

Dave Beal

Help from the Heavens?

A new drive for a state tax credit highlights the role of angel investors.

Can a Minnesota tax credit persuade angel investors to be more angelic? That's an enduring question, and one likely to generate more debate at the Minnesota Legislature next year.

Angels, wealthy individuals who take modest equity stakes in start-ups or early-stage companies, play an increasingly important role in financing these businesses. Angels helped launch Google, Apple, Starbucks and other corporate giants. Today, angel investors occupy a niche largely abandoned by venture capital firms: smaller financings, generally below \$2 million.

At least 18 states offer such investors the opportunity to reduce their state tax liability by taking credits for the capital they sink into promising new companies that are growing up within state borders. Minnesota is not among them.

Steve Mercil is the founder and CEO of St. Paul-based RAIN Source Capital, which formed and manages a network of 23 groups of angel investors in six states, many of them in greater Minnesota. (The name RAIN derives from "regional angel investment network.") Together, they've invested \$75 million in 55 companies. Mercil, who is also treasurer of the national Angel Capital Association (ACA), says that angel tax credits can create an environment that encourages investors on the sidelines to look seriously at putting capital into start-ups.

"The tax credit is not a silver bullet, but it will level the playing field

regarding one of many factors that influence investors' decisions," Mercil says. "Most importantly, an angel tax credit will enhance part of an investment infrastructure or ecology that begins to encourage investors to focus on early-stage investing as well as a variety of new technologies."

MOVING TO WISCONSIN

For years, backers of a Minnesota tax credit have sought it in legislative

A proposed tax credit for angels will likely be weighed against alternatives such as direct state aid to start-up companies.

bills. This year, a 25 percent credit for taxpayers putting up to \$50,000 into small, technology-oriented enterprises made it into the omnibus tax bill that went to Governor Tim Pawlenty. But the governor, who supports the credit, vetoed the bill because it boosted taxes.

Meanwhile, the 2009 Wisconsin Legislature passed and Governor Jim Doyle signed a bill that, starting in 2011, will triple to \$37.5 million the amount Wisconsin has budgeted annually for its popu-

lar tax credit for angels and venture capitalists.

According to the Wisconsin Technology Council, investors in the state's growing network of angel groups put \$15 million into 53 deals last year, up from \$1.7 million in 11 deals in 2003. Council President Tom Still says the state's credits, inaugurated in 2005, were among the factors sparking this increase. He notes that even as early-stage investing fell nationally last year, it rose 28 percent in Wisconsin. Figures aren't available for Minnesota.

That claim and the recent decisions of two well-regarded Twin Cities start-ups to move to Hudson, Wisconsin, have injected a new sense of urgency into the drive for a Minnesota tax credit.

One of the companies, Rapid Diagnostek, moved from St. Paul last year. It makes sensors to identify bacteria, viruses, and disease markers in medical, food safety, and environmental testing.

The other, VitalMedix, is planning to move from Minneapolis this fall. VitalMedix, which is working on a

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RIDING THE WAVES

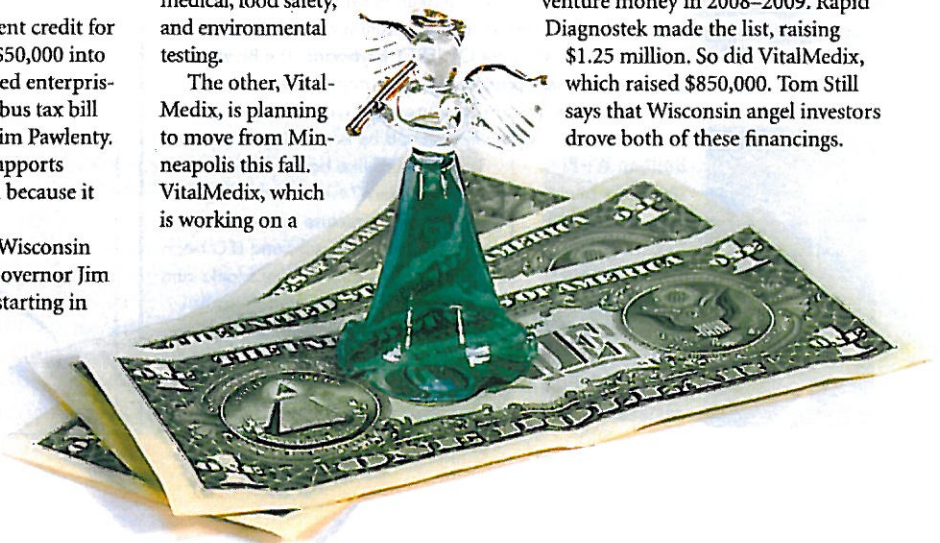
Life insurance firm Securian is adjusting to a world of "Black Swans."

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drug and a delivery device to save the lives of trauma victims, arose out of research done at the University of Minnesota.

This summer, the Wisconsin Technology Council published a list of 37 new and emerging Wisconsin companies—many of them biotechnology firms—that received angel and venture money in 2008–2009. Rapid Diagnostek made the list, raising \$1.25 million. So did VitalMedix, which raised \$850,000. Tom Still says that Wisconsin angel investors drove both of these financings.



WORKING THROUGH TOUGH TIMES

In recent years, angels have organized into alliances, such as the ACA and RAIN Source, that mirror the organizations formed a generation ago by venture capitalists. Investors in these alliances leverage their resources by working together to syndicate deals, speed up due diligence, and share information on best practices.

But angel investing faces tough challenges. Declines in the securities markets have eroded many angels' wealth, leading some to shy away from risky start-ups. An ACA survey found that angel groups' activity was down roughly 10 percent last year—measured by deals and dollars—from 2007. Marianne Hudson, executive director of the ACA, predicts declines again this year. She cites another study that estimates overall angel investing—both angel groups and individual angels—fell 26 percent last year.

"Flat is the new up," quips John Huston, chairman of the ACA.

Another concern is the gloomy U.S. market for initial public offerings. IPOs and acquisitions have been the two basic ways for angels to cash out with significant returns. But at RAIN Source's annual regional conference in Bloomington this September, the alliance's executive vice president, Brian Johnson, cited sobering data from a recent Grant Thornton study to suggest that "the small-capitalization IPO is gone forever."

Small investment banks have gone out of the business, Johnson says in a later conversation, and "the costs to be a public company have gone up to the point where a company needs to raise at least \$50 million or more. So there are no more 'small-cap IPOs.'"

DEBATE HEATS UP

Such worries fuel arguments for the tax credit, which would raise prospective returns for angel investors. As the 2010 legislative session approaches, three advocates are starting a broad campaign to enact the credit: Senator Kathy Saltzman (DFL, Woodbury); John Alexander, founder and chairman of Twin Cities Angels, a group whose investors have stakes in a dozen

young companies in the region; and Peter Bianco, director of life science business development at Hallelund Health Consulting in Minneapolis.

They are certain to run up against the views of Representative Ann Lenczewski (DFL, Bloomington), chair

"The climate for biotech is better in Wisconsin than in Minnesota," says VitalMedix CEO Jeff Williams of his company's relocation.

of the House Tax Committee and a staunch skeptic about tax breaks and subsidies. She argues that evidence for the credit's effectiveness is only anecdotal, that investors' gains will be reduced by up to 35 percent because the credit will lower their federal deductions for state taxes, and that state aid for start-ups would be better structured as an outright grant to them.

Proponents of the angel credit are gathering data to counter her arguments, stressing the credit's potential for encouraging job-creating private investment and strengthening Minnesota's climate for entrepreneurship.

They have significant bipartisan backing. At the RAIN Source meeting, Dan McElroy, economic development chief for the Republican Pawlenty administration, gave the tax credit proposal a hearty endorsement and noted that the DFL speaker of the House, Margaret Anderson Kelliher of Minneapolis, also supports it. "I think it's a good idea," she says.

The angel tax credit could face rough going in the legislature once again in the next session, given the continuing budget squeeze facing Minnesota and the often treacherous political environment at the Capitol. It's too early to assess its chances for passage in 2010, but odds are growing that the debate this time will be longer and louder. **TCS**