Mr. Chairman and Committee Members:

Reasons for Angel Fund Investment Tax Credits in North Dakota

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North Dakota needs to **diversify and grow its** economy that is all too dependent on the energy and agriculture sectors. **Private investing in Innovation, entrepreneurship and technology is key** along with developing a **capital industry** along with venture development services and programs.

The **Angel Fund Investment Tax Credit** is **essential** to:

1. Provide **incentive to create an early stage capital** industry in North Dakota – starting from zero, infant industry with a long way to go
2. Provide **incentive for angels to gather together** in pooled funds to professionalize and maximize private equity – long horizon for ROI
3. **Syndicate with angel funds outside North Dakota** to draw capital to ND deals – capital must flow both ways or won't happen
4. Form the capital to attract **Entrepreneur Ventures** - access to capital is essential magnet for new venture formation.
5. Be **years before Angels** have a **Return on Investment (ROI)** - only return on capital so far is tax credit – high risk, long term return investing. Takes years to build large company.

When established by the Legislature, the **angel fund tax incentives** were **about creating an equity capital industry** in North Dakota, *not the usual economic development incentive*. The Seed Capital Tax Credit came first to encourage individual angels to invest in North Dakota companies, but the results were meager. **Angels needed to aggregate** to form angel funds, utilizing seed capital tax credits to help other angels follow the lead angels in pooled funds. Thus the state needs to **measure capital**, not jobs or companies. The state needs to measure how many **angel funds were created**, and how much **total capital was aggregated**, and how many **out-of-state investors were attracted**. On these measure the angel fund investment tax credit **is working** to form an early stage capital industry, but it is still a small beginning. North Dakota ranks 47th out of 50 states in venture capital so we have a long way to go to be truly competitive.

Angel Funds need to build a **strong portfolio** of venture investments, and they **cannot be restricted to in-state deals.** They need to build a strong portfolio and strong deals will find them. The ND deal flow is not strong enough to do only North Dakota deals, and any venture capital funds restricted to a single state has been a failure. **State politics should not dictate investment.** Investment opportunity should direct the investment activity, not government interference. Restricting investments to North Dakota would likely destroy the emerging angel fund industry as angel investors would quickly loose interest with that political restriction. They know they could not attract out of state syndication to fill out the required investment round. No sense trying to win a tough battle with your hands tied behind your back.

In 1993 North Dakota became the 2nd state in the nation to offer Seed Capital Tax Credits (behind Maine in 1987) to provide a tax incentive for angel investors to invest in high growth entrepreneurial ventures that create jobs, wealth and a more diverse economy. The tax credits were restricted to the long form and were not utilized until 2002. Nearly 100 certified companies have utilized the seed capital tax credit since 2002, and average of 6 to 7 companies per year with an average of 15-20 investors per company who are not family or partners (ineligible). Nearly $50 M was attracted under the program over 13 years. Over the last six years there is an average of $336,000 of tax credits issues per year to attract **$4.5 M of seed capital investments**. *The state incentive worked as* ***angels invested $50 M in companies.***

North Dakota *became the* ***first state*** *to approve tax credits for* ***Pooled Angel Funds in 2007,*** encouraging angel investors to form **angel funds** to build investment portfolios in entrepreneur ventures. ***The 45% tax credit is responsible for the formation of 22 angel funds in North Dakota, a vital source of entrepreneur capital that did not exist before.*** *The tax credit has a maximum credit of $45,000 per year per investor i.e. on the first $100,000 invested in growing ventures.* An average of 25 angels pooled their investments in 22 angel funds to build a portfolio of 10 or more ventures, a larger portfolio that hopefully there is more wins than losses. The Tax Dept reports **22 Angel Funds - with 553 investors - invested $41.3 M**, which included **34 out-of-state investors** investing $3.9 M. Plus there was syndication with out of state angel funds which is typical, **but an unreported result**. Our angel funds attract more money to North Dakota, and also must invest in surrounding states to build strong portfolios. Usually 5-8 angel funds invest in a single company, thus out of state funds are required to fill out the investment round.

Angel capital is a high risk investment with a long horizon for a return on investment (ROI). There are 10 angel funds affiliated with the Center for Innovation angel ecosystem. They invested $27 M in 47 companies with **only 5 exits so far (!!!).** Since 2006, only five exits (10% of companies in portfolio) have resulted with a return of $358,486 on $27 M of invested capital Obviously after 9 years of investing, **it will be a long time before there will be a return of the principle ($25 M)** much less a return on that investment (ROI). *Meanwhile the ventures are growing, hiring staff, and paying taxes.* **That long horizon for ROI is the major reason the state tax credits are so important**. The tax credit is a shared risk with the investor, but the state has no transaction costs like state loans, grants or investments which has high overhead. It is encouraging the private sector to do economic development. The investors are dependent on mergers, acquisitions, leverage buyouts and the rare IPO to get their investments back with a return. The flat economy since 2008 has resulted in a slow M&A activity for exits. **The angel tax credit is an important incentive to encourage angel investing, a high risk, long horizon, activity. The state gets immediate returns from company growth, jobs, and taxes. Thus the tax credits are working.**

Angel Capital is essential for entrepreneur success**, as only equity funding will fund these high risk startups.** Banks cannot, should not. Family & friends only go so far. State tax credits for angel funds are essential to have private equity available for fast growth companies. The Angel Capital industry is vital for venture development. We are a flyover state for venture capital so **angel capital is our only source**. Being 47th in venture capital is not acceptable for our future economy.

A majority of states (at least 27) offer angel investment tax credits in early-stage growth companies. Several of the states without tax credits have it under consideration as entrepreneur activity is lacking. States use tax credits instead of appropriated funds to stimulate private investment. The tax credits encourage wealthy accredited investors to invest in private companies rather than just in public markets, real estate, and other lower risk investments; something they have not done before. These tax credits brought 519 accredited investors into the entrepreneur ecosystem.

Jobs come from growing entrepreneur ventures, but entrepreneurs are starved for equity capital which is required before debt is secured. Angels are sophisticated investors who may invest in new and emerging ventures with a small portion of their investment portfolio. In a recession or flat economy, it is difficult to encourage angels to invest. One way is through tax credits.

Angel money is vital - not all ventures can be bootstrapped or financed from friends and family. Banks should not invest until a company cash flows for 2-3 years. Venture capital overwhelmingly invests in later stage ventures, not startups and early stage ventures. **So our state need angels for the critical $50,000 to $2 M often needed for vital venture growth.**

Tax Credits move money - available seed capital (debt and equity) for new ventures has dramatically shrunk over the years. Tax credits are a way to incentivize seed capital, reducing risk for the investor - with no transaction or administration costs for the state. Ventures stall out and die when no capital is available. Growth takes capital, and reducing risk encourages money to move.

Angels provide entrepreneur expertise - angles provide more than funding as they have experience, expertise and connections that are valuable to entrepreneurs. The tax credit encourages angels to provide funding and brainpower while doing economic development– ***a triple bottom line return.***

Money follows money – angels follow fellow angels when making investment decisions – it is like investing in oil wells – no deal is so good you do it alone. Kick starting angels to invest attracts other angels to invest – including out-of-state angels who know North Dakota angels. More out of state funds can be attracted by allowing the sale or transfer of investment tax credits. North Dakota ventures benefit from the angel investment, and they angels can transfer/sell their credits to North Dakota taxpayers. North Dakota needs to attract equity investment from angels who live elsewhere. North Dakota cannot be an investment island and be successful. Restricting where angel funds to North Dakota deals would be a huge setback to the emerging industry.

***Conclusion**: Entrepreneur funding is painfully short, tax incentives encourage angels to invest, pooled angel funds are the secret to building the venture capital industry, angels attract other angels including from out of state. Thus: Angel investing = venture growth = jobs = tax revenues. The tax credits do pay for themselves. A restriction to investments in North Dakota would be destructive and a major setback to the emerging angel capital industry.*