# INFORMAL SOURCES OF VENTURE FINANCE

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## 1. INTRODUCTION

One of the most interesting insights from the Global Enterprise Monitor (GEM) – an annual international survey of entrepreneurial activity in some 40 countries - is that informal sources of finance overwhelm formal ones (Bygrave et al, 2003). GEM's methodology captures two sources of informal financing – family members (often termed 'love money') and other individuals, the latter comprising investors who have come to be known as *business angels*[1] who invest in new and young businesses where there is no family connection. Some 3.4% of the adult population in the 18 countries where information is available meet the definition of being an informal investor.[2] They provide $196m per year to new and growing companies, equivalent to 1.1% of the GDP of these countries, and accounting for between 60% and 90% of total venture capital, including institutional sources (which is the subject of another chapter in this volume). In the USA, 5% of the population are informal investors, collectively investing $108 billion per annum, which is 3.5 times the amount invested by venture capital funds in seed and start-up investments (Bygrave and Reynolds, 2004). Most informal investment flows to family members and friends. In the 18 GEM countries, some 50% of informal investment goes to relatives, 29% to friends/neighbours, 11% to work colleagues and just 8% to a stranger (Bygrave et al, 2003). The proportions for the USA are almost identical (Bygrave and Reynolds, 2004).

This chapter focuses on business angels who collectively make-up what is termed the *informal venture capital market* (in contrast to the formal, or institutional venture capital market – see Chapter 8). The role of the family in funding entrepreneurial ventures is an under-researched topic. However, by definition access to finance from family members is constrained by ties of blood and marriage, and is therefore only available to other family members. Accordingly, it does not constitute a

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[1] The term *angel* was coined by Broadway insiders in the early 1900s to describe wealthy theatre-goers who made high risk investments in theatrical productions. Angels invested in these shows primarily for the privilege of rubbing shoulders with the theatre personalities that they admired. The term *business angel* was given to those individuals who perform essentially the same function in a business context (Benjamin and Margulis, 2000: 5). There is a long tradition of angel investing in businesses (Sohl, 2003). However, this type of business financing has only become significant since the 1950s and 1960s when a lot of the pioneering garage start-ups in Silicon Valley obtained their initial funding from this source.

[2] Anyone who had personally invested in a business start-up which was not their own, excluding stock and mutual funds.

market. If an entrepreneur is unfortunate enough to come from an impoverished family then this source of potential funding is closed-off to them. Business angels, in contrast, do invest in businesses that are owned by strangers (as well as those owned by acquaintances) and it is quite appropriate for an entrepreneur seeking finance to approach them for funding. Indeed, business angels constitute the largest pool of equity capital available for start-up and emerging companies in advanced economies (Gaston, 1989a). Moreover, as we will see later in this chapter, they contribute much more than just money to their investee companies.

The research base on informal venture capital is limited. Prowse (1998: 786) commented in the late 1990s that "the angel market operates in almost total obscurity. Very little is known about its size, scope, the type of firms that raise angel capital and the types of individuals that provide it." Indeed, prior to the 1980s business angels were unknown both to researchers and policy-makers. The emergence of informal venture capital as a distinct topic within the entrepreneurship literature is therefore relatively recent. Pioneering studies by Wetzel (1981; 1983; 1987) and others (e.g. Tymes and Krasner, 1983; Haar et al, 1988; Gaston, 1989b) began to establish its importance in the USA during the 1980s. Subsequent studies in Canada (Riding and Short, 1989; Short and Riding, 1989), Europe (e.g. Harrison and Mason, 1992; Landström, 1993; Mason and Harrison, 1994; Reitan and Sørheim, 2000; Brettel, 2003; Stedler and Peters, 2003; Paul et al, 2003), Australasia (Hindle and Wenban, 1999; Infometrics, 2004) and Asia (Tashiro, 1999; Hindle and Lee, 2002) confirmed that business angels were not just a USA phenomenon.[3] There is also evidence of angel activity in less developed regions of the world, such as South America (Pereiro, 2001).[4] Whereas these studies are in what has been termed the 'ABC' tradition of angel research (attitudes, behaviour and characteristics), other so-called second generation studies have sought to develop a more in-depth understanding of business angel investment activity by focusing on process (Mason and Harrison, 2000a). Accordingly, Prowse's (1998) claim is no longer valid. Nevertheless, both the body of literature on informal venture capital and the number of active researchers remain

[3] See Hindle and Rushworth (2001) for an international comparison of angel profiles.
[4] Nevertheless, business angels remain largely a phenomenon of Anglo-Saxon countries. For example, in Europe business angels are much more prominent in North West Europe than in Southern Europe. One possible explanation is that in such countries other actors – such as *Impannatori* in the industrial districts of Italy – perform the functions of business angels (Lazzeretti et al, 2004).

small in comparison to the amount of scholarly activity that is devoted to investigating institutional venture capital. This is despite the much greater role of informal venture capital in funding the start-up and initial growth of entrepreneurial ventures.[5] A further limitation is that much of the research lacks theoretical foundations and simply reports survey findings. Only by attracting more scholarly effort and producing research that is theoretically informed will informal venture capital lose this Cinderella status.

This chapter adopts a supply-side perspective. This reflects the focus of the overwhelming majority of the literature on this topic which is largely concerned with who business angels are, what motives them and how they invest. By way of contrast there is very little literature that takes a demand-side perspective, looking at informal venture capital from the viewpoint of the entrepreneur. The chapter is structured as follows. The next section provides an overview of the 'ABC' of angels (attitudes, behaviour and characteristics). Section 3 reviews the economic importance of business angels, highlighting the nature of their investments and the size of the market. This is followed in section 4 by a brief discussion of government efforts to expand the supply of informal venture capital. Section 5 adopts an investment process perspective. Section 6 examines the emergence of new organisational formats for angel investing. The concluding section offers some thoughts on future research possibilities.

## 2. THE INFORMAL VENTURE CAPITAL MARKET: AN OVERVIEW

The informal venture capital market comprises business angels who are conventionally defined as *high net worth individuals who invest their own money, along with their time and expertise, directly in unquoted companies in which they have no family connection, in the hope of financial gain*. Several aspects of this

[5] This paradox is explained, at least in part, by the contrasts in data availability. There are databases on formal venture capital investments whereas informal venture capital investments go unrecorded. In addition, venture capital fund managers are listed in directories whereas business angels are invisible. The consequence is that researchers must adopt creative techniques for identifying business angels and getting them to respond to surveys. In practice, much of the research is based – of necessity - on samples of convenience which cannot be tested for representativeness because the population of angels is unknown (Wetzel, 1981). Difficulties in identifying business angels and low response rates because of their desire for privacy results in small sample sizes which restricts the scope for rigorous statistical analysis (Mason and Harrison, 1994: 71-76; Hindle and Rushworth, 2001: 10-11).

definition need to be emphasised in order to emphasise the distinctiveness of business angels as a type of investor.

*High net worth.* Having wealth is a pre-requisite for becoming a business angel. Business angels invest upwards of £10,000 per deal (sometimes in excess of £100,000) and typically have a portfolio of two to five investments (some angels have more). However, they are not investing their entire savings in this way. Because of the high risk of investing in unquoted companies, most angels allocate just 5% to 15% of their overall investment portfolio to such investments. Thus, if these investments fail, as they often do, the losses will not affect their lifestyle. Some rather dated evidence on the wealth of angels suggests that they tend to be 'comfortably' off rather than super-rich. Gaston (1989b) reported that 1 in 3 business angels in the USA had a net worth (excluding principal residence) in excess of $1 million. There were also 'very few' millionaires in the study by Haar et al (1988). Mason and Harrison (1994) noted that only 19% of UK business angels were millionaires.

*Investing their own money*. The fact that angels are investing their own money distinguishes them from institutional venture capital funds whose investment funds come from such sources as pension funds, banks and foundations and, as a result have a legal duty of care for how they invest such funds. First, business angels do not have to invest if they do not find appropriate investments whereas venture capital funds have a fixed life, typically 10 years, over which the fund must invest and exit. Second, they can make quicker investment decisions (Freear et al, 1995). Third, angels have less need for specialist financial and legal due diligence, so the costs for the investee business are lower. Fourth, business angels can adopt idiosyncratic investment criteria whereas venture capital funds have raised their investment funds to invest in specific types of businesses and so must follow these investment criteria when investing.

*Direct.* Business angels make their own investment decisions as opposed to investing in some form of pooled investment vehicle in which the investment decisions are made by fund managers. This implies that those people who become business angels have both the personal networks that will provide a flow of investment opportunities and the competence to undertake the appraisal of new and young entrepreneurial companies. Indeed, a consistent theme in the literature is that

the majority of business angels are successful, cashed-out entrepreneurs, while the remainder either have senior management experience in large businesses or have specialist business expertise (e.g. accountant). On account of these backgrounds such individuals have access to deal flow and the competence to make investment decisions. Becoming a business angel is therefore a way for such individuals to recapture their successful experience, making investments based on the analytical skills and intuition that they have developed in business. This reinforces their self image and sustains recognition in the communities in which they live (Margulis and Benjamin, 2000). However, it is fair to say that competence levels amongst business angels is variable, and a career as a successful entrepreneur, or in a senior position in a large company, does not necessarily provide an individual with all of the skills required to be a successful business angel. Angels report in surveys (Sørheim, 2003) that their initial investments involved a steep learning curve.

*Time and expertise.* Part of the investment approach of business angels involves the support their investee businesses through a variety of hands-on roles, including mentoring, the provision of strategic advice, networking and in some cases direct involvement in a specific functional capacity. This has prompted the description of informal venture capital as being “capital and consuliting”. The opportunity to be involved with a business start-up is a significant motive for business angels. Involvement also reduces information asymmetries and moral hazard and so is a means of risk reduction.

*Unquoted companies*. Business angels are investing in unquoted companies as opposed to companies that are listed on a stock market. As we will see more clearly in the next section, while angels invest in all sorts of situations, including management buyouts and buyins and rescue/turnaround situations, their typical investment is in a new or recently started business. The key point here is that business angels want to be active investors in the companies in which they invest, helping them to grow, whereas stock market investing is passive.

*Financial gain*. Business angels are investing in the hope of achieving a financial return, typically in the form of a capital gain that is accomplished through some form of harvest event such as an acquisition of the investee company or an IPO.

However, psychic income is also an important motivation. Studies are consistent in identifying that the fun and enjoyment that is derived from such investments is an important subsidiary reason for becoming a business angel. This links back to an earlier point: business angels are also characterised as being *hands-on investors*. The ability to provide support to investee companies reinforces the tendency for business angels to have a business background. Some angels also express altruistic motives. Paul et al (2003) quote one Scottish angel as follows: "don't get me wrong, I want to make money. But I've done well out of Scotland and I'd like to help others to do the same." US evidence indicates that most business angels would be willing to forego *some* financial return either to invest in businesses that were seen as socially beneficial (Sullivan, 1994) or simply to support new entrepreneurs (Wetzel, 1981). Evidence of altruistic motives is much weaker in other countries.

One of the striking features in the literature is the remarkable consistency in the characteristics of business angels across countries. Japan is the only country where research suggests that angels have a distinctively different profile (Tashiro, 1999). The profile of the *typical* business angel is characterised as follows:

- *Male.* Studies in various countries are consistent in finding that upwards of 95% of business angels are male. This can be attributed to the relatively small numbers of women who have built successful entrepreneurial companies or hold senior positions in large companies. However, the small minority of women who are business angels have similar characteristics to those of their male counterparts (Harrison and Mason, 2005).
- *In the 45-65 year age group.* This reflects the length of time required to build significant personal net worth, the greater amount of discretionary wealth of this age group as their children cease to become financially dependent on them, and the age at which people with a successful business career might chose, or be forced to, disengage. Becoming a business angel is often a way in which such individuals to remain economically active. For example, cashed out entrepreneurs in their 40s or 50s often report that they became business angels because they quickly became bored by a life of leisure – as one angel noted, "the attractions of playing golf seven days a week quickly palls." There are some international differences. Angels are slightly younger in the USA and

slightly older in Nordic countries (Landström, 1993). Recent studies hint that business angels may be becoming slightly younger (e.g. Infometrics, 2004). This may be linked, at least in part, to the acquisition frenzy of the closing years of the technology boom of the late 1990s which enabled a lot of younger entrepreneurs to cash-out.

- *Successful cashed-out entrepreneurs.* Most business angels have had experience of business start-up and growth. As Freear et al (1992: 379) note, this implies that many angels "have acquired the kind of experience … that it takes to start, manage and harvest a successful entrepreneurial venture. In a sense their entire professional careers have prepared them to conduct the due diligence necessary to evaluate the merits and risks of prospective investments and to add value of their know how to the ventures they bankroll." The remainder are typically either people who have held senior positions in large companies or have specialist commercial skills and are involved in working with entrepreneurial companies (e.g. accountants, consultants, lawyers) and whose wealth is derived from high income. It is also important to emphasise that non-business professionals (e.g. doctors, dentists) and public sector employees are conspicuous by their absence from the ranks of business angels (Gaston, 1989b).
- *Well educated.* Economic success is underpinned by a high level of education. Business angels typically have a university degree and/or professional qualifications. However, angels with PhDs are rare. This reflects other research that suggests that the relationship between education and entrepreneurship is an inverted U-shape (i.e. both too little and too much education is a hindrance to entrepreneurial behaviour) (Reynolds, 1997).

There have been surprisingly few attempts to compare business angels with non-investors. Lindsay (2004) finds that angels score more highly on measures of entrepreneurial orientation – pro-activeness, innovativeness, risk-taking strategies – which, in turn, suggests that they act in an entrepreneurial manner in undertaking their investment activities. However, this might simply reflect the entrepreneurial background of most business angels. Duxbury et al (1996) suggest that angels are distinctive from non-investors in terms of their psychological traits, with an internal

locus of control, very high need for achievement (nAch), a moderately high need for affiliation and autonomy and are intrinsically motivated. But here again, these are also entrepreneurial traits.

This profile masks considerable heterogeneity in the business angel population, not so much in terms of their demographics but rather in their motivation and investment focus. The most basic distinction is between *active angels* – those individuals with experience of investing and who are continuing to look for investments, *latent angels* – inactive investors who have made investments in the past, and *virgin angels* – individuals who are looking to invest but have yet to make their first investment (Coveney and Moore, 1998).

There are several classifications of active investors. Gaston (1989b) identifies ten distinct types of business angel but without elaborating on the methodological basis for the classification. Coveney and Moore (1998) identify three types of business angel based on their level of entrepreneurial activity and intensity of investment activity (Table 1):

- *Entrepreneur angels*: the most active in terms of number of investments and amount invested, the most experienced angels and also the most wealthy. Their preference is to invest at start-up and enjoyment is a major motivation. Their key investment criterion is the personality of the entrepreneur. Entrepreneur angels are also the most open to investing outside of their own field of experience. They are unlikely to play a role in the day-to-day management of their investee companies.
- *Income seeking angels*: significantly less wealthy investors, less active and less motivated by fun and enjoyment considerations, tend to invest in industries in which they are familiar and looking for a formal management role in the ventures in which they finance.
- *Wealth maximising angels*: predominantly self-made investors but includes some with inherited wealth, interested primarily in the financial return, more likely to invest in industries in which they have personal experience and more likely to take a full-time position in their investee businesses.

Table 1. Differences between types of business angel: I - Coveney and Moore

| characteristic | Entrepreneur angel | Wealth maximising | Income seeking |
|---|---|---|---|
| Total funds invested | £590,000 | £131,000 | £35,000 |
| No of investments | 3.4 | 2.1 | 1.5 |
| Personal net worth | 74% > £1m | 43% > £1m | 75% > £1m |
| Reason for investing | returns/fun | returns | job/income |
| *Typical deal* | | | |
| Average total amount invested | £174,000 | £54,000 | £24,000 |
| Average initial amount invested | £111,000 | £21,000 | £17,000 |
| Average number of rounds | 2 | 1.75 | 1.5 |
| Average number of co-investors | 2.3 | 2.5 | 3.0 |
| Average size of equity stake taken | 38% | 31% | 20% |

Note: based on a survey of "nearly 500 business angel investors/potential investors … and 467 actual investment deals involving a total level of funds of more than £50 million" (Coveney and Moore, 1998: 8). However, the methodology for classifying investors is not explained.

Table 2. Differences between types of business angel: II – Sørheim and Landström

| | Lotto investors | Traders | Analytical investors | Business angels |
|---|---|---|---|---|
| Investors with gross income over 500,000 NOR (%) | 14 | 42 | 39 | 77 |
| Net worth over 2 million NOR (%) | 6 | 29 | 17 | 74 |
| Number of investment proposals | 8.2 | 19.9 | 7.9 | 44.5 |
| Number of investments made | 1.4 | 4.5 | 1.7 | 7.3 |
| Invested with other business angels (%) | 31 | 48 | 59 | 83 |
| Invested with banks, venture capital funds, etc (%) | 12 | 25 | 18 | 43 |
| Functioned as lead investor | 2 | 11 | 5 | 42 |
| Served as board member for investee businesses | 3 | 14 | 34 | 61 |
| Acted as consultant to investee businesses | 2 | 3 | 8 | 24 |

Based on a sample of 425 "informal investors"

Sørheim and Landström (2001) use cluster analysis to differentiate Norwegian business angels in terms of their competence and investment activity. This produces four distinct types of business angel (Table 2):

- *Lotto investors* (30%): low investment activity level and limited experience of starting and running businesses. They make very few investments and have limited ability to add value to their investments.
- *Traders* (24%): high investment activity but limited experience of starting and running entrepreneurial businesses. They are keen to invest but have limited ability to add value.
- *Analytical investors* (21%): low level of investment activity but possess fairly high competence.
- *Business angels* (25%): very high level of investment activity and high competence.

From a demand-side perspective these studies underline the differentiated nature of the supply of informal venture capital. Clearly, "not everybody's money is green." The implication for entrepreneurs is that they must ensure that the type of business angel who is offering to invest is both willing and capable of contributing the value-added that they require.

Other studies have focussed on specific types of business angel. Kelly and Hay (1996; 2000) have focused on the most active investors who account for a disproportionate amount of investment activity. They note that such angels are more financially driven and formalised in their approach, which they suggest reflects their experience of living through unforeseen problems and obstacles. Visser and Williams (2001) examine "takeover and turnaround artists" – business angels who specialise in investing in distressed companies with the aim of turning them around to start on a growth path again.[6] As they note, these investors are "performing the same function as … other types of business angels … – breathing new life into a business – but at

[6] Visser and Williams (2001) emphasise that T&T artists are distinguished from 'company doctors' who may be called in to turn a business round, but do not necessarily invest their own money, and from 'corporate raiders' who may, or may not, invest their own money but whose aim is to sell off valuable components of the business as soon as possible.

the other end of the business spectrum – when the business is about to die" (Visser and Williams, 2001: 2).

## 3. THE ECONOMIC SIGNIFICANCE OF THE INFORMAL VENTURE CAPITAL MARKET

The informal venture capital market is recognised as playing a vital role in economic development at both national and local/regional scales. Indeed, one UK Government report argued that "an active informal venture capital market is a pre-requisite for a vigorous enterprise economy…." (ACOST, 1990: 41). There are three aspects of the informal venture capital market which are significant from an economic development perspective.

First, the amount of finance that business angels have invested, or have available to invest, is significant. Unfortunately, it is impossible to be precise about the number of business angels, the number of investments made and the amount invested. This is because there is no obligation for business angels to identify themselves or register their investments. Indeed, the vast majority of business angels strive to preserve their anonymity and are secretive about their investment activity, not least to avoid being inundated by entrepreneurs and other individuals seeking to persuade them to invest or provide financial support for other causes (Benjamin and Margulis, 2000). Thus, all measures of the size of the informal venture capital market are fairly crude estimates. Gaston (1989a) has estimated that in the USA business angels invest 13 times more dollars than venture capital funds and make 40 times more investments. A more up-to-date estimate by Sohl (2003) suggests that there are 300,000 to 350,000 business angels in the USA, investing approximately $30 billion per annum in close to 50,000 ventures. Venture capital funds, in contrast, invest $30-$35 billion in fewer than 3,000 entrepreneurial ventures. The equivalent estimate for the UK is 20,000 to 40,000 business angels investing £0.5 billion to £1 billion per annum in 3,000 to 6,000 companies. They make eight times as many investments in start-up companies as venture capital funds (Mason and Harrison, 2000b). However, these calculations of the amounts invested by business angels are an under-estimate of the size of the informal venture capital market. First, most business angels have further funds available to invest (Coveney and Moore, 1998; Mason and Harrison, 1994; 2002a) but cannot identify appropriate investment opportunities. This

uncommitted capital is substantial: one study reported that it exceeded the amount invested by the respondents in the three years prior to the survey (Mason and Harrison, 2002a). Second, there is a substantial pool of potential, or virgin, business angels who share the characteristics of active angels but have not entered the market (Freear et al, 1994a; Coveney and Moore, 1998). However, with appropriate forms of support – such as help with deal flow and with the technical aspects of investing – they could be encouraged to enter the market (Mason and Harrison, 1993; Freear et al, 1994a). Sohl (1999) has estimated that these potential angels exceed the number of active investors by a factor of five to one.

The economic significance stems from where this capital is invested. Finance from business angels occupies a crucial place in the spectrum of finance available to growing businesses. In terms of *size of investment*, business angels invest in what is often termed (at least in Europe) the 'equity gap', providing amounts of finance that are beyond the ability of entrepreneurs to raise from their own resources and from family and below the minimum investment threshold of venture capital funds[7] – a figure that is in excess of £1m in the UK and $5 million in the USA (Sohl, 2003). Business angels, investing on their own or in small ad hoc groups, will typically invest up to £100,000, or even £250,000, while the larger angel syndicates (see section 6) will make investments of £500,000 and above. This is usually provided in the form of equity or a combination of equity plus loans. However, all-loan investments are by no means unusual.[8] In terms of *stage of business development*, investments by business angels are skewed towards the seed, start-up and early growth stages whereas venture capital funds focus on later stage deals. The role of business angels in seeding new ventures has become even more critical in recent years as institutional venture capital funds in North America and Europe have raised their

[7] For a venture capital fund the transactions costs involved in making investments – the time involved in undertaking the evaluation and negotiation of a deal, professional costs and the provision of post-investment support – are both substantial and largely fixed regardless the size of the investment. In 'small' investments these transaction costs represent a significant proportion of the overall investment, making them uneconomic. Business angels are able to make small investments because they do not cost their time in the same way as a venture capital fund managers and their requirement for professional support, for example from lawyers and accountants, is minimal.

[8] As Gaston (1989b) notes, the financial needs of new and young businesses are not neatly boxed into separate loan and equity categories. Their capital needs frequently shift between these types. Angels make their investments in the form of loans (usually unsecured), loan guarantees, equity and combinations of these types of finance.

minimum investment size and continued to shift their investment focus to later stage investments (Jensen, 2002; Sohl, 2003).

The second factor which underpins the economic significance of the informal venture capital market is the hands-on involvement of business angels in their investee businesses. Demand-side studies indicate that many entrepreneurs are seeking 'smart money' and for this reason business angels are valued ahead of other funding sources (Cressy and Olofsson, 1997; Lindström and Olofsson, 2001; Sætre, 2003). It has already been noted that business angels derive considerable psychic income from this involvement. Their entrepreneurial and business backgrounds have also been highlighted. Further discussion of the nature of this involvement can be found in section 5: suffice to say at this point that it ranges from informal coaching, mentoring and advice to Board participation. Business angels typically invest in industries and markets with which they are familiar. As a consequence, the entrepreneurs who are funded by business angels derive consider value from the expertise, knowledge and experience that their investors pass on through this hands-on involvement. This, in turn, increases the prospects for the success of their businesses. Indeed, entrepreneurs often report that the hands-on involvement of business angels is more valuable than the capital that they have received. However, hard evidence on the impact of this involvement on business performance remains elusive.

The informal venture capital market and the institutional venture capital market can therefore be seen as playing complementary roles in supporting entrepreneurial activity. This is evident in terms of the size and stage of investments made by business angels and venture capital funds (Freear and Wetzel, 1990). Harrison and Mason (2000) have highlighted other forms of complementarity in the form of information sharing, co-investing and sequential investing and note significant collaboration in these areas between business angels and venture capital funds in the UK. However, they also highlight the frequent tensions that arise from the different motives and expectations of angels and fund managers, the bureaucracy of venture capital funds and the unequal power relationship between angels and funds. Mason (2006) suggests that this relationship may have deteriorated during the post-

2000 technology downturn.[9] The importance of business angels in providing a deal flow for venture capital funds is highlighted by Madill et al (2005) who note that 57% of technology firms in Ottawa who had received funding from angels went on to raise institutional venture capital, compared with only 10% of firms which did not raise any angel investment. It is therefore clear that a thriving institutional venture capital market requires a healthy informal venture capital market, and vice versa. Policy-makers often fail to appreciate these connections and focus their intervention on the institutional venture capital market. But as this discussion makes clear, the impact of such interventions will be compromised if the informal venture capital market is under-developed.

A third contribution of informal venture capital to economic development arises from its geographical characteristics. This has two dimensions. First, "angels live everywhere" (Gaston, 1990: 273). Gaston's US research suggests that the proportion of business angels in the adult population is fairly constant at around four angels in every 1000 adults. Certainly, research has documented the presence of business angels in various economically lagging regions such as Atlantic Canada (Feeney et al, 1998; Farrell, 1998; Johnstone, 2001) where institutional sources of venture capital are largely absent.[10] Second, various studies indicate that the majority of investments by business angels are local. This reflects both the localised nature of their business and personal networks through which they identify most of their investments (see section 5) and their hands-on investment style and consequent need for frequent contact with their investee businesses. Two implications follow. First, in

[9] Many business angels suffered serious losses in the technology downturn. Those most affected were investors in technology businesses. Many of these businesses failed as a result of market decline or faulty business models. However, business angels also lost out in situations where businesses were able to raise further funding from either their existing venture capital investors or from new investors. In these circumstances, a combination of the inability of angels to provide follow-on funding, the much lower valuation of the subsequent funding compared with the original investment by the angels ('down-rounds') and their loss of rights as a result of the very onerous terms and conditions under which the venture capital funds invested in down rounds (e.g. liquidation preferences) resulted in a significant dilution in the angel's investment, often to the extent of rendering it worthless even if the investee company was a going concern. The consequence of this aggressive behaviour by venture capital funds has been to create considerable bad feeling between them and the angel community (Mason, 2006).

[10] However, there is a greater chance of a mismatch between the needs of the entrepreneurs and the preferences and value-added skills of potential investors in such regions. Johnstone (2001) notes that in the case of Cape Breton demand for angel finance is concentrated amongst IT businesses and they want investors to provide marketing and management inputs whereas the investors typically have no knowledge of the sector and so have limited ability to add value.

most areas outside of major financial centres and technology clusters business angels are the only source of risk capital (Gaston, 1989b). Second, the informal venture capital market is an important mechanism for retaining and recycling wealth within the region that it was created.

Informal venture capital also plays an important role in the emergence of technology clusters. This issue has attracted little explicit attention in the literature. However, it is obvious that nascent technology clusters lack indigenous sources of institutional venture capital do not have the visibility and track record to interest venture capitalists in other cities and regions. Thus, the only source of risk capital available to technology entrepreneurs in such clusters is likely to be business angels, although, of course, they will have made their money in different (and probably mature) industries and so need to be willing to take a 'punt' on businesses operating in industries that they do not understand. This was the case in the Ottawa technology cluster where the first generation of technology start-ups in the 1960s and 1970s were funded by business angels from traditional sectors (Mason et al, 2002). Once a technology cluster develops some momentum successful cashed-out technology entrepreneurs play a critical role in providing initial funding, hands-on support and credibility to the next generation of technology-based firms, grooming them for subsequent investment by venture capital funds which, by this stage in the cluster's development are now actively investing in the cluster's businesses. Silicon Valley, Cambridge, UK as well as Ottawa all provide good examples of this process.

## 4. GOVERNMENT SUPPORT FOR THE INFORMAL VENTURE CAPITAL MARKET

This evidence on the economic significance of the informal venture capital market has prompted governments at national and state/regional scales to develop initiatives to increase investment activity by business angels. These initiatives have taken two main forms. First, evidence from early studies that business angels and entrepreneurs were incurring high search costs in trying, often unsuccessfully, to find one another on account of the fragmented nature of the market and invisibility of angels (Wetzel, 1987; Mason and Harrison, 1994), prompted the establishment of *business angel networks* (BANs). The function of these organisations – which can be thought of as being similar to 'dating agencies' – is to enable entrepreneurs seeking

finance to come to the attention of business angels and at the same time enable business angels to receive information on investment opportunities (filtered to meet their investment criteria if desired) without compromising their privacy (Mason and Harrison, 1996a). The pioneering BANs, such as Venture Capital Network (VCN) in New England (Wetzel and Freear, 1996) and Canada Opportunities Investment Network (COIN) in Canada (Blatt and Riding, 1996) that were established in the 1980s offered computer matching services which were intended to ensure that angels only received details of investment opportunities that matched their investment criteria. COIN started as an Ontario initiative but was extended across Canada. In the USA, ACE-NET was created in the 1990s to enable investors to use the Internet to search for opportunities in all local/state BANs across the country (Acs and Prowse, 2001). UK and continental European BANs, in contrast, have been established using investment bulletins and investment forums as their main matching mechanisms. Here again there have been attempts to forge local BANs into a national marketplace (e.g. by the UK's National Business Angel Network).

BANs have received a mixed assessment. Harrison and Mason (1996) were positive about the early impact of pilot BANs in the UK, arguing that they had mobilised capital that would otherwise have remained invisible and promoted a relatively significant number of investments which, in turn, unlocked bank lending. Entrepreneurs have also benefited from advice and signposting to more appropriate sources of assistance, feedback from investors to whom they were introduced but did not invest, while there have been wider benefits in terms of the education of entrepreneurs, investors and intermediaries and a general raising of awareness about equity. However, other evidence from the UK and Canada reveals mixed satisfaction with BANs amongst investors. Many investors report that BANs have failed to provide them with a superior quality of investment opportunities. Certainly, they have been a marginal source of investments for most angels (Blatt and Riding, 1996; Mason and Harrison, 1996b; 1999). The case for the public subsidisation of BANs (Mason and Harrison, 1995) has also been challenged in the light of the willingness of private sector businesses to offer matching services. However, Mason and Harrison (1997) argue that publicly supported BANs are operating in a different part of the market than commercially-oriented BANs which focus on bigger, and often later stage, investments which are able to support their fees. Meanwhile attempts in the

UK, Canada and the USA to create national BANs have failed on account of the strong local/regional nature of investment activity (Blatt and Riding, 1996). There is now a growing consensus that BANs need to refocus away from pure financial intermediation to a broader approach which emphasises the education of participants in the market (Wetzel and Freear, 1996; Mason and Harrison, 1999; 2002a; Lange et al, 2002; San José et al, 2005).

Second, governments have created schemes which provide business angels with *tax incentives* in order to improve the risk-reward balance of investing in early stage businesses. Business angels are undoubtedly sensitive to levels of tax which is one of the few macro-economic factors that has a significant effect on encouraging or discouraging their investment activity (Mason and Harrison, 2000c). The UK's Enterprise Investment Scheme (EIS) enables investors who make investments which qualify under the scheme's rules to write-off the amount invested against income tax. In addition, capital gains are not subject to tax, losses can be offset against tax and, perhaps most useful of all, tax that is liable on capital gains from any type of investment can be deferred if part or all of this gain is invested using the EIS. A recent evaluation of the EIS has suggested that additionality is over 50% (i.e. at least half of the monies would not have been invested by these investors in the absence of the scheme) and that companies also benefited in terms of attracting investors who also provided business advice and expertise (Boyns et al, 2003). Several US states also offer business angels tax incentives (Lipper and Sommer, 2002). However, it is important to stress that business angels do not take the availability of tax incentives into account when evaluating *specific* investments, although this will influence how the investment is structured. For example, investments have to be in ordinary shares in order to qualify for EIS relief, even though current best practice suggests that preference shares may be a more appropriate investment instrument.

These initiatives have been supplemented by *amendments to securities legislation* which control the promotion of share issues in order to provide investor protection. Firms wishing to raise finance from the general public are required to produce a prospectus which has been approved by an authorised organisation to ensure that they are not potentially misleading. However, the costs involved are too high for the typical fund-raising exercise. This is no longer necessary in several

countries, such as the USA, Australia and, most recently, the UK, if the offer is promoted to self-certified high net worth individuals or sophisticated investors who give up certain legal protections and channels of legal redress to receive investment opportunities (HM Treasury, 2004a; 2004b). BANs in the UK have been exempt from the regulations concerning the promotion of investments for some time (Clarke, 1996).

However, in the light of recent evidence that business angels continue to be opportunity constrained despite being members of BANs (Mason and Harrison, 2002a), it is now recognised that there are also demand-side barriers to investment. A lot of businesses looking for investment from business angels are not investment ready, with missing information in the business plan (e.g. competitor analysis) and poorly developed ideas about the business model, markets, route to market and unrealistic expectations about investor requirements (e.g. involvement) (Feeney et al, 1999; Mason and Harrison, 2001; 2004a). These deficiencies are often accompanied by poor presentation (Mason and Harrison, 2003). Accordingly, recent interventions have sought to address the issue of 'investment readiness' (Mason and Harrison, 2001). There are examples of investment ready programmes in Canada (Industry Canada, 2001) and the UK (SQW, 2004). An alternative approach of *investment facilitation* is discussed by Mason and Harrison (2004a).

The most recent form of initiative is *co-investment schemes*. This has been prompted by the post-2000 venture capital investment downturn which followed the collapse of the technology bubble of the late 1990s. The response of venture capital firms was to cut back on making new investments in order to focus their attention on the businesses in their existing portfolios. The consequence for business angels was that they were unable to pass on those businesses in their portfolios to venture capital funds for follow-on investments and so had to do more follow-on investments themselves. This meant that they had less money and time available to make new investments. Co-investment schemes have addressed this liquidity constraint by matching angel investments with public money on a one-to-one basis up to a maximum figure. Angels have also co-invested alongside technology programmes such as SBIR and the Advanced Technology Program in the USA (Chang et al, 2002) and SMART in the UK which provide grants to technology companies to make the

transition from the laboratory to the market place. These schemes are particularly attractive to business angels. First, the funds provide a means of risk sharing. Second, the competitive peer review process by technology and business experts provides an independent source of assessment which assists in the due diligence process (Sohl, 2003).

## 5. THE INVESTMENT PROCESS

The aim of the early studies of the informal venture capital market was, in the words of William Wetzel jr, the pioneer of the field, "to put boundaries on our ignorance" (Wetzel, 1986: 132) by generating insights into the characteristics of business angels and their investment activity. In contrast, 'second generation studies' have focused on the investment process (Mason and Harrison, 2000a). Following Riding et al (1993) and Haines et al (2003) a number of discrete stages can be identified (Table 3):

- Deal origination
- Deal evaluation: this can, in turn, be sub-divided at least two sub-stages:
    - initial screening
    - detailed investigation
- Negotiation and contracting
- Post-investment involvement
- Harvesting

This sequence is similar in most respects to the investment decision-making model of institutional venture capital funds (Tyebjee and Bruno, 1984; Fried and Hisrich, 1994). However, the approach of business angels is less sophisticated.

Agency theory provides a framework to study the investment process. An agency relationship is said to exist when one individual (the principal) engages the services of another individual (the agent) to perform a service on their behalf (Jensen and Meckling, 1976). This involves the delegation of a measure of decision-making authority from the principal to the agent. Both are assumed to be economic-maximising individuals. The central concern of agency theory is opportunism. The separation of ownership and control creates the risk that the agent will make decisions that are not in the best interests of the principal. This creates two types of risk for the

Table 3. Stages in the Business Angel's Investment Decision

| | |
|---|---|
| Deal origination | The investor becomes aware of the opportunity – typically through one of the following channels: chance encounter, referral from business associates or other individuals or organisations in their network, or personal search |
| Deal evaluation | Two stages: (i) Initial screening/first impressions: key considerations are the 'fit' with the investor's personal investment criteria, their knowledge of the industry/market and their overall impression of the potential of the proposal. Also influenced by the source of the referral. (ii) Detailed evaluation: the investor will examine the business plan in detail, consult with associates, will meet the principals, take up references, research the proposal. The decision will be influenced by the potential of the industry, the business idea, impressions of the principals and potential financial rewards. |
| Negotiation and contracting | Negotiations with the entrepreneur over valuation, deal structuring and the terms and conditions of the investment. Main factor is pricing. |
| Post-investment involvement | Investor is likely to become involved with the business in some kind of hands-on capacity, including advice and mentoring, networking, functional input and member of board. Degree of involvement may vary according to the stage of business development and the performance of the business. |
| Harvesting | Exit from the business, either because it fails or by selling their shares to another investor. Investors normally exit from successful investments by means of a trade sale. |

principal (i.e. the investor). The first is adverse selection which arises as a result of informational asymmetries: the agent is better informed than the principal about their true level of ability. However, agents may deliberately misrepresent their abilities to the principal. The second risk is moral hazard. In situations where it is not possible for the principal to observe the behaviour of agents the agent may shirk, engage in opportunistic behaviour that is not in the interests of the principal or pursue divergent interests that maximise their economic interests rather than those of the principal. Fiet (1995) argues that every investment decision also includes market risk - the risk that the business will perform less well than anticipated on account of competitive conditions (e.g. competition, demand, technological change). This section considers how business angels manage these sources of risk.

### 5.1 Deal Origination

The evidence is consistent in suggesting that business angels adopt a relatively *ad hoc* and unscientific approach to identifying investment opportunities. Atkin and Esiri (1993) emphasise that most investments arise from chance encounters. Informal personal contacts – business associates and friends – are the most significant sources of deal flow. Professional contacts are much less significant: of these, accountants are the most frequent sources whereas few business angels receive deal flow from lawyers, bankers and stockbrokers. Those angels who are known in their communities also receive approaches from entrepreneurs. Information in the media is another source of deal flow for a significant minority of business angels. Some business angels also undertake their own searches for investment opportunities. Those business angels who are members of BANs also report that they are significant sources of deal flow (Mason and Harrison, 1994; 2002a). In some cases – especially in the case of *ad hoc* investors - the entrepreneur is not a stranger but a business associate who is known to the angel (e.g. client, supplier) (Atkin and Esiri, 1993). Kelly and Hay (2000) observe that the most active investors have less reliance than occasional investors on 'public' sources (e.g. accountants, lawyers, etc) for their deal flow and. place more emphasis on 'private' sources. Thus, most of their deals are referred by individual and institutional sources in their extensive and longstanding networks of relationships.

However, these various sources of information differ in their effectiveness. Freear et al (1994b) have calculated yield rates for various sources of deal flow (i.e. comparing investments made against deals referred for each information source). This points to the informal personal sources of information - business associates, friends and approaches from entrepreneurs – as the ones that have the highest probability of leading to investments whereas non-personal sources such as accountants, lawyers and banks have a low likelihood of generating investments. These findings are largely corroborated by Mason and Harrison (1994) for the UK. However, in their study the highest yield rates are recorded by some of the infrequently used professional contacts, notably banks and stockbrokers. This study also notes the low yield ratio for BANs. Riding et al (1995) find that the rejection rate at the initial screening stage for deals referred by business associates is lower than that for other referral sources.

Investing in businesses that are referred by trusted business associates and friends is an obvious way in which business angels can minimise adverse selection problems. As Riding et al (1995) comment, "even if the principals of the firm are unknown to the investors, if the investor knows and trusts the referral source risk is reduced." Deal referrers are passing judgement on the merits of the opportunity and so are putting their own credibility and reputation on the line.

**5.2 Deal evaluation**

The process of evaluating investment opportunities involves at least two distinct stages – initial screening and detailed investigation (or due diligence (Riding et al, 1993) – although this is not reflected in most studies. The initial step of business angels is to assess investment opportunities for their 'fit' with their own personal investment criteria. The investment opportunity will also be considered in terms of its location (how close to home?), the nature of the business and the amount needed and any other personal investment criteria (Mason and Rogers, 1997). The business angel will also typically ask themselves two further critical questions: first, 'do I know anything about this industry, market or technology?' and, second, 'can I add any value to this business?' Clearly, the ability to add value is very often a function of whether the angel is familiar with the industry. If the answer to either question is negative then the opportunity will be rejected at this point.

Angels then undertake a quick review of those opportunities that fall within their investment criteria to derive some initial impressions. Although most business angels expect a business plan, they are unlikely to read it in detail at this stage. Their aim at this point in the decision-making process is simply to assess whether the proposal has sufficient merit to justify the investment of time to undertake a detailed assessment. This stage has been the subject of a detailed analysis by Mason and Rogers (1996; 1997) using verbal protocol analysis, an experimental-type technique which asks subjects (in this case business angels) to think out loud as they perform a task (in this case evaluating a real investment opportunity). They observe that angels approach this stage with a negative mindset, expecting that the opportunity will be poor (because of the opportunities that they have previously seen) and looking for reasons to reject it. This approach has been termed 'three strikes and you're out' (Mason and Rogers, 1996; 1997) and is supported by evidence that the rejection of

opportunities is generally based on several factors rather than a single deal killer (Mason and Harrison, 1996c). The market and the entrepreneur are the key considerations at this stage. Less significant are the product/service and financial factors. Indeed, angels exhibit considerable scepticism about the value of financial information in the business plan of start-ups: as one investor in the Mason and Rogers (1996: 45) study commented, "I take [financial projections] with a great pinch of salt, especially from accountants because they can tweak the assumptions and come up with any figure. So, it's the last thing I look at." Nevertheless, investors want to see that there is the potential for significant financial return, that the principals are financially committed and what the money that is invested will be used for. Some angels will be flexible, willing to treat these criteria as compensatory (e.g. a strong management team would compensate for a distant location), whereas others will regard them as non-compensatory (Feeney et al, 1999).

The purpose of the initial screen is to filter out 'no hopers' in order to focus their time on those opportunities that appear to have potential. These are subject to more detailed appraisal. The investor will read the business plan in detail, go over the financial information, visit the premises, do some personal research to gather additional information on market potential, competition and so on, and assess the principals. Indeed, getting to know the principals personally (by a series of formal and informal meetings) is the most vital part of the process (May and Simmons, 2001). This stage has received little attention from researchers. According to May and Simmons (2001: 101) "it might consist of a few phone calls and a visit or two, or weeks of meetings, documents flying back and forth and questions, questions, questions." However, it would appear that most angels emphasise their intuition and gut feeling rather than performing formal analysis (Haines et al, 2003) – although more experienced angels, and angel groups (see section 6) adopt more sophisticated approaches (e.g. see Blair, 1996).[11]

Once the opportunity has passed from the initial screen the importance of 'people' factors becomes critical (Riding et al, 1995), with investors emphasising management abilities, an understanding of what is required to be successful, a strong

[11] Benjamin and Margulis (2000: 205-18) provide an example of a due diligence questionnaire.

work ethic, integrity, honesty, openness and personal chemistry (Haines et al, 2003; Mason and Stark, 2004). This reflects the long and personal nature of the angel-entrepreneur relationship.[12] Rewards, realism of the projections and potential also assume greater importance while 'investor fit' becomes less of a consideration (Riding et al, 1995).

This stage ends when the investor has decided whether or not to negotiate a deal with the investor. In their Canadian study Riding et al (1993) found that 72.6% of opportunities were rejected at the initial impressions stage, a further 15.9% were rejected following more detailed evaluation, and as this stage proceeds another 6.3% were eliminated, a cumulative rejection rate of 94.8%. Thus, business angels proceed to the negotiation stage with only 5% of the investment opportunities that they receive.

The key role of the entrepreneur/management team in the decision whether or not to invest is confirmed in other studies. Using conjoint analysis – a method to measure quantitatively the relative importance of one decision-making criteria in relation to another (see Shepherd and Zacharakis, 1999) – Landström (1998) found that business angels attach the greatest importance to the leadership capabilities of the principals, followed by the potential of the firm's market and products. Feeney et al's (1999) approach was to ask business angels "what are the most common shortcomings of business opportunities that you have reviewed recently?" This highlighted shortcomings in both the management (lack of management knowledge, lack of realistic expectations, personal qualities) and the business (poor management team, poor profit potential for the level of risk, poor fit, undercapitalised/lack of liquidity, insufficient information provided). Asking investors "what are the essential factors that prompted you to invest in the firms that you have chosen?" (Feeney et al, 1999) highlighted three management attributes – track record, realism and integrity and openness – and four attributes of the business – potential for high profit, an exit plan, security on their investment and involvement of the investor. However, while the

[12] Riding et al (1995) quote one Canadian investor who said that the potential investee business had to pass what was termed 'the Toledo test'. That is, if the angels was not willing to spend a weekend in Toledo (a particularly unattractive US city with few diversions) with the principal(s) the investment would not be undertaken. The British equivalent might be "the Luton test" or "the Hull test" (these cities have the dubious privilege of coming out top of the first and second *Crap Town League*: www.craptowns.com).

primarily deal killer is the perception of poor management, the decision to invest in an opportunity involves a consideration of management ability, growth and profit potential. In other words, angels are looking for businesses that show growth potential and have an entrepreneurial team with the capability to realise that potential (Feeney et al, 1999). Both these studies also emphasise that investment criteria are personal, with angels using different criteria in their assessment of investment proposals. For example, Feeney et al (1999) suggest that the decision processes of more experienced investors differs from that of less experienced investors.

This emphasis on the entrepreneur reflects the view of angels that agency risk is more of a threat than market risk. Fiet (1995) argues that business angels lack information or the tools and resources to evaluate market risks effectively. As a consequence, they specialise in evaluating agency risk – assessing whether or not the entrepreneur can be relied upon as a venture manager – while relying upon competent and trustworthy entrepreneurs to manage market risk.[13] This contrasts with venture capital funds which attach more importance to market risk than agency risk. They are less concerned with agency risk because they have learnt how to protect themselves using stringent boilerplate contractual provisions which allows them to replace an entrepreneur who is not performing or is found to be incompetent. Thus, "compared with venture capital investors, business angels place much more importance upon screening entrepreneurs than deals for market risk" (Fiet, 1995: 567).

### 5.3 Negotiation and contracting

Having decided, in principle, to invest the business angel must negotiate terms and conditions of the investment that are acceptable both to themselves and also to the entrepreneur. There are three main issues – valuation, structuring of the deal (share price, type of shares, size of shareholding, timing) and the terms and conditions of the investment, including the investor's role. In agency theory terms deal structuring – mechanisms for allocating the rewards to the investor and entrepreneur – are an

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[13] Sørheim (2003: 357) makes a similar point. ".. Experienced business angels in the study emphasize that they are investing in the very early stage in the life cycle of entrepreneurial ventures. Consequently, they must by-and-large depend on the information provided by the entrepreneur or entrepreneurial team, and are therefore very much concerned with [their] perceived trustworthiness… The investors in this study perceive the creation of some kind of common platform involving shared goals and values as an antecedent for developing trustworthy relationships between entrepreneurs and [themselves]. If this common platform is found to be lacking they reject the opportunity."

attempt to align the behaviour of the entrepreneur with that of the investor, while the terms and conditions attempt to control the behaviour of the entrepreneur. These are major lacunae in the informal venture capital market research.

In the study by Riding et al (1993) half of the investment opportunities that reached this stage were not consummated. The most frequent reason for not making an investment was associated with valuation, notably "inappropriate views by entrepreneurs (in the opinion of the investors) regarding the value of the firm as a whole and, within the firm, the value of an idea compared to the overall value of a business. Most investors note that potential entrepreneurs overvalue the idea and undervalue the potential contributions (both financial and non-financial) that are required to grow and develop a business" (Haines et al, 2003: 24). Putting a value on the 'sweat equity' of the entrepreneurs is also problematic.

There is no universally agreed method of valuing a small company. Market-based valuations are inappropriate because small businesses are not continually valued by the market and appropriate comparator stocks are unlikely to be available. Asset-based valuations are more commonly used although finance theory prefers earnings or cash-flow based valuations because they value the business in terms of the future stream of earnings that shareholders might expect from the business. However, these approaches are complex. Valuation of new and early stage businesses adds further complications because they may only have intangible assets (e.g. intellectual property). It is therefore not surprising, especially since most angel investments are concentrated at start-up and early stage, that methods of pricing and calculating the size of shareholdings are remarkably imprecise and subjective (Mason and Harrison, 1996d), based on rough rules of thumb or gut feeling. As investors, May and Simmons (2001: 129) note that "the truth about valuing a start-up is that it's often a guess." Where an attempt is made to price the investment on a more rigorous basis then the earnings based approach is the most common method (Lengyel and Gulliford, 1997).

Angels draw up contracts as a matter of course to safeguard their investment, although their degree of sophistication varies. Contracts specify the rights and obligations of both parties and what will by done, by whom and over what time

frame. Their objective is to align the incentives of the entrepreneur and the investor by means of performance incentives and direct control measures. Kelly and Hay (2003) note that certain issues are non-negotiable: veto rights over acquisitions/divestments, prior approval for strategic plans and budgets, restrictions on the ability of management to issue share options, non-compete contracts required by entrepreneurs on the termination of their employment in the business, and restrictions on the ability to raise additional debt or equity finance. These issues give investors a say in material decisions that could impact the nature of the business or the level of equity holding. However, there are also a number of contractual provisions to which angels attach low importance, and which might be considered to be negotiable. These include forced exit provisions, investor approval for senior personnel hiring/firing decisions, the need for investors to countersign bank cheques, management equity ratchet provisions and the specification of a dispute resolution mechanism. Less experienced investors place relatively greater emphasis on the need to include a broad array of contractual safeguards to protect their interests. However, experienced investors are more likely to include specific provisions that can impact the level of their equity stake (share options, ratchets) and the timing of exit (forced exit provisions). In other words, with experience business angels become more focused on those elements that can impact their financial return.

Investors recognise that the investment agreement must be fair to both sides (May and Simmons, 2001): contracts that favour the investor will be detrimental to the entrepreneur's motivation. In Mason and Harrison's (1996d) study, two-thirds of investors and entrepreneurs considered that the investment agreement was equally favourable to both sides, and half of the investors reported that this was their objective. Indeed, a significant minority of investors believed that the agreement actually favoured the entrepreneur. Thus, the available evidence suggests that in most cases entrepreneurs are not exploited by investors when raising finance.

The inclusion of contractual safeguards does not indicate whether investors will be willing to invoke them to protect their interests. Moreover, contracts are, of necessity, incomplete by their very nature. There are three reasons for this: it is costly to write complete contracts; it is impossible to foresee all contingencies; and on account of asymmetric information (van Osnabrugge, 2000). Thus, in practice

investors place a heavy reliance on their relationship with the entrepreneur to deal with any problems that arise (van Osnabrugge, 2000; Kelly and Hay, 2003). Indeed, Landström et al (1998) argue that one of the purposes of establishing a contractual framework at the outset is to provide a basis for the development of a relationship between the parties to develop. In other words, the contract is less a protection mechanism *per se*; rather, it is a means by which mutual behaviour expectations of all parties in the transaction can be clarified.

Most angel investments involve input from professional advisers. For example, lawyers would normally review, and might draw up, the investment agreement, but would not be involved in the negotiations. Similarly, accountants may be consulted for advice but would rarely play a more prominent role. Thus, transactions costs are low (Mason and Harrison, 1996d). In Lengyel and Gulliford's (1997) study the entrepreneur's costs amounted to an average of 5.1% of the funds raised (and 29% reported no costs) while for the investor the average costs were 2.8% of the amount invested (and 57% reported no costs).

The time taken by business angels to make investments is much quicker than that of venture capital funds (Freear et al, 1995). Mason and Harrison (1996d) report that in their study the entire investment process rarely extended over more than three months, and often took less than a month. Most negotiations took less than a week to complete whereas the evaluation could take up to three months or more. Thus, in nearly half of the investments less than a month elapsed between the entrepreneur's first meeting with the investor and the decision to invest; in 85% of cases the elapsed time was under three months.

**5.4 Post investment involvement**

From an agency perspective, monitoring is the main way in which principals attempt to mitigate the risk of opportunistic behaviour on the part of the agent going undetected. In line with this expectation, most business angels play an active role in their investee businesses. There is a spectrum of involvement: at one extreme are passive investors who are content to receive occasional information to monitor the performance of their investment while at the other extreme are investors who use their investment to buy themselves a job. However, most angels do not want day-to-day

involvement hence the typical involvement ranges from a day a week (or its equivalent) to less than a day a month (Mason and Harrison, 1996d). Nevertheless, Sætre (2003) emphasises that some angels are so involved, and involved so early, that they are indistinguishable from the entrepreneurs, and are seen by the entrepreneurs as being part of the entrepreneurial team. In similar vein, Politis and Landström (2002) see angel investing as simply a continuation of an entrepreneurial career.

Madill et al (2005) identify a number of roles that business angels play in their investee businesses: advice about the management of the business, contacts, hands-on assistance (e.g. legal advice, accountancy advice, provision of resources), providing business and marketing intelligence, serving on the Board of Directors or Advisory Board, preparing firms to raise venture capital and providing credibility and validation. Sørheim (2005) emphasises the role of business angels in helping their investee businesses to raise additional finance. The nature and level of involvement is influenced by geography. Landström (1992) notes that frequency of contact between angels and their investee companies is inversely related to the geographical distance that separates them. It will also be influenced by the performance of the business, with angels more involved at particular stages of business development and in crisis situations.

However, in contrast to agency theory the involvement of angels in their investee businesses is not motivated by monitoring considerations. First, as noted earlier, angels derive psychic income from their involvement in their investee businesses in the form of fun and satisfaction from being involved with new and growing businesses and their belief that their experience, know how and insights can ‘make a difference’. May and Simmons (2001: 156) quote one investor as follows: “I’ve never had as much fun in my life. It’s a joy to see someone listen, take action and win.” Second, angels see themselves as ‘offering help’ rather than ‘checking up’ on their investee businesses by acting as mentors, providing contacts, guidance and hands-on assistance (Haines et al, 2003). Third, as Kelly and Hay (2003: 309) comment, “from the outset, the relationship between the business angel and the entrepreneur appears to be more positive and trusting in character than the inherently adversarial one implied by agency theorists.”

A majority of entrepreneurs and angels regard their relationship as productive and consensual – although entrepreneurs have a more favourable view of its productiveness than angels (Freear et al, 1995; Mason and Harrison, 1996d). One study reported that half of the entrepreneurs who had raised finance from business angels regarded their contributions as being helpful or very helpful (Mason and Harrison, 1996d). Another study reported that entrepreneurs considered that the most valuable contribution of their business angel has been as a sounding board (Harrison and Mason, 1992). There is a suggestion that entrepreneurs want their investors to be more involved in certain areas, especially financial management (Ehrlich et al, 1994). Criticisms by entrepreneurs who have raised finance from angels are mainly concerned with those who lack knowledge of the product or market (Lengyel and Gulliford, 1997). Finally, most business angels report that they have derived fun and enjoyment from their investments, often more than expected, in cases where the investment is still trading, but not when the business has failed. Psychic income returns are therefore related to business performance rather than compensating for financial loss (Mason and Harrison, 1996d). However, there has been no rigorous attempt to assess whether this involvement of business angels has a favourable impact on the performance of their investee businesses. There is no evidence from research on venture capital funds that greater involvement is a necessary condition for adding value nor whether involvement produces enhanced business performance (Sapienza and Gupta, 1994; Fried et al, 1998). This may be because the involvement of venture capitalists is concentrated on their poorly performing investments, determining whether and how they can be turned around, or even whether continued support is desirable (Zider, 1998; Higashide and Birley, 2002).[14] There are also formidable methodological challenges.[15]

### 5.5 Harvesting

Investing in unquoted companies is regarded as being high risk. Certainly, the performance of European venture capital funds specialising in early stage investments (in practice this means technology-focussed investments) have much lower rates of

[14] In contrast, Sapienza et al (1996) argue that venture capitalists adopt a 'home run' strategy of focussing their attention on likely winners rather than those businesses in their portfolio which are likely to yield little return.
[15] Harrison and Mason (2004) propose critical incident analysis as an alternative way in which to assess the contribution of investors.

return than those which focus on later stage investments (EVCA, 2005). Diversification is the main strategy for reducing risk. However, this is not an option for business angels. First, typically they have just a handful of investments in their portfolios. Second, they often restrict their investments to sectors which they know and understand, so their portfolios are unbalanced. Third, as the first external investor in a business, and generally lacking the financial resources to make follow-on investments, they are vulnerable to being diluted in the event that further funding rounds are required.

There have been only two studies of the investment returns of business angels, a small scale Finnish study (Lumme et al, 1998) and a larger UK study (Mason and Harrison, 2002b). It is important to note that these studies only measure multiples achieved on the amounts invested. However, many angels also attempt to draw back at least part of their investment in the form of a director's fee or interest on loans provided, either immediately or at some stage in the future when the business is financially stronger. This could be quite a significant proportion of the investment in smaller deals (Mason and Harrison, 1996d; Lengyel and Gulliford, 1997). The UK study highlights the highly skewed distribution of returns, with 40% of investments making a loss (34% a total loss), and another 13% only achieving break-even or generating bank account-level returns. However, there was a significant subset of investments, some 23% in total, which generated internal rates of return (IRRs) in excess of 50%.

The UK study went on to explore the types of *investments* that were likely to be successful. It identified large investments, large deal sizes and deals involving multiple investors as being more likely to be high performing investments (Mason and Harrison, 2002b). A separate analysis of the returns distribution of technology and non-technology investments found no significant differences in the returns profile (Mason and Harrison, 2004b). This may suggest that the risk of investing in technology sectors has been over-stated. Another possibility is that business angels are better able to mitigate the risks involved in investing in technology businesses on account of their specialist expertise and entrepreneurial background.

The Finnish study, in contrast, sought to identify differences between the most, and least, successful *investors*. The most successful investors were more likely to be motivated by the fun and interest of making such investments, have a large deal flow and have a lower estimation of the value of their hands-on involvement. The least successful investors were more likely to be motivated by altruism, have a low deal flow and make few investments and rely to a greater extent on friends for deal flow. They were also more likely to make investments in friends' businesses and have a different pattern of hands-on involvement, over-emphasising contributions that other research has suggested are least important in adding value (Lumme et al, 1998).

Comparison with the returns achieved by institutional venture capital investors is problematic because the reporting unit is the fund, whereas angels invest on a deal-by-deal basis. However, Murray (1999) has reported deal specific returns for one UK venture capital fund. Comparing the returns achieved by business angels with this information reveals a much higher loss rate by the venture capital fund (64%) and a lower proportion of investments that generated a moderate return, but very similar proportion of high return investments (IRR in excess of 50%). The interpretation of these differences is that because the venture capital fund is seeking to maximize the performance of the fund it can be more ruthless with those investments that are performing moderately, in order to focus the time of its executives on supporting the best performing investments whereas business angels invest on a deal-by-deal basis (Mason and Harrison, 2002b).

Business angels are thought to be relatively patient investors, willing to hold their investments for up to seven years or more (Wetzel, 1981; Mason and Harrison, 1994). In reality, angels hold their investments for a much shorter time. The median time to exit in the UK is four years for high performing investments and six years for moderately performing investments, while failures appear, on average, after two years (Mason and Harrison, 2002b). In Finland investments that had a positive outcome were five years old at harvest whereas those which failed had an average holding time of 2.8 years. In both studies a trade sale (i.e. sale of the company to another company) was the most common exit route for successful investments, with an IPO only accounting for a small minority of cases. Trade sales, along with sale to existing

shareholders were the most common exit routes for investments with little or no value.

## 6. THE EVOLUTION OF THE ANGEL MARKET

Recent research in the USA has revealed that the angel market place is evolving from a largely invisible, atomistic market dominated by individual and small *ad hoc* groups of investors who strive to keep a low profile and rely on word-of-mouth for their investment opportunities, to a more organised market place in which angel syndicates (sometimes termed 'structured angel groups') are becoming increasingly significant. As a result, the angel market place is in the process of being transformed from a 'hobby' activity to one that is now increasingly professional in its operation, with published routines for accessing deals, screening deals, undertaking due diligence, negotiating and investing (May, 2002). Sohl et al (2000) claim that "angel alliances are the fastest growing segment of the early stage equity market." However, solo investors still dominate the market (Lengyel and Gulliford, 1997; Investor Pulse, 2003; Infometrics, 2004)

The Band of Angels, which was founded in Silicon Valley in 1995, is generally regarded as the first organised syndicate to be formed. Others, such as Tech Coast Angels (1997), Sierra Angels (1997), Common Angels (1997) and The Dinner Club (1999), soon followed.[16] There are currently estimated to be around 200 angel syndicates located throughout the USA and growing evidence of specialisation by industry sector (e.g. health care angel syndicates) and type of investor (e.g. women-only angel syndicates). A national body to bring angel groups together for the purposes of transferring best practice, lobbying and data collection was created in 2003 (Angel Capital Association, 2005). The same trend is also clearly evident in the UK although at an earlier stage, and it has not attracted the same degree of attention from researchers or commentators.[17]

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[16] Several of these angel groups have been profiled in the scholarly literature (May and Simmons, 2001; May, 2002; Cerullo and Sommer, 2002; Payne and Mccarty, 2002; May and O'Halloran, 2003).

[17] For example, in Scotland there are estimated to be, depending on definition, between 6 and 12 angel groups which invested around £40m in more than 50 companies. The leading syndicates – for example, Archangels and Braveheart - have high visibility, including their own web sites which list their investments, and their investments are reported in the media. Archangels has been operating for about ten years. Its web site lists 20 investments in which they have invested over £30m. In 2002 it invested £1.5m in six new investments and £4.3m in eight follow-on investments. Some of these investments

Angel syndicates emerged because individual angels found advantages of working together, notably in terms of better deal flow, superior evaluation and due diligence of investment opportunities, and the ability to make more and bigger investments, as well as social attractions. They operate by aggregating the investment capacity of individual high net worth individuals (HNWIs). Some groups are member-managed while others are manager-led (Preston, 2004). Syndicates take various forms but the most common generic type of model (at least in the USA) is as follows:

- Limited and selective membership of angels (typically 20-75 members) who typically play an active role in the investment process
- Meet regularly (e.g. for dinner) to hear 'pitches' by entrepreneurs seeking finance
- A syndicate manager supports members by organising meetings, communications and manages logistics.
- The manager or a core group of members will screen the deal flow and select the companies which are invited to pitch
- Q&A session follows each pitch
- Angels vote whether to pursue their interest in the business
- If the vote is in favour a sub-group will be appointed to undertake the due diligence and report back to the full membership
- If the recommendation is positive, individual members make their own decisions whether or not to invest (there is likely to be a minimum investment threshold for each deal) and the syndicate will combine all of the member dollars into a single investment. Alternatively, if the syndicate operates a pooled fund a majority vote will decide whether or not to invest.
- An expectation that each member of the syndicate will make a certain number of investments per year.

Some of the larger and longer established US syndicates have also established sidecar funds – that is, committed sources of capital that invest alongside the angel group.

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were made as part of syndicated deals involving other angel syndicates and venture capital funds. Braveheart has been operating since 1997. It has 50 members. It has made 22 investments in 17 companie. To put the scale of their investment in some kind of perspective, both Archangels and Braveheart now make more early stage investments in Scotland than any single venture capital fund. Moreover, both syndicates participate in Scottish Enterprise's Co-investment Scheme, underlining their 'institutional' status. Curiously, in England angel syndicates adopt a much lower profile.

The investors in such funds are normally the syndicate members but may also include other HNWIs or institutions. These funds give the syndicate additional capital to invest in deals to avoid dilution, enables syndicate members to achieve greater diversification by exposing them to more investments than they can make directly through the syndicate, and is a means of attracting 'right-minded' investors who want to participate in seed and early stage deals but cannot be active members of a syndicate (e.g. because of lack of time).

The emergence of angel syndicates is of enormous significance for the development and maintenance of an entrepreneurial economy. First, they reduce sources of inefficiency in the angel market. The angel market has traditionally been characterised by inefficiency on account of the fragmented and invisible nature of angels. There was no mechanism for angels to receive a steady flow of investment opportunities. They found their deals by chance. The entrepreneur's search for angel finance was equally a hit-or-miss affair. Investors and entrepreneurs both incurred high search costs (Wetzel, 1987; Mason and Harrison, 1994). This encouraged many to drop out of the market as either suppliers or seekers of finance. Angel syndicates, in contrast, are generally visible and are therefore easier for entrepreneurs to approach.

A further source of inefficiency was that each investment made by an investor has typically been a one-off that was screened, evaluated and negotiated separately. However, because of the volume of investments that angel syndicates make they have been able to develop efficient routines for handling investment enquiries, screening opportunities and making investment agreements.

Second, they have stimulated the supply-side of the market. Syndicates offer considerable attractions for HNWIs who want to invest in emerging companies, particularly those who lack the time, referral sources, investment skills or the ability to add value. However, many individuals who have the networks and skills to be able to invest on their own are also attracted by the reduction in risk that arises from investing as part of a syndicate, notably the ability to spread their investments more widely and thereby achieve greater diversification, and access to group skills and knowledge to evaluate investment opportunities and provide more effective post-

investment support. Other attractions of syndicates are that they enable individual angels to invest in particular opportunities that they could never have invested in as individuals, offer the opportunity to learn from more experienced investors and provide opportunities for camaraderie and schmoozing with like-minded individuals. Syndicates will also be attractive to individuals who want to be full-time angels. Thus, angel syndicates are able to attract and mobilise funds that might otherwise have been invested elsewhere (e.g. property, stock market, collecting), thereby increasing the supply of early stage venture capital, and to invest it more efficiently and effectively.

Third, they are helping to fill the 'new' equity gap. Venture capital funds have consistently raised their minimum size of investment and are increasingly abandoning the early stage market (after briefly returning during the "dot-com bubble" of the late 1990s). Most funds have a minimum investment size of at least £500,000 and the average early stage investment by UK venture capital funds in recent years has been around £1m (BVCA, 2004). This has resulted in the emergence of a new equity gap – roughly the £250,000 to £2m+ range which covers amounts that are too large for typical '3F' money (founder, family, friends) but too small for most venture capital funds. Angel syndicates are now increasingly the only source for this amount of venture capital in this range. The same trends - increasing deal sizes by venture capital funds and emergence of angel syndicates to fill the gap - are also evident in the USA where the 'gap' is estimated to be in the $500,000 to $5m range (Sohl, 1999; 2003).

Fourth, they have the ability to provide follow-on funding. One of the potential problems of raising money from individual business angels is that they often lack the financial capacity to provide follow-on funding. The consequence has been that the entrepreneur is often forced to embark on a further search for finance. Moreover, in the event that the need for additional finance is urgent then both the entrepreneur and the angel will find themselves in a weak negotiating position with potential new investors, resulting in a dilution in their investments and the imposition of harsh terms and conditions. With the withdrawal of many venture capital funds from the small end of the market individual angels and their investee businesses have increasingly been faced with the problem of the absence of follow-on investors. However, because angel syndicates have got greater financial firepower than individual angels or *ad hoc* angel

groups they are able to provide follow-on financing, making it more efficient for the entrepreneur who avoids the need to start the search for finance anew each time a new round of funding is required.

Fifth, their ability to add value to their investments is much greater. The range of business expertise that is found amongst angel syndicate members means that in most circumstances they are able to contribute much greater value-added to investee businesses than an individual business angel, or even most early stage venture capital funds. May and Simmons (2001: 156), leading angel syndicate practitioners in the USA, comment that "when angels band together … their smorgasbord of advice and strategic services frequently makes the difference between life and death for a start-up."

Finally, angel syndicates have greater credibility with venture capitalists. Venture capital funds often have a negative view of business angels, seeing them as amateurs whose involvement in the first funding round of an investment could complicate subsequent funding rounds because of their tendency to over-price investments, use complicated types of investment instruments and make over-elaborate investment agreements (Harrison and Mason, 2000). Venture capitalists may therefore avoid deals in which angels are involved because they perceive them to be too complicated to do. However, because of the professionalism and quality of the membership of angel syndicates venture capital funds hold them in much higher esteem. Accordingly, the increasing prominence of angel syndicates results in much greater complimentarity between the angel market and venture capital funds, to the benefit of fast-growing companies that raised their initial funding from angel syndicates but now need access to the amounts of finance that venture capital funds can provide.

## 7. CONCLUSION

This chapter has sought to highlight the significance of the informal venture capital market as a source of funding for entrepreneurial businesses. However, its significance is frequently overlooked in both the academic and practitioner literature and by policy-makers where the emphasis continues to be placed on institutional venture capital, despite its almost non-existent role in funding new and recently started businesses. There are three inter-related reasons why the informal venture

capital market is often overlooked. First, the market is invisible and fragmented. There are no directories of angel investors and their investments are not recorded in any systematic way. Second, because of the invisibility of business angels, and their efforts to maintain their secrecy, it is extremely difficult to undertake research on the size and operation of the market. Research is typically based on small-scale snapshot samples of convenience which are unsuited to statistical analysis. Third, the research base is limited and largely atheoretical. Indeed, the initial studies in the 1980s and early 1990s were descriptive, aimed at profiling angel characteristics, motivations and investment activity. However, recent research has become more analytical, focusing on actual behaviour rather than preferences, on aspects of the investment process rather than on the actors, and has become more anchored in theory, with several studies using agency theory as a framework for analysis. Nevertheless, the opportunities for further research are considerable.

First, there is an urgent need to get way from snapshot surveys of the angel market and to develop longitudinal research on the angel market. This involves two dimensions (Sohl, 2003). The first has the business angel as the unit of analysis and seeks to develop information on investor and investment trends. The challenge, as always, is in the methodology. One approach is simply to repeat snapshot surveys at regular intervals. A more manageable, if partial, approach is to identify and survey angel syndicates on a regular basis, while a third approach would be to develop an angel panel which is surveyed on a regular basis. The second approach takes the deal as the unit of analysis and tracks it from the point of referral to the angel through to rejection or investment and on to subsequent funding round and exit. Much of the research in venture capital is 'timeless' in the sense that it does not reflect the economic conditions of the time (Mason and Harrison, 2004c). Thus, an important dimension of such longitudinal studies involves relating investment trends to the wider economic conditions of the time. For example, how angels responded to the post-2000 investment downturn remains largely unexplored and unanswered (but see Mason, 2006, for a brief discussion).

Second, the emergence of angel syndicates raises a series of questions. Are they attracting investors who are new to the market, and thus new money that would otherwise have been invested elsewhere, or are they attracting solo angels? If they are

attracting solo angels, will this deplete the population of small-scale investors and thereby re-open the sub £250,000/$500,000 equity gap? As angel syndicates become more organised and develop fixed costs will this lead to an upward drift in their investment activity, thereby re-opening the equity gap?

Third, taking a 'food chain' perspective, are the complementarities between angels and venture capital funds diminishing as venture capital funds continue to shift their investment focus to larger and later stage deals. Can angel syndicates fill this gap – are their financial resources big enough to by-pass venture capital funds and take their investee businesses to a harvest event themselves, or by co-investing with other angel syndicates? Indeed, are we seeing the beginning of a bifurcation of the venture capital market between businesses that because of the scale of their R&D or capital investment require multi-million dollar investments over several rounds (e.g. life sciences, telecoms infrastructure), and therefore need funding from venture capital funds, and businesses (e.g. software) whose funding requirements are more modest, in the $10m-$20m range, and so could be funded largely or entirely by angel syndicates?

Fourth, the chapter has noted that many governments now recognise the economic significance of business angels and have introduced various measures to support the informal venture capital market. However, Aernoudt (1999) argues that the case for government intervention is not proven. Thus, there is scope for further applied research which explores whether the case for intervention is justified, and if the case is supported what is the most appropriate form(s) of intervention. Can the studies of that various national venture capital associations undertake of the economic impact of venture capital be replicated for informal venture capital? Research from various countries is consistent in finding that angels are opportunity constrained. Understanding the reasons would seem to be the top priority for policy-makers. How much stems from the limitations of the investors themselves (e.g. restricted investment criteria, competence limitations), how much is due to the inefficiencies in the operation of the market and how much is a result of the lack of investment readiness amongst businesses seeking finance? Can 'second generation' business angel networks – which focus on raising the competence of the participants in the market – make a difference?

There are also a host of issues where information is either lacking or requires corroboration. Examples of the former include identifying the characteristics of altruistic investors (Sullivan, 1994), women business angels (Brush et al, 2002; Harrison and Mason, 2005) and successful investors. The concept of an 'angel career' (Politis and Landström, 2002) offers a potentially useful way in which to explore angel learning. The negotiation, valuation and contracting stages remain poorly understood. For example, exploring the entrepreneur's perspective would be a useful way in which to extend Kelly and Hay's (2003) pioneering study of business angel contracts. Many aspects of the post-investment relationship also require to be examined. Understanding the relational component is one issue. How do the parties cope with adversity? When do business angels find it necessary to assert their rights and how do they do so? (Kelly and Hay, 2003). Quantifying the impact of the value-added contribution of angels on business performance, and the contributions of different types of business angels, is another issue that requires attention. Mason and Harrison's (2002a) study of investment returns requires corroboration. Meanwhile, adopting new methodological approaches to explore topics that are better understood (e.g. investment decision-making) might provide new insights or challenge existing understanding. Finally, future research needs to have stronger theoretical foundations. Agency theory – the most commonly used theoretical framework - has been shown to have its limitations in a business angel context (Landström, 1992; Kelly and Hay 2003), thus, there is a need for alternative theoretical perspectives.

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