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Angel Investment & the Global Financial Crisis

The global financial crisis triggered by the USA sub-prime disaster continues to spread and deepen. The question is being asked, "How are angel investors affected?"

Answers are offered here in three parts, being for angels, for angel-backed companies and for the community at large.

FOR ANGELS:

Angels predominantly invest in early-stage companies committed to high growth over a period of 3-6 years. Early-stage investing is inherently counter-cyclical. In other words, when times are hard and the 'market' is depressed early-stage investors are eager and active. Witness the marked activity of those quality VC firms around the world who already have their investment funds. VC who do not have their funds probably won't be raising new funds any time soon.

In down turns valuations are lower and the quality of entrepreneurs is often higher because the market is

not cluttered with me-too guys and gals attracted by the successes that appear in the early days of the up turn in the cycle. Those very successes are the ones nurtured by investors who invested during the down turn.

It usually takes 2-3 years to build a business to the point where it is best equipped and positioned to take advantage of an upturn in the market. Further, a business developed and refined during lean times is more likely to be an efficient, responsive operation able to optimize margins and adapt rapidly to market change.

At the personal level, angels have a choice about where to place their funds. In down markets the decision to put their discretionary funds in the hands of brokers and bankers who live off transaction fees is less appealing. The decision to invest in angel deals is a vote of confidence in themselves and their ability to use their own skills,

experience and networks to build and harvest value.

FOR PORTFOLIO COMPANIES:

From the entrepreneur's perspective money is never easy. In the years ahead raising investment capital will be even more challenging. Around the world early-stage investors (angels & VC) are advising their portfolio CEOs to batten down the hatches and plan for a prolonged period of self-sufficiency.

As always for young businesses, cash is king so, unless a company has over 12 months of cash reserves, it should raise funding as soon as possible and raise as much as possible.

If a company's market position is weak and/or the target customer segment is severely impacted then cash requirements will be going up. In those cases aggressively

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News 2009 NATIONAL ANGEL CONFERENCE – BRISBANE, FEBRUARY 18-20

You will shortly receive your invitation to register for the 2009 Conference. To get the member's discount join AAAI now and receive a full 2009 membership. Just check our web site for information, or email your request for a membership application to info@aaaai.net.au.

The conference will open with networking cocktails the evening of February 18th, 2009 on Brisbane's stylish South Bank Boardwalk. Earlier that day all AAAI conference delegates will enjoy free admission to the Queensland Government Clean Technology Investor Forum featuring Australian and International angel and venture capital speakers, followed by presentations from ten Australian CleanTech companies.

That afternoon the AAAI has organised a Government Policy Forum around the theme "Angel Investors Drive Innovation". Federal, State and Territory governments are invited to a collaborative session with AAAI to identify opportunities to work together to increase the economic success of Australian innovation.

Following on the success of the 2008 conference, the first morning of the conference will again be dedicated to Master Class workshops in angel investing. Following those sessions and the Active Deals lunch the AAAI is pleased to again provide an array of local and international speakers from the angel, venture capital and service provider sectors in six interactive panel sessions.

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Angel Investment & the Global Financial Crisis

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examine and pursue M&A opportunities. Remember, everybody will have lower valuations and now might be the perfect opportunity to combine with one or two competitors to ensure that, together, there are resources to weather the crisis and to ensure critical mass (including funding, customers, rolodex power, market share, cash, synergy, etc.). Or consider getting closer to corporate partners as investors, or even as acquirers.

Hopefully, entrepreneurs already know how much cash they have, their expenditure at the current "burn rate" and when they will run out of cash. They need to cut costs, even if it means staff reductions, fewer features and lower general expenses. This is equivalent to raising an internal round through cost reductions to buy more time before the need to raise money again. Losing staff is hard and often emotional but, consider services for

their higher capital efficiency.

Re-evaluate development plans, customer acquisition timelines and revenue milestones to achieve more with less. Sounds like blood out of a stone to most entrepreneurs but, this is essential to survival. The lesson learned from the Tech Wreck and other down turns is that the winners are those left standing.

First to market means bearing the brunt of market education and other front runner costs that demand deep pockets. Speed to market remains critical but, aim to be the last one standing.

FOR THE COMMUNITY:

High growth SME are a key driver of our economy. These businesses drive product and service innovation thus lowering costs for customers while driving their own growth of revenues, staff and profits.

Small, agile businesses backed by experienced, successful business people can rapidly address the changing needs of the distressed markets. While large firms struggle to adapt through mass lay-offs and other unproductive cost cutting efforts they become more aggressive acquirers of innovative technologies and services that improve their productivity. The interplay of angel-backed businesses can sustain, or introduce key capabilities for the competitive advantage of Australia.

A vital, active angel community applying its resources to fostering, mentoring and funding commercially successful innovation while working in partnership with inspired government leadership and initiatives can underpin the rapid evolution of Australian business that is essential to protect and improve our lifestyle, our culture and our security.

Venturous Australia - The National Innovation Review Green Paper

The AAAI Board received substantial assistance from a working committee of members and supporters via the AAAI Policy Committee to submit a detailed report to the Innovation Review. A copy of the submission is available on the Review web site (www.innovation.gov.au/innovationreview/Pages/SubmissiontotheReviewA-D.aspx).

This was a huge, two month, intensive, volunteer effort by dozens of AAAI members and associates reflecting the concerns and vision for the innovation sector of the AAAI constituency. Thanks to AAAI directors Jordan Green, John Ballard and their dedicated team of volunteers for a comprehensive and well-considered submission.

With cuts to state and federal research grants angel investment is an essential element to filling the Funding Gap (see submission for description and quantification of the Fund Gap).

The AAAI is very pleased to note that the Innovation Review Green Paper prepared by Cutler & Company Pty Ltd recognised the importance of angel investing to fund early stage innovation with a specific recommendation to support the organised angel community (Recommendation 9.10).

COMMENTS ON THE GREEN PAPER

Comments were invited by the Government on the Green Paper and the AAAI Board took the opportunity to reiterate and elaborate on the specific support that government can provide to encourage and support a vibrant angel contribution to the innovation economy. Features of those comments included:

- AAAI support for recommendations 8.2, 8.3, 8.4, 8.5 and 8.6. The proposal for a refundable Tax Credit of 50% to smaller firms and a 40% non-refundable Tax Credit to larger and foreign-owned firms strikes a good balance.
- AAAI concern that the Review has not explicitly stated that the proposed Tax Credit of 50% will be extended to tax loss companies where the shareholding of public sector institutions is above 25%, the limit imposed under the current R&D Tax Offset program.
- It is becoming common in other Western countries, including many USA states, to provide tax credits to individuals who invest in early-stage innovative firms. AAAI recommended that similar arrangements be considered in Australia and be extended to SMSF to help access crucial funding support for innovation and help prevent Australia falling further behind other countries in innovation performance.
- AAAI strongly supported recommendation 9.10 that angel groups be supported to establish increased profile, networking and to promote investor-education programs. [Ed: *Bet that's a surprise 😊*]
- The proposal to establish a competitive grants program to assist innovative firms (recommendation 9.1) is inferior to and overlaps with the proposed 50% Tax Credit for innovative SME. Because it would be repayable from royalties or earnings streams, it is similar to the R&D Start loans program which was discontinued some years ago, apparently due to poor acceptance from industry. There would also be serious difficulties for asset-poor companies having repayable loans on their Balance Sheets because there would be a risk of the firms being considered as trading while technically insolvent.
- AAAI supported the proposal to expand the COMET program and extend it for another five years (recommendation 9.2). AAAI also supported the proposal to include a voucher to fund collaboration with public sector research institutions within

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Stop Press

Special thanks to Investec Bank, Macpherson+Kelley and ICN (Victoria) for their generous support of the October AAAI Summit in Melbourne. ICN hosted the two days of Board meeting, Macpherson+Kelley hosted a boardroom lunch in their city office and Investec hosted a delightful cocktails networking event in their offices.

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Events - AUSTRALIA

AAAI National Angel Conference
 February 18-20 2009 Brisbane

Melbourne Angels
 Lunch October 31st 12-2pm, Toorak
 Meeting November 12th 4:15-6:15pm

Capital Angels Meeting
 October 22nd 6pm Canberra

Brisbane Angels Entrepreneurs Welcome
 October 21st 6:30pm Brisbane

BioAngels Meeting
 November 12th 5:30pm Adelaide
 December 10th 5:30pm Adelaide
 (w/SA Angels)

Queensland Gov't Clean Technology Investor Forum, February 18th, 2009 Brisbane

INTERNATIONAL

Angel Association New Zealand Summit 08
 5th November

Cable Bay Vineyards, Waiheke Island

EBAN Winter University
 21st October, Luxembourg

EBAN 9th Annual Congress
 27-28 April 2009 Madrid, Spain

ACA National Summit
 15-18 April 2009 Atlanta, Georgia, USA

COMMENTS ON THE GREEN PAPER**[FROM PAGE 2]**

COMET (recommendation 9.5) but had some concern that it would be complex and expensive to administer. AAAI noted that the National Manager of COMET had indicated the importance of angel investors in COMET-supported companies with 69% of firms reporting subsequent equity capital raised from angels.

- AAAI recognised that attraction of international venture capital funding to Australia (recommendation 9.6) is potentially worthwhile but the profound trend of VC funds towards support of more mature companies may not be the best use of Government funding that is intended to promote innovation in Australia.
- AAAI supported recommendation 9.8 to introduce a fourth round of the Innovation Investment Fund.
- AAAI supported the need for Government-supported funding to firms at a stage earlier than provided by the IIF program, but did not consider that the present arrangements for Pre-Seed Funds are ideal (recommendation 9.9). Instead AAAI suggested that an "evergreen", or "recirculating" fund be established with 100% Government funding that invests on an automatic dollar for dollar basis with accredited angels, or accredited angel groups after those investors have completed due diligence and negotiated investment terms with the potential investee. This arrangement would substantially reduce the operational costs of the fund because the role of the contracted fund manager would not include selection of investees, due diligence nor post-investment support, all of which would be carried out by the accredited angels, or angel groups. Moreover, this process would introduce access to groups that are most appropriate for providing funds and mentoring at the pre-seed stage, while

the "evergreen" arrangement would overcome the present dilemma that a Pre-Seed Fund must exit an investment within a fixed timeframe even if liquidity has not been achieved.

- AAAI supported recommendation 12.1 that a new National Innovation Council be established to replace PMSEIC. AAAI further supported the proposal that members be appointed on the basis of individual merit, taking into account their "overall experience and links within the sector". AAAI suggested that this overall experience should include experience in investing within the innovation sector.
- AAAI supported recommendation 12.4 that the AusIndustry network should be the single major agency to deliver innovation support for firms.

AAAI made suggestions as a constructive guide for programs to be implemented under Recommendation 9.10. Consistent with practices of angel investors worldwide, who are always self-funded, none of the payments would provide direct or indirect salary support to angel investors.

The suggested programs covered angel education, development of an angel accreditation program, industry data collection, international collaboration and support for the growth and accreditation of regional angel groups.

As emphasised in the Vitale Report delivered to DITR in 2006, there is only anecdotal information on the quantum and outcomes of angel investments in Australia. That report estimated angel investments of USD2.55bn in 2003 in Australian firms, seven times the amount of classical venture capital investments. AAAI proposes to work in collaboration with AusIndustry and ABS to provide comprehensive annual reports to our members, DIISR and the community.