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Can Angel Investors Earn Heavenly Returns?

By JASON ZWEIG

This may be the best time in years for an investor to become an angel. But that doesn't mean you should rush out to get yourself fitted for wings and a halo.

An angel investor is anyone who privately provides capital to a promising business, often a start-up, that isn't run by a friend or family member. Scott Shane, an economist at Case Western Reserve University in Cleveland, estimates that the U.S. has at least 140,000 active angels who collectively invest some \$20 billion a year in new businesses.



Heath Hinegardner

Right now, the rationale for becoming an angel sounds almost heavenly. Commercial and industrial lending by banks, the lifeblood of small and medium-size businesses, has dried up, falling 13% over the past 12 months. And the money raised by venture-capital funds, another leading source of financing for start-ups, is down 67% from last year. That has presented unusually

attractive opportunities for outsiders who can provide financing.

Catherine Mott, president of BlueTree Allied Angels, a group of 43 wealthy angel investors in Pittsburgh, said one local high-tech start-up has orders for several million dollars' of goods from national distributors, but banks won't lend it the working capital to make its products. So the start-up is willing to give local angels an equity stake in exchange for cash to manufacture goods that are all but certain to sell, a situation that Ms. Mott, a former commercial banker, called "amazing."

Before you get in line for those flowing white robes, take a deep breath. Being an angel is hellishly risky. To be sure, one recent study found that 7% of the angel investments with final outcomes went up at least tenfold. And many fledgling angels are driven by the dream of finding the next Google while it still is in the cradle.

But roughly half of all new businesses fail within their first five years, according to the Small Business Administration. Not surprisingly then, researchers have estimated that at least half of all angel investments lose money and 48% of investments with final outcomes result in a 100% loss.

Worse, those returns were earned by "accredited" angels, individual investors with at least \$200,000 in annual income and \$1 million or more in net worth. The vast majority of the profits from angel investing appear to be earned by the top 10% of angels, who tend to be rich,

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well-connected veterans of high-growth industries. Unaccredited angels, with less capital to offer and weaker links to expert advice, are likely to see fewer deals with potential for high returns.

Furthermore, these private businesses are illiquid, so angels can't dump their holdings at will, the way mortals do every day in the stock or bond market. Thus, being an angel takes enormous patience. "Your losers die faster than your winners win," said Robert Wiltbank, a business professor at Willamette University in Salem, Ore. "So for the first three to five years you should expect only bad news."

And being an angel isn't cheap. If you join an accredited angel network, which pools expertise and resources, you could pay \$2,500 to \$5,000 in annual fees. An angel fund may charge management fees of 1% to 2%. Go it alone and you will have to hire your own legal and accounting expertise.

If you want to do well with an angel portfolio, you should expect to invest not just money but time. By some estimates, one in four angels does no due diligence before making the investment. Such trusting angels are unlikely to be blessed with high returns.

Too many angels get stars in their eyes, bedazzled by a charismatic entrepreneur bearing gee-whiz technology. Too few ask tough questions to determine the market potential for the company's products, the obstacles to growth and whether the entrepreneur has any aptitude for the details and drudgery of day-to-day management.

So why would anyone want to be an angel, and who should consider it? "You get to play God a little," said Paul Kedrosky, an active angel investor and a senior fellow at the Kauffman Foundation, which studies entrepreneurship. "You get the charge of helping to create something exciting, without having too many annoying partners."

If you love business, enjoy mentoring and have wisdom to impart, then the psychic rewards of becoming an angel might be worthwhile. Many angels, said Marianne Hudson, executive director of the Angel Capital Association, are motivated much more by the satisfaction of "being a coach and giving back to the community" than by money alone. That is a luxury you can afford only if you can afford to lose every dollar you

invest.

For most investors, however, heaven can wait.

Write to Jason Zweig at intelligentinvestor@wsj.com

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