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Subject: Angel Investment Tax Credits are essential in North Dakota

Mr. Chairman and Committee Members:

Reasons for Angel Fund Investment Tax Credits in North Dakota

By: Bruce Gjovig, CEO, UND Center for Innovation Foundation, Grand Forks
April 26, 2016

North Dakota ranks 47th out of 50 states in access to venture and angel capital so we have a long way to go to be truly competitive. The angel fund industry is in the early stages in North Dakota – and the 550 angels have yet to see a return on investment (ROI) on the $41 M they invested. Please be very cautious with any changes as it can easily damage or set back this infant industry that is crucial for our economic growth.

North Dakota must **diversify and grow its** economy that is too dependent on commodities. **Private investing in Innovation, entrepreneurship and technology is key** which requires ***developing a private equity capital industry***. If access to capital is diminished, so will venture development - the future economy we need.

I am unable to be before your Committee because I just returned from a 10 day business trip and have board meetings Wed and Thurs. Work demands come first. You will have the benefit of two of the best emerging Angel Fund leaders in the state (and nation), Emily O'Brien of Dakota Venture Group and Greg Syrup of the 701 Angel Fund. They will let you know of the importance of these angel capital tax credits.

Shane Goettle, as Commerce Commissioner, was instrumental in advocating for this angel fund tax credit as an **incentive to establish an angel capital industry in North Dakota**. He will confirm the importance of these tax incentives as there were NO organized angel capital networks in North Dakota before 2006. The **Angel Fund Investment Tax Credit** is **essential** to:

1. Provide **incentives to create an early stage capital** industry in North Dakota – we still have a long way to go
2. Provide **incentives for angels to gather together** in pooled funds to professionalize and maximize private equity available
3. **Syndicate with angel funds outside North Dakota** to draw capital TO ND deals – capital must flow both ways or it won't happen
4. Form angel funds to attract **Entrepreneur Ventures** - access to capital is a magnet for new venture formation.
5. Recognize it is **years before Angels** have a **Return on Investment (ROI)** –this is high risk, long term return investing. Takes years to build large companies. State realizes taxes from new companies, new employmees, and ROI on angel returns.

The state achieves a return on the tax credit from the Angel ROI as well as ongoing return from income and sales taxes generated from growing ventures that angels fund like Edgewood, Larada. Streamline, C2Renew, Packet Digital, Buzz 360, Altavian, and more. Edgewood Vista, headquartered in downtown Grand Forks, now has over 3,000 employees in seven states and they are the leader in their market niche in North Dakota. A great entrepreneur – Phil Gisi from New Rockford – was only able to build a national company… with private investors.

When established by the Legislature, the **angel fund tax incentives** were **about creating an equity capital industry** in North Dakota, *not an economic development incentive*. **Angels need to aggregate** to form angel funds, and the state incentive is critical to this process.

The **Angel Capital Association** (ACA) lists **27 states** with angel investor tax incentives. Several states without angel tax credits have it under consideration as entrepreneur activity is lacking from lack of entrepreneur capital. States used this incentive because they realized they were falling behind states that had numerous venture capital funds. Creating Angel Capital Networks was the best way to build a private equity market as venture funds are not interested in "fly over states." States use tax credits instead of appropriated funds to stimulate private investment, letting private investors absorb all the transaction costs (legal, accounting, due diligence, etc.). The tax credits encourage accredited investors to invest in private companies rather than just in public markets out of state, or real estate and other lower risk investments. Our tax credits brought 519 accredited investors into the entrepreneur ecosystem we did not have before. That is impact.

Angel Funds need to build a **strong portfolio** of venture investments, and they **cannot do that if restricted to just in-state deals.** The ND deal flow is not strong enough to do only North Dakota deals. In other states *any venture or angel capital funds restricted by government to a single state has been a failure*. We do not want to repeat that mistake. **State politics should not dictate investment, telling the market what is a good investment.** Investment opportunity should direct investment activity, not government interference. Restricting investments to North Dakota would likely diminish the emerging angel fund industry as angel investors would quickly lose 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. Nearly 100 certified companies have utilized the seed capital tax credit since 2002, with an 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, a good ROI**. *The state seed capital tax 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.*** *Legislation allows 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 per fund pooled their investments in 22 angel funds to build a portfolio of 10 or more ventures. With a larger portfolio there hopefully is more wins than losses to get a positive ROI. 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 in those pooled funds. Plus there was syndication with out of state angel funds which is significant additional capital, **but an unreported result**. Our angel funds attract significant investment to North Dakota, as they also must invest in surrounding states to build strong portfolios in a dynamic marketplace. Usually 5-8 angel funds invest in a single company, thus out of state angel funds are required to fill out the investment rounds.

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, those five exits (10%) have resulted in a return of $358,486 on $27 M of invested capital. Obviously **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 have high overhead. Tax credits encourage the private sector to do high risk economic development which is critical for long term success. 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. The state gets immediate returns from company growth, jobs, and taxes. Thus the state 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. **So our state need angels for the critical $50,000 to $2 M often needed for vital venture growth.**

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 like Minnesota allows. 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: **We suggest a committee be formed to study the best outcome and changes to the Angel Investment Tax Credit for all involved – the state, entrepreneurs and investors. The Committee should be comprised of Legislators, Dept of Commerce leaders, and at least four chairs of current angel funds to address the legislative concerns. It is important to not destroy or diminish an emerging angel capital industry that is vital for venture development and economic growth in North Dakota.**

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