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The importance of angels in starting a US biotech venture

Jeffrey Sohl[1]
Jeffrey Sohl is at the Center for Venture Research (CVR) at the University of New Hampshire's Whittemore School of Business and Economics in Durham, New Hampshire 03824-3593, USA. http://www.unh.edu/cvr/. The CVR has collected and analyzed data on the angel market since 1979. e-mail: cvr@unh.edu

An inventor looking for seed funding should take some time to understand the common attitudes and behaviors of angel investors.

Angel investors have been in existence for many years, providing seed funds for ventures from the Bell Telephone Company in 1874 to the 1994 investment into what became Amazon.com. But they are in many ways our nation's least understood, and most underutilized, economic resource. Quietly providing the majority of the seed and startup capital for biotech entrepreneurial ventures, the angel market is in constant flux. The recent volatility of the private equity market, from the rise up to 2000 to the decline after 2000, has only provided additional motivation to understand the role of these critical early-stage investors.

Who are these angels?

There are many types of investors who finance private companies: large corporations, buyout funds and venture capital (VC) funds, to name a few. VC can be defined as any form of equity investment into a high-growth company with liquidity as an exit goal (that is, not dividends), and angel investors fall into this category. But whereas the capital in most VC funds is raised from pension funds and foundations, angels are wealthy individuals who invest their own money.

Although philanthropy may be part of their social activity, angels treat angel investing as the active part of their financial investment portfolio. Angels are typically former entrepreneurs, whose wealth is often derived through successfully cashing out of their own ventures. As such, angels bring substantial business experience to the ventures in which they invest, assisting the entrepreneur in creating a viable company with a chance for sustainable growth.

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First and foremost, based on their extensive startup experience, angels can provide the entrepreneur with valuable know-how in starting and growing a business. In studies conducted by the Center for Venture Research (CVR), the vast majority of entrepreneurs value this guidance even more than the capital provided by the angels[1]. Also, this advice is a two-way street. By improving the chances of the venture's success, the angel improves the chances of a substantial capital gain for himself; second, angels derive personal gratification from their angel investment activity by giving back to the entrepreneurial culture from which they derived substantial wealth.

In what do they invest?

Angels have a higher propensity than VC funds to provide the crucial smaller rounds of seed and startup financing required by the early-stage venture. Angels, a relatively invisible source, are the oldest and largest segment of the US VC industry and comprise several million individuals with a net worth in excess of $1 million, excluding personal residences. Private investors are also the major source of capital in the seed and startup stage, with over half of their investments in these critical early stages. An angel deal is typically in the $300,000 to $500,000 range, but larger investments, up to $1 million are also undertaken.

According to the CVR's research, in the first six months of 2004, the angel market invested a total of $12.4 billion into 27,500 entrepreneurial ventures, a projected 31% increase from the full year 2003. The number of active angel investors in this time frame was 135,000 individuals, with 59% of investments in seed and startup stage entrepreneurial ventures. In contrast, the institutional VC industry invests primarily in later-stage, and consequently larger-sized, deals. According to the MoneyTree Survey[2], venture capitalists invest about $7 million per deal, and total investments for the first half of 2004 were $11 billion in 1,481 deals. However, only 92 (about 7%) of these deals went into the seed and startup stage. For the past decade, VC seed and startup deals have rarely exceeded 10% of their total investments.

Angels do not exactly swarm to the biotech sector because of long, costly timelines to get a return on their investment, as well as a high probability that their original investment will get overdiluted before reaching an exit point[3]. In the first half of 2004, only 8% of all angel dollars went to biotech, compared with 18% of VC funds[2]. But when the total number of dollars and percentages in the preceding paragraph are taken into account, one can crudely estimate that angels put about $40–60 million into biotech startups in this time frame, whereas venture capitalists put in only about $10–20 million. Angels are clearly an essential source of funding for biotech startups.

How to find them?

There are two paths to find angels, each with its own distinct advantages and disadvantages. First is the 'angel group' route, of which there are currently about 140 in the United States that are actively investing. Most angel groups do not specialize in any one sector, but rather tend to invest in multiple areas to diversify their portfolios. These groups can usually be found through active web searches and by scanning the business media. They are organized in a variety of ways, from a collection of angels making individual investment decisions to the more formal groups that require some consensus among members to make an investment. Most have some form of screening committee that vets deals and decides which ones get to present to their angels at one of their periodic meetings.

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This angel group route is easy to find but hard to get in. Although referrals help, the entrepreneur must still get through the screening committee, which, unfortunately, may have members who do not understand your venture. So, there may be angels in the group that would likely invest in your deal, but you might never see them if you can't pass muster with the screening committee. Once chosen, you then make the pitch to a large group of investors and hope the members who understand your business are in the audience.

The second path is the 'individual angel' route, which is often referred to as 'look left, look right, look under a rock—and you will find an angel.' These individual angels are the largest source of angel capital in the United States. They also invest in groups of 4–6 investors, but these groups are informal and amorphous in the sense that the group is formed for a specific deal, rather than for sourcing deals. These individual angels are best sourced through networks, including contacts with lawyers, accountants or fellow entrepreneurs. They are hard to find, and often require a referral, but once you get into the network and find one angel, then you will likely find many more.

Location, location, location

Whether you are looking for a formal angel group or an individual angel, the vast majority of private investors prefer to invest close to their principal place of residence, typically within a half day's travel time[4]. This localized nature of the market stems from several important behavioral characteristics of angel investors.

As former entrepreneurs, these individuals continue to yearn for the excitement of the high-growth venture, but tend to eschew the sleepless nights associated with running a startup company. They also often take bigger risks or accept lower rewards when they are attracted by the nonfinancial characteristics of an entrepreneur's proposal, such as the desire to create jobs in their own communities. Angels are, quite literally, 'adventure' investors who seek a connection with the company through a mentorship role and offering advice at a strategic level, but a return on investment remains the major consideration. Because these investments are startups with substantial risk, close proximity enables the angel to keep a close watch on the investment while providing knowledge and experience to the venture.

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In for the long run

Because they fund mostly seed-stage ventures, business angels typically have exit horizons in the 5 to 7 year range, which is longer than their average VC fund manager counterparts. Thus, seed capital is often termed 'patient capital.' This longer exit horizon affords both the entrepreneur and the investor the time to build value into the venture, which subsequently brings higher valuations when additional funding is sought from the larger

VC funds. Increased value also translates into smaller dilution of stock ownership in future rounds, an important consideration for both entrepreneurs and angels.

The long-term nature of a seed investment makes the private investor market a relationship-building market, especially in the evaluation stage of the investment. The angel investor works closely in a mentorship role with the entrepreneur and his management team throughout the long term of the investment. Because of this close working relationship, the angel has to believe not just in the success and technology of the product, but more importantly in the strength and ability of the management team to create the product they envision. Because the seed investor is investing predominately in the entrepreneur and this asset is a very mobile commodity, the vision of the entrepreneur must be congruent with the investment objective of the business angel. The entrepreneur should envision this investor relationship as a marriage, albeit one without the possibility of a divorce, because the equivalent of divorce is bankruptcy for the entrepreneur and loss of investment for the investor.

Final words of advice

Whatever strategy you adopt, be prepared for an arduous process (see Box 1). Don't go looking for angel money when you need it to survive, but when you need it to grow. Prepare in advance[5, 6, 7], learn what angels are looking for in a deal and expect to take some time locating the right angel. Make sure you are 'investor ready' before your first meeting with potential investors and allow 3 to 4 months for the due diligence necessary to complete the deal. Most of all, keep in mind that it is not the technology that seals the deal, it is the ability of the management team to wrap a business around the technology.

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Box 1: Checklist for attaining angel funding

- Prepare a solid business plan with experienced management[5,6,7]
- Expect 3 to 4 months due diligence before the deal is completed
- Look at the investment as gaining a long-term mentor
- Look for an angel near your location
- Most angel groups invest in diverse sectors and have a vetting board, so prepare your pitch to have broad appeal
- Your most likely way of meeting an angel is through networking