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Embracing Angels: A VC's Perspective

Bob Pavey 3/31/11

Is there increased tension between venture capitalists (VCs) and angel investors? Lots of stories these days would lead you to that conclusion. Are angels cutting into our deals? Are they making venture capitalists less relevant, especially if some angels are raising sizable funds? Are we competing with them for LP money? The answer to each of these questions is "Yes," but that is not really the point. Not only do I think we need to co-exist with angels, I think we need to embrace them, champion them and get Congress and other policy makers to enact tax and state policy that encourages more of them. It seems clear to me that the more angel investors we have, the better—not only for entrepreneurs (which is obvious), but also for our VC ecosystem as well as for the country at large.

I've been a VC for 42 years and served as a past chairman of the National Venture Capital Association (NVCA). For better or worse, I have a long historical view. Angels have always been with us—you can say Queen Isabella (who was even before my time) was an early angel when she financed Columbus' storied trip across the Atlantic in 1492 (and just like entrepreneurs of today, he too had to change his plans when the unexpected, i.e. America, came up).

Before the late 1940s there were only angels. The earliest VC firms were Venrock, JH Whitney, and Bessemer, which grew out of the angel activities of the Rockefeller, Whitney, and Phipps families respectively. My firm also evolved from the Whitney family. Similarly, the California VC industry was developed by some very early California angels like Reid Dennis and Arthur Rock. In fact, Reid Dennis probably gets the record. I can think of six venture firms which can trace their roots back to him—IVP, TVI, Sigma, Redpoint, August, and Benchmark. Reid's impact on the US VC industry is really impressive.

Today, angels quietly help spur our economy. According to the Center for Venture Research, in the first half of 2010, there were 125,000 angel investments totaling $8.5 billion into 25,000 companies at the rate of $70,000 per investment or $340,000 per company. That is almost as much money as VCs invested during that same six month period. The number of companies financed by angels, however, is more than 50 times the number that we VCs finance. In addition, there is sure to be an enormous number of smaller—$10,000-20,000—transactions with "Friends and Family" that are not counted.

What's an Angel?

Before I go on about why we need to celebrate angel investors, let's define what they are. First we need to recognize that there are something like 250,000 of these angels, and they are in all 50 states—so needless to say, they are not all alike. What they have in common is that they have some money and they are willing to risk serious amounts of that money in illiquid, risky investments—backing an entrepreneur who wants to build a company, create jobs, and make a mark on the world. Early stage VCs like my firm start some companies from scratch but otherwise it is rare for us to see a deal that has not been funded by an angel. The majority of angels invest their own money (as opposed to VCs who invests a pool of money from their limited partners, like pension funds, endowments, etc.).

Angels fill a critical funding gap between “friends and family” money and VC money. For example, an entrepreneur may be able to raise tens of thousands of dollars from friends and family, but his or her next round will usually come from an angel. That’s because a typical VC firm cannot consider investments below $1 million. Angel investors can put in small amounts; some as little as $10,000. And they can band together with other angels to meet a funding round’s capital requirement. Once the startup reaches certain company milestones and needs a bigger infusion of capital, it is common for them to seek their next round from VCs.

There’s been a lot of talk about “super angels.” Some people say super angels are those who do more than 10 deals a year. Some say they have sizeable, institutional funds. Some notable recent funds include: IA Ventures, a $50 million fund set up by Roger Ehrenberg, former president of DB Advisors; Floodgate, a $74 million fund started by Mike Maples; Felicis Ventures, a $40 million fund started by former Google executive Aydin Senkut; SoftTechVC II, a $35 million fund started by investor Jeff Clavier; and SV Angel II LP, a $20 million fund by startup investor Ron Conway. The Angel Capital Association estimates there are about 100 angel funds in the US at present, but they and the super angels are just the tip of a very large angel iceberg.

So What’s the Gripe?

I think the level of acrimony has died down since late last year, but if you’ve been reading the blogs and so-called “smack downs” between VCs and angels, then you know it was not all “kumbaya” among us. In a nutshell, the angst comes from competition (what a surprise!). Some young companies will need only a few million dollars, and we VCs as well as some angels are interested in the best of these. So we have to compete—some may not like that but that’s the way we do things in this country. There is also the misperception that choosing investors is a binary decision—that if you pick an angel, you can’t pick a VC. In reality there is often room for both and there are different roles for different investors. The 80/20 rule applies here: A great majority of successful angel-backed companies are sold for under $30 million and everyone is happy with that outcome. We VCs look for much bigger exits…because we need to impact bigger funds. For the most part, we are looking for home runs. There are many good investment opportunities for angels in early stage companies, and the more options an entrepreneur has, the better.

Sweeten the Deal

If our leaders really want more job growth in this country, Congress and state policy makers should encourage the growth of the angel investment community with lower tax rates. Every successful angel investor pays capital gains tax today. I think there should be an even lower tax rate for investors in very young, pre-revenue companies. Angel investing is the most efficient way to give as many entrepreneurs as possible a chance at bat…and in the long run that creates more jobs. Angels were behind Google, Apple and **Facebook** when they first started. And VCs were there when they swung for the fences. A strong country needs both.

Bob Pavey is a partner at Morgenthaler Ventures and a past chairman of the National Venture Capital Association. He currently sits on the boards of eight companies including CLK Design, OmniPV, Paratek Microwave, Peregrine Semiconductor, R2 Semiconductor and Sezmi Corporation. Previous investments included Apple, Synopsys, and Atria.