
Angel Investing – Return Expectations

A Whitepaper by Rick Norland

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A. PROLOGUE – A WORD ABOUT THE AUTHOR

Rick Norland has been a volunteer for over ten years supporting the Ottawa Economic Development Corporation's Entrepreneur and Business Development Unit. He has been part of numerous research and program development efforts to support Ottawa's Angel community. He has been part of over 60 financial transactions, ranging from \$10,000 to \$350 million. He has supported 13 startups, nine of which were VC-backed, five from the point of founding. Among the newly founded companies, he has co-founded three of them. He has been an Angel investor in six companies. Augmenting his primarily Ottawa-based experiences, Mr. Norland has followed with interest the Angel community research from other areas. He has also researched and prepared business plans for the creation of three different venture capital funds. The philosophies set out in this whitepaper are the culmination of this broad and varied background, and are the author's personal views. They have not otherwise been independently verified or researched.

B. INTRODUCTION

Recently, there has been a growing concern wondering why Angels experience lower portfolio returns than venture capital investors. I think it is worth exploring the "inverse" of that question - "Why should Angels expect to even match VC portfolio returns?", or "What returns should Angels expect?"

C. WHAT RETURNS DO VCS GET?

In most situations, VCs expect a 5x to 7x return on their investment over a five-year period, representing a cumulative annual growth rate (CAGR) of between 38% and 48%. Clearly, not all investments realize returns in that range - some are lower and some are higher.

As investors, venture capitalists are expected to return profits to the institutional clients that invest in their funds. Successful venture capitalists understand two key realities: (1) To survive, they must at least triple the assets with which they have been entrusted during the life of their partnership; and (2) Given the risks involved in startup investing, a significant number of their portfolio companies will fail and be total write-offs.

There are a number of “rules of thumb” that VCs consider in assessing the return expectations of individual companies and of their overall portfolio. The first rule of thumb has to do with the relative mix (see Table 1) of performance that individual companies will achieve. The general expectation is that, of ten investees, two will achieve a 10x return (high growth), three will achieve medium growth, three will have slow or no growth, and two will go bankrupt.

Table 1: VC Portfolio Performance Expectations

	Mix	\$ Multiple	5 Yr CAGR
High growth	15%	10x	111.47%
Medium growth	30%	5x to 10x	62.66%
Slow growth	25%	2x to 5x	36.78%
No growth	15%	1x	0.00%
Business fails	15%	-1x	-100.00%
Portfolio Average		3x to 5x	30.00%

An average VC portfolio will have 20 to 30 companies, each requiring \$2 million to \$3 million, for an overall portfolio size of approximately \$70 million. It is more difficult to achieve the standard mix with fewer companies.

A second rule of thumb relates to the definitions of each growth profile. These are normally expressed as a multiple returned on the originally invested capital. To compensate for the write-offs in the mix and to maintain the portfolio’s overall returns, the portfolio superstars have to be big winners - companies that create at least \$50 to \$100 million or more of market value. Lastly, the type of VC fund (i.e. Seed Stage, Later Stage, Expansion, etc.) will determine the number of years over which the growth rate must be sustained to meet the return expectations. In Table 1, the average investment life is shown to be five years (the Cumulative Average Growth Rate).

Obviously, VCs intend to maximize the returns they expect their fund to achieve, in part to ensure investors will support their efforts to raise other funds in the future. As a result, there must be a logical possibility for every portfolio investment to create at least \$50 million of market value and to return five to 10 times the invested capital. That only a fraction actually do is function of normal market forces.

With these various expectations, the average VC portfolio return is 30%. Seed Stage VC funds normally expect higher returns of, say, 45%. As an investment class, venture capital portfolios will generate annual returns of between 35% and 45%.

D. A LOOK AT ANGELS' PORTFOLIOS

Not all Angel-backed companies go on to attract venture capital (i.e. not all are on the "VC Path"). According to research by Alan Riding, only about 52% of Angel-backed companies go on to attract venture capital. In other words, only 52% of Angels' investments should expect returns that are comparable to those of VCs.

Let's not forget two other factors in this discussion though. Angels normally invest at least one round before VCs, presumably at a lower valuation. By "coming in sooner," Angels effectively assume greater risk and, as the saying goes, "higher risk, higher reward." If this is true, then Angels should expect a marginally higher return (about 40% to 50%) on the companies in their portfolios that have attracted venture capital.

But not all Angel-backed companies go on to attract venture capital. It seems intuitively obvious that, almost by definition, venture capital flows to the "riskiest" and highest return opportunities. The corollary seems to be that investments in non-VC Path companies will yield annual returns that are below 35% to 45% (otherwise VCs would choose them).

This would suggest that, on average, 42% of Angels' investments are in opportunities that generate annual returns below the typical VC portfolio. A weighted average calculation of the returns from VC-Path companies and other types of investments suggests that there is a structural reason why Angels' returns will always be below those of VCs. Alternatively, for Angels to have a higher return than for VC portfolios, 100% of the Angels investments would have to be VC-Path companies.

This discussion becomes further complicated by the realization that VCs' returns are often given a higher priority to Angels' returns (hence, a higher probability) with the benefits of many common term sheet clauses, such as:

- Liquidation preferences
- "Pay-to-Play" provisions
- Anti-dilution provisions
- Redemption privileges
- Dividend privileges

The impact of such term sheet clauses is discussed elsewhere.