. What data does exist needs to be more widely and effectively communicated.

A maximum of up $750k SCIF funding in any one venture is too small, particularly for life science and clean-tech deals.

SCIF should focus more on companies already in its portfolio. There is anecdotal evidence that the lack of follow-on funding is forcing trade sales earlier than optimal and that companies are "going to the wall" when it may not be entirely necessary. Government policy makers might consider an "expansion fund" which could be deployed to provide larger sums of follow-on funding for venture growth.

SCIF should move from 4% to 6% success fees both on upfront and follow-on rounds to allow professional leads to invest sufficient time in leading due diligence and syndication and enable them to syndicate with other groups, which require at least 3% in a shared or syndicated deal.

SCIF should have a more flexible and nimble mandate with more money to deploy with new partnerships. The current $40m fund is too small. The SCIF mandate should be reviewed every two years with the ability to amend it expeditiously. The market moves and changes more quickly than the mandate.

There is a real need for administrative support for the networks and funds. The groups are unsustainable as they are and the angel membership base and quantum of funding being provided is not growing as fast as it could. Were government funds to be provided for administration these should preferably be provided other than through SCIF to avoid potential conflicts of interest.

The Halo Fund, developed by the industry in conjunction with SCIF in 2009, was designed to fill an obvious market gap providing for passive angel investment. The gap in the capital market is still there and it should be filled.

The pathway to a follow-on SCIF fund should be clearer and more straightforward. In a similar vein so should the pathway to establishing a venture capital fund. Specifically, it would be very useful for the partner, particularly in attracting Asian investors, to be able to demonstrate a soft commitment from SCIF/NZVIF conditional upon securing private funds.

At the very front end of securing opportunities for angels to invest in, there is a need for a small fund to assist companies to become investment-ready for angels. This would be early seed money and could be capped at $50,000, not requiring co-investment and could be administered the same way as SCIF. The angel network or SCIF partner would prepare the documentation and certification and SCIF would manage the fund. In effect this would be a market validation fund. If a company came through an incubator, there might be a weaker rationale for the provision of this intervention as by virtue of incubation much of the market validation and other investment readiness work will have been provided.

8.0 Summary and Recommendations

SCIF has played a vital role in creating a New Zealand angel community and to ensure this community is well grounded and positioned for on-going growth and viability the initiative should be rolled over for at least another decade.

There are a number of design changes that should be made to any SCIF II Fund including compelling reasons to increase the amount of funding provided per deal. Once a venture has received initial funding the rationale for active SCIF involvement is less compelling and follow-on rounds should be more pro-forma with SCIF acting more genuinely as a passive fund.

A case can be made for a more nimble Government mandate allowing the key parameters for SCIF funding to be changed on a regular basis to ensure the Fund is accurately tracking and reflecting the broader industry development.

The SCIF remit should be expanded to include the provision of resource – financial, time and/or personnel – to support professional development and administration of angel funds and networks in the industry.

Angel investment is a particularly inspirational end of the capital markets. Without doubt entrepreneurs and the wider community benefit from the experience, connections and skills and particularly the aspiration angels have for the ventures and local economies they are supporting.

To date SCIF has played an important role in facilitating the development of the angel community and the Angel Association believes there are strong grounds for this continuing.