

Organizing Angel Investment to Benefit Angels, Companies, and Communities

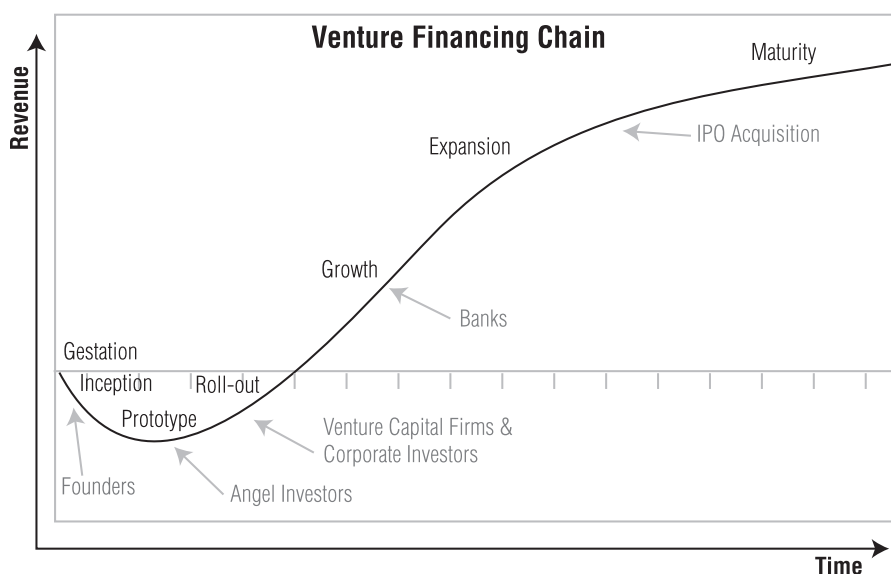
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Across the country, thousands of promising small companies need financing and sound business counsel if they are to grow and meet their potential. Many of these companies are in rural communities not targeted by traditional venture capital—communities that could benefit enormously from the jobs, wealth creation, and quality of life that growing companies provide. These same communities are also often home to wealthy individuals who have an interest in investing their money in ways that provide a return and also contribute to their community.

The Role and Challenges for Angels

Angel investors are the largest private source of capital for early-stage entrepreneurs, and they are the most likely source of seed and early-stage capital. While venture capital is typically aimed at companies that are more developed and are ready for larger investment dollars (\$5 million or more), angel investors provide private financing for emerging growth companies that are too small to attract venture capital but too big to rely on funding from family or friends. Even though the amount is less than venture dollars (anywhere from \$50,000 to \$1 million or more), angel dollars often come at critical points in a company's development, enabling it to get past funding and growth hurdles in its early years.



Angel investors are defined as individuals with income exceeding \$200,000 or having a net worth of more than \$1 million. Our experience is that 60 percent or more of angel investors are often self-made, cashed-out entrepreneurs who have capital and business experience and are interested in helping other companies grow.

There are an estimated 20 million prospective angels nationwide, but only about 227,000 to 350,000 angels who are actively investing. The Center for Venture Research indicates that in 2005 angels invested \$23.1 billion in 49,500 companies.¹ And unfortunately for rural ventures, most of the active investors tend to be in major metropolitan areas.

According to the Angel Capital Education Foundation, approximately 90 percent of outside equity capital in seed/start-up companies comes from angel investors. Angels also invest more money in a greater number of companies than the venture capital community, and they have a better record of companies that go public than those invested in by the venture capital community. In addition to money, angels invest time and expertise in companies that can help them be more successful.

The challenges for angels trying to invest by themselves can be daunting. Deal sourcing and reading business plans are time-consuming; due diligence may require locating and using outside experts, sometimes at a cost; and legal support can be expensive. In addition, it requires time and expertise to monitor the investments and determine follow-on or exit strategies. One way to overcome those obstacles is to join a group of angel investors because members share the work, the expertise, the risks, and the rewards of investing.

RAIN Funds and the RAIN Fund Network

This intersection of growing companies, investment interest, and community needs has helped fuel the development of RAIN Source Capital, an organization that organizes, capitalizes, and manages groups of angel investors into RAIN angel funds. RAIN Source Capital is a growing multi-state network of RAIN® funds that works with angel investors who are interested in supporting growing companies. RAIN Source helps bring together like-minded angel investors to form individual RAIN funds, and then provides these funds with additional capital, a process for due diligence, legal templates, management support, access to deal flow, and other resources. In fact, RAIN funds share expertise, deals, and experience between and among the RAIN funds to support growing companies throughout the area.

RAIN Source Capital got its start in July 1998 as the Minnesota Investment Network Corporation, with initial capitalization from a quasi-state agency in Minnesota. The organization increasingly gained the interest and support of institutional investors and foundations, and led to expanding opportunities beyond its initial geographic focus of Minnesota. In early 2006, we became RAIN Source Capital, with a focus on developing RAIN funds in

¹ "The Angel Investor Market in 2005," Center for Venture Research, University of New Hampshire Whittemore School of Business and Economics. The report is available at: http://www.unh.edu/news/docs/CVR_2005.pdf.

Minnesota, Iowa, North Dakota, South Dakota, Montana, Oregon, Idaho, and Washington, with ongoing interest coming from other states.

As of November 2006, the RAIN network included 19 funds, with more than \$20 million invested in 40 companies. Funds range in size from seven to 61 members, and they have pooled anywhere from \$500,000 to \$2 million. Through RAIN Source Capital,

- members can co-invest with other funds, enabling funds to consider more investment opportunities and leverage the expertise available throughout the network
- members have access to RAIN[®]street, a proprietary Web-based deal flow and due diligence tool
- members meet annually at the RAIN[®]makers conference to hear national speakers, share strategies, and build on the success and experience of individual RAIN funds

The RAIN fund concept grew organically, based on the experience we gained from working in venture capital, seed funds, and economic and community development. More recently, two other models for working with groups of angel investors have emerged. The first is a club model, where people pay an annual fee and attend luncheons featuring presentations by pre-screened companies. Individual investors follow up with the companies they are interested in funding. The second model is the formation of a limited liability corporation (LLC) that is professionally managed. Members pay a fee to join, and a formal management team makes the investment decisions. RAIN Source Capital operates as a hybrid of these two approaches, even though it predates both of them.

The RAIN fund model offers several advantages. First, it allows us to bring small towns into the game of investing in a meaningful way. Essentially, our model is an example of what Thomas Friedman describes in his book *The World Is Flat*, as opportunities for the “small being able to act really big” and from anywhere—you don’t have to be in a big city to be an entrepreneur or an investor.

Second, because individual funds can tap into other funds in the entire network, they can leverage the broad base of intellectual and financial capital. That allows an investor with a \$100,000 commitment to have a network of 200 experts and many millions of dollars in capital support. In addition, experience has demonstrated that most RAIN fund members invest about the same amount of capital side-by-side in the local RAIN fund as they commit to their local fund. For example, a member who commits \$50,000 to a local RAIN fund will often also invest another \$50,000 side-by-side in deals their RAIN fund invests in. Now multiply that by 20 members, each of whom does the same thing. The result may be another \$1 million of leverage.

The process of forming a fund has three stages:

- **Formation**—potential members begin to develop trust, gain an understanding of the RAIN fund and angel investing concept, and establish fund leadership. Individual fund members must be accredited angel investors, with an average investment of anywhere from \$25,000 to \$100,000 in the fund.

- **Capitalization**—members develop the focus of their fund and raise initial capital. We require at least \$500,000 in capital before a fund can be launched.
- **Operation**—fund members start operating as a group and begin actively pursuing and reviewing potential deals.

Along the way, we have experienced a few obstacles in developing new funds. For example, before the stock market bubble burst in 2000, many investors felt they could make money in stocks and did not need to consider other options. Then, after the bubble burst, it took time for people to get back to the reality of what a normal return on investment looks like and what a normal timeline is for investing. So at least in the late 1990s, it was not the easiest environment presenting the message about RAIN funds. That's different today. There is a lot more understanding and interest in being an active investor and in having colleagues who share the work.

Monitoring the RAIN funds is relatively easy because RAIN Source Capital is an active investor in each of the funds. We are at the table for investment meetings and know what is happening. In addition, we have developed proprietary software that provides value-added tools to each RAIN fund, and that software also enables us to help support and appropriately guide fund activities.

RAIN Source Capital and its network of RAIN funds have supported a variety of companies. For example:

- The network aggregated \$700,000 of capital to help finance the turnaround of a rural electronic repair business employing 450 people.
- Another rural enterprise turnaround was 100 percent financed by the network with \$1.5 million invested. RAIN Source Capital and a lead RAIN fund put the financing together, organized the Board of Directors, and brought in new management team members.
- A rural medical-device company has had support from the network since its seed stage. The network has provided \$3 million of the total \$13 million raised by the company, which is now completing its FDA application.

By design, RAIN funds both meet the needs of potential angel investors and benefit entrepreneurs and communities. "Angel investment groups can have an enormous difference in the number and quality of deals that angel investors can consider, as well as in the amount of potential capital available in a given region," said Marianne Hudson, director of angel initiatives for the Kauffman Foundation's Angel Capital Education Foundation, based in Kansas City. "Through its RAIN funds, RAIN Source Capital adds an excellent structure that makes investment options much more streamlined for angel investors. This also helps fill a huge capital gap for entrepreneurs."

Angel Funds Benefit Investors, Entrepreneurs, and Rural Communities

Formed as LLCs, RAIN funds are member-led groups of like-minded angel investors who pool their finances, their expertise, and their time to invest in companies. The best candidates for membership in RAIN funds are people who have money to invest, are interested in becoming active investors in growing companies, and see fund membership as part of their social and community involvement. In addition to individual investors, funds can also include participation by banks, local units of government, foundations, and other institutional members, as determined by the individual fund.

Member-led, each RAIN fund determines what industry it will focus on and the type and level of financing it will provide, based on the interests and expertise of the fund members. The members decide which companies to invest in, the amount of the investment, and the length of time to invest.

RAIN Source recommends how a fund can be structured, but each fund determines roles and responsibilities of specific members. Just like any group, some fund members are more active than others. Some members may want to play an active role in due diligence or monitor a company's performance. Others would rather just attend meetings and vote on the issues in front of them.

"RAIN Source Capital provides a solid template that makes it possible for people who would like to be active investors to step up to the plate," said John Reid, a RAIN fund member. "Through the RAIN funds, individual angel investors can share the expertise, the capital, the work, the risk, and the financial and emotional rewards of supporting entrepreneurs, building growing companies, and having a positive impact on their community, as well as making money."

RAIN Source Capital and the RAIN funds work to help entrepreneurs by building and nurturing their solid growth companies. In addition to capital, RAIN funds contribute strategic, financial, and operational expertise to help companies grow.

RAIN Source Capital has developed a procedure that makes it relatively easy for entrepreneurs to receive initial consideration for funding. Companies may contact RAIN Source Capital at any time by phone or e-mail to start the process of funding consideration. Initial screening involves providing preliminary information and answering six proprietary questions. Companies selected for a next level of screening are given the opportunity to make a presentation to a RAIN fund.

Companies in a variety of industries and with different growth needs are eligible for funding. In general, emerging companies that need early-stage capital, or need financing to support expansions, turnarounds, ownership transitions, and related growth opportunities, are eligible to be considered for financing. Ideal candidates for financing consideration are businesses that have already raised some capital from angel investors (family and friends) and have the potential to become a \$10 million company within five years. The only restrictions are that RAIN funds do not typically invest in restaurants, retail operations, or in mining or timber companies.

RAIN Source Capital works to provide timely feedback and expedite companies through the process. If a company is selected for financing, the process may take two to five months from the company's initial inquiry until the first check is mailed. The organization offers competitive investment terms and conditions commensurate with the geographic business environment. Through RAIN Source Capital's multi-state network, companies have the opportunity to be considered by more than one fund. Companies that receive financing can be considered for follow-on funding by one or more RAIN funds.

Finally, RAIN funds provide a vehicle for rural communities to harness and focus their capital on local business ventures. These networks are particularly beneficial in bringing the power of angel investing to smaller communities that are home to emerging entrepreneurial companies but are not typically targeted by equity funding sources. RAIN funds benefit communities by:

- Creating a sustainable investment fund
- Providing a source of capital and expertise critical to early- and high-growth companies
- Helping to recruit and nurture technology companies that pay good wages
- Building the capacity for local wealth creation
- Growing businesses that create good jobs

For example, one rural company had two employees before the investments by the RAIN funds; today that company has 22 employees, the majority of whom are in technical, high-wage jobs.

In addition, one fund usually cannot support a company's growth needs. Through the RAIN fund network, communities can draw from the entire network of RAIN funds as a local company grows.

"Launching our fund is the realization of a long-term idea for some of us," said Duane (Dewey) Tietz, chairman of a North Dakota RAIN fund. "For the past four years, we have been trying to put together something like this, where individuals have an easy way to help invest in our local companies. But we weren't able to get it structured and off the ground. Then we heard about RAIN Source Capital and its RAIN funds, and we realized this is exactly what we have been trying to do. We will be able to benefit from the business model developed by RAIN Source Capital and support area entrepreneurs, inventors, and small businesses that want to grow. In doing so, we can also help create the kind of dynamic, prosperous environment that provides opportunities for young people to stay and work in the area."

Future Growth: Opportunities and Challenges

Various reports estimate that by 2013 the number of millionaires in America will triple, thanks to inheritances from World War II-generation parents. If that's the case, we have even more opportunity for up-and-coming investors to support growing companies.

RAIN Source Capital is proceeding with a growth plan that includes forming at least one RAIN fund a month. To do so, we are educating potential angel investors through seminars and other outreach programs, as well as providing them with tools for organizing and establishing RAIN funds.

We are also building infrastructure and resources to help fund members take full advantage of what the network has to offer, because, in this case, we know that the sum truly is greater than the parts. With each new fund that we add, the opportunities for RAIN fund members grow exponentially. Through the network of funds, we are unlocking the door to more angel investor dollars, expanded deal flow, and more experience to tap into.

All around us are examples that underscore the importance of angel investors. Amazon.com, Google, and many other companies point to angel investors as having been instrumental in providing them with the funding they needed at the right time in order to survive and grow.

For the angels who participate in RAIN funds, the stories can be even more compelling, because RAIN fund angel investors are often motivated by helping other entrepreneurs and having a positive impact on the community, as well as making money. In fact, that is really how RAIN Source Capital got started. Before RAIN Source, I ran a seed fund that helped make an investment in a southwestern Minnesota company, a company that was in the business of making dumb valves smart—by putting controls and intelligence into valves used in a variety of industries, from hazardous waste control to other applications. Local members of the community also wanted to invest, and talked about wanting to figure out ways to work together to leverage our knowledge as well as our capital. Those discussions really led to the first RAIN fund. In addition to providing funding, RAIN Source Capital and the RAIN fund helped the company round out its board of directors, implement good governance procedures, hone its business strategies, and connect it with an ongoing financial manager. In addition, RAIN Source Capital served as a partner in negotiating the company's sale in a way that enabled the company to continue to grow and provide jobs in its community. That sale also became the fund's exit strategy. This is one of many examples that are occurring across the network of RAIN funds.

Our goal is to increase the expertise and the size of the angel investor community in areas of underinvestment. Angel capital is a long-term investment that gives investors the opportunity to take an active role in supporting growing companies. It can be very rewarding not only to be part of a company's success, but to see its broader contributions to the community as well.

Steve Mercil is the founder, president, and CEO of RAIN Source Capital. A board member of the Angel Capital Association, he is a pioneer in bringing angel investment opportunities, which have historically been clustered on the coasts, to states across the country and to the often-ignored rural areas of those states.