Thompson, Emily L.

Subject: FW: Reasons for Angel Investment Tax Credits in North Dakota

From: Bruce Gjovig [mailto:bruce@innovators.net]
Sent: Wednesday, January 13, 2016 3:59 PM
To: Dockter, Jason D. <jddockter@nd.gov>; Bellew, Larry D. <lbellew@nd.gov>; Dosch, Mark A. <mdosch@nd.gov>; Headland, Craig A. <cheadland@nd.gov>; Hogan, Kathy L. <khogan@nd.gov>; Klemin, Lawrence R. <lklemin@nd.gov>; Koppelman, Ben <bkoppelman@nd.gov>; WKretschnar@nd.gov; Lefor, Mike <mlefor@nd.gov>; Mitskog, Alisa <amitskog@nd.gov>; Mooney, Gail <gmooney@nd.gov>; Muscha, Naomi T. <nmuscha@nd.gov>; Nathe, Mike R. <mrnathe@nd.gov>; Toman, Nathan P. <nptoman@nd.gov>; Weisz, Robin L. <rweisz@nd.gov>; Bekkedahl, Brad <bbekkedahl@nd.gov>; Burckhard, Randall A. <raburckhard@nd.gov>; Cook, Dwight C. <dcook@nd.gov>; Dotzenrod, Jim A. <jdotzenrod@nd.gov>; Mathern, Tim <tmathern@nd.gov>; Unruh, Jessica K. <jkunruh@nd.gov>
Cc: Anderson, Alan R. <alranderson@nd.gov>; Lucy, Paul J. <plucy@nd.gov>; Dever, Justin R. <jdever@nd.gov>
Subject: Reasons for Angel Investment Tax Credits in North Dakota

Mr. Chairman and Committee Members: Unfortunately I was unable to journey to Bismarck today, but please accept my testimony to the Political Subdivision Taxation Committee on seed capital and angel capital tax credits. Bruce Gjovig

Reasons for Angel Investment Tax Credits in North Dakota

By: Bruce Gjovig, CEO, UND Center for Innovation Foundation, Grand Forks
Jan 13, 2016

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

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 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 the private sector encouraging 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.**

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 seed funding and angel funds are essential to have private equity available for fast growth companies. We are a flyover state for venture capital so angel capital is our only source.

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.

***Conclusion**: Entrepreneur funding is painfully short, tax incentives encourage angels to invest, angels attract other angels including from out of state. Angel investing = venture growth = jobs = tax revenues. The tax credits do pay for themselves.*