How profitable is angel investing? V3

What is the purpose of this article?

1) Share with you some fact-based profitability analysis from the U.S. angel community. I am not aware of similar detailed fact-based based analysis of the Canadian angel community.
2) Enable you to think about whether you want to make money as an angel investor and what you might have to do to make money.

What are the critical learnings in this article?

1) The chances of you making money depend upon both a large portfolio and investing early.
2) A study of 10,665 investor portfolios showed the realized and unrealized IRR to be 15% BUT the median IRR for a portfolio of 50 companies was about 10%. 11% of the 50 company portfolios lost money.
3) Most returns come from a single large exit. You may need: a large portfolio, luck, and being able to wait 10+ years.

What are the three ways to look at angel investing profitability data?

1) As an overall asset class, considering many angel investors.
2) As an individual angel group or angel fund.
3) The profitability of an individual angel investor, such as yourself.

You have the potential to make money as an angel investor if:

1) You or your co-investors have deep market knowledge of each portfolio company's customers and market.
2) You devote significant time to due diligence.
3) You remain involved with the company post-initial financing.
4) You have the financial resources to create a diversified portfolio of at least 25 companies and to make follow-on investments.
5) You can wait 10 years to achieve a significant financial return.

How profitable has angel investing been in the period leading up to 2007?[1]

This study examined the results from of 1,137 exits ((acquisition, IPO, or company closure) from 539 angel investors in angel associations over a 20-year period, with most of the exits occurring after 2004. The average return was 27% (excluding out of pocket costs and assuming zero value for the investors' time).

Due diligence had a large impact on investor capital returns.

1) Angels who spend less than 20 hours have an average return of 1.1X capital.
2) Angels who spend more than 20 hours have an average return of 5.9 X capital.
3) Angels who spend more than 40 hours have an average return of 7.1 X capital.

Investor knowledge of the portfolio company's industry had a large impact on capital returns.

1) Investors with at least 14 years of relevant industry experience had double the capital returns of investors who did not have relevant industry experience.

Ongoing involvement with the portfolio company (e.g. coaching and mentoring, being the lead investor, serving on the advisory board or board of directors) has a large impact on investor returns.

1) Angels who interacted with the company twice a month achieved a 3.7X return.
2) Angels who interacted twice a year received a 1.3X return.
3) Interacting more than twice a month does not improve returns. The quality and type of interaction was more important than frequency.
4) 52% of all exits were at a loss.
5) 7% of the exits returned more than 10 times the money invested, and accounted for 75% of the total returns.
6) 39% of the investors had portfolios that lost money.
7) The top 10% of investors earned 50% of the returns.
8) 45% of the startups had no revenue when they received the angel investment.

How profitable has angel investing been in the period leading up to 2020? [2]

The data scientists at AngelList analyzed 10,665 investor portfolios. The analysis showed that the realized and <u>unrealized</u> IRR for all the investments is 15%. The 2007 study above only examined <u>realized</u> IRR.

The median IRR return for investors is heavily driven by the number of companies in their portfolio.

1) 50 company portfolios had a median IRR of about 10%; 11% of these investors lost money.

2) 20 company portfolios had a median IRR of about 7%; 16% of these investors lost money.
3) 10 company portfolios had a median IRR of about 6% 32% of these investors lost money.
1) 1-5 company portfolios had a median IRR 0%.

What has been the performance of some individual angel funds in the U.S. in 2020?
The ACA (Angel Capital Association) Investor Insights report for 2020 shares insights from some large, long established U.S. angel groups. My article does not name those groups. You should refer to the report if you wish the names of the groups. The report is available to members of the ACA.

Angel group A analyzed 159 outcomes (exits and shutdowns) since 1997.
#1 A large portfolio is key to large returns
1) Equal sized investments in all the companies would have generated 4.8X return.
2) 3 of the 159 exits generated 74% of the total return.
3) Monte Carlo simulation showed that only 26% of investors with 5 company portfolios would have obtained 4.8X return
4) Even with a portfolio of 50 companies, there was only a 37% chance of achieving 4.8X return.

#2 Large returns require investors being able to wait 10 years.
1) It takes 4.5 years for investors to get their initial investment back. There are lots of failures in the first few years.
2) It takes 10 years to achieve 4.8X return. After 10 years, there is a very modest increase in returns.

Angel group B analyzed the return of their 27 members over 20 years.
1) A large portfolio is key to large returns. Investors with 25 company portfolios had 4.5 times the IRR return of investors with 1-4 company portfolios.

How profitable has an individual portfolio and 3 angel funds been?[3]
The ROI's ranged from 7.2% to 7.7%%, significantly below the S&P 500 index.
This analysis was based on the timing and dollar amount over every individual investment and exit.

Why the difference from other published results?
1) Published results for angel groups often don't consider the timing and dollar amount of every individual investor action. Assumptions are made because the angel group members don't share details for every transaction.
2) One example of the impact: an angel group reported a 12X return while analysis author only got a 1.5X return. The 12X return was if you invested day 1. The author invested in a later round. The angel group analysis assumed that all investments were made on day 1.

Some of the conclusions the author came to included:
1) Most returns come from a single large exit. You need a large portfolio and luck.
2) Expect to wait 10 years to get original investment back and 12-15 years for the big wins.
3) The real return from angel investing is the satisfaction of helping founders.

What are your next steps?
1) Review your overall investment thesis e.g. what asset classes will you be investing in, why, and what expected returns (this includes volatility, and time to achieve returns)
2) Determine is angel investing would be a charitable activity or an asset class that is helping you achieve your overall investment thesis. Many angel investors are not interested in financial return, and their angel investments are not part of their financial return focused investment portfolio.
3) Define your angel investment thesis.
4) Determine if you have the skills, knowledge, and finances to create your own diversified portfolio or if you will invest with fund managers or if you will join a group of angel investors.
5) If you are investing with a fund manager you must do due diligence. It is key to analyze their cash returns over 10 years. I have come across many funds that include unrealized returns. Unrealized returns are not cash in the bank. You will also have to assess their talent and processes. If the funds returns are driven by only one exit, you must determine if their overall results have been driven by luck or by knowledge, skills, experience, and processes.
6) If the fund manager is just starting their fund or has only been in operation for a few years, then you need to do more detailed due diligence, just as you would for any other startup. If you don't have deep relevant experience in the fund industry, then you need some with that experience to work with you. Your due diligence focus will be on talent assessment and the fund's investment thesis.
7) If you decide to invest via an angel investor group, you need to do due diligence. You need to asses whether the processes and talent will help you build and manage a profitable long-term portfolio. It is key to analyze the groups

metrics and cash returns. One large U.S. angel group tracks 83 (yes 83) metrics for every investment made by a member. Some U.S. angel groups have detailed metrics regarding their members. If the group's return is driven by one large exit, then you must determine if their overall results have been driven by luck. Assess which members have deep relevant industry experience aligned with your angel investment thesis. Assess the angel group processes. If you don't already have deep relevant angel investing experience, then you need help from those who have that experience.

Footnotes

[1] Robert E. Wiltbank, PhD Willamette University, Warren Boeker, University of Washington, "Returns to Angel Investors in Groups, November 2007"
https://www.angelcapitalassociation.org/data/Documents/Resources/AngelGroupResarch/1d%20-%20Resources%20-%20Research/ACEF%20Angel%20Performance%20Project%2004.28.09.pdf

[2] "How portfolio size affects early-stage venture returns", Nigel Koh and Abfraham Othman, AngelList,
https://angel.co/pdf/lp-performance.pdf

[3] "How much do angle investors earn?", DC Palter
https://entrepreneurshandbook.co/how-much-do-angel-investors-earn-1bc06cc8166f#:~:text=Conclusions,from%20a%20single%20huge%20exit.

What further reading should you do?

Are you an angel investor or a gambler?
This article contains an example of the capital you need to be an Angel investor.
http://koorandassociates.org/selling-a-company-or-raising-capital/are-you-an-angel-investor-or-gambler/