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# BUSINESS ANGELS

## Colin M Mason*

### 1. INTRODUCTION

Business angels 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*. 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). Moreover, angel investing is now an international phenomenon, found in all developed economies and now diffusing to emerging economies such as China (Lui Tingchi, and Chen Po Chang,, 2007). However, it has only attracted the attention of researchers since the 1980s.

Several aspects of this definition need to be highlighted in order to emphasise the distinctiveness of business angels as a type of investor.

* Hunter Centre for Entrepreneurship, University of Strathclyde, Glasgow G1 1XH, United Kingdom. Tel: +44 141 548 4259. Fax: +44 141 552 7602. E-mail: colin.mason@strath.ac.uk

*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 (1989a) reported that 1 in 3 business angels in the USA had a net worth (excluding principal residence) in excess of $1 million. Mason and Harrison (1994) noted that only 19% of UK business angels were (sterling) 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. This has several implications. 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, business angels can make quicker investment decisions (Freear et al, 1995). Third, they 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 such backgrounds these individuals have access to deal flow and, at least in theory, the competence to make investment decisions. However, angels report in surveys (e.g. Sørheim, 2003a) 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. 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. Although 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. 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.

## CHARACTERISTICS OF BUSINESS ANGELS

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

- *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 try 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.
- *Successful cashed-out entrepreneurs*. Most business angels have had experience of business start-up, growth and harvest. In the process this has given them the kind of experience necessary to become an investor. 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, 1989a).
- *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 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 (1989a) 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: entrepreneur angel, income seeking angels and wealth maximising angels. 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:

- *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.

## ECONOMIC SIGNIFICANCE OF BUSINESS ANGELS

Business angels are recognised as playing a vital role in economic development at both national and local/regional scales. 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. It is impossible to be precise about the number of business angels, the number of investments made and the amount invested because they have no obligation 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 (1989b) 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, 2000a). 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 of business angels 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[1] – currently 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, while the larger angel syndicates (see below) can make investments of £250,000 and above. This is usually provided in the form of equity or a combination of equity plus loans. 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 minimum investment size and continued to shift their investment focus to later stage investments.

A second factor which underpins the economic significance of angel investing is the hands-on involvement of business angels in their investee businesses, with the nature of this involvement ranging from informal coaching, mentoring and advice to Board participation. Demand-side studies indicate that many entrepreneurs are seeking

[1] 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.

‘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). 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.

Taken together these points highlight the complementary roles of business angels and institutional venture capital funds 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. 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.

The third contribution of business angels to economic development arises from its geographical characteristics. This has two dimensions. First, “angels live everywhere” (Gaston, 1989a: 273). According to Gaston’s US research the proportion of business angels in the adult population is fairly constant at about four per 1000 adults. This contrasts with investments by institutional venture capital which are geographically concentrated (Mason, 2007). Second, 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 below) and their hands-on investment style and consequent need for frequent contact with their investee businesses. Business angel investment is therefore an important mechanism for retaining and recycling wealth within the region that it was created.

**THE INVESTMENT PROCESS OF BUSINESS ANGELS**

A number of discrete stages can be identified in the investment process of business angels:

- 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. However, the approach of business angels is less sophisticated.

**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. In some cases – especially in the case of occasional 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). Most of the deals that business angels receive are referred by individual and institutional sources in their extensive and longstanding networks of relationships. Professional contacts are much less significant than friends: 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. 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.

Calculating yield rates for various sources of deal flow (i.e. comparing investments made against deals referred for each information source) indicates that informal personal sources of information - business associates, friends and approaches from

entrepreneurs –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 (Freear et al, 1994b; Mason and Harrison, 1994). 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.

**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). 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.

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 (Mason and Rogers, 1997). 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.

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). 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 adopt more sophisticated approaches (e.g. see Blair, 1996).

Once the opportunity has passed from the initial screen to detailed investigation 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 work ethic, integrity, honesty, openness and personal chemistry (Landström, 1998; Haines et al, 2003; Mason and Stark, 2004). This reflects the long and personal nature of the angel-entrepreneur relationship.

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 proceeded 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 emphasised by Feeney et al (1999). Their 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 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).

**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 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, 1996), based on rough rules of thumb or gut feeling. May and Simmons (2001: 129) - who are themselves investors - note that "the truth about valuing a start-up is that it's often a guess."

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.

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 (1996) 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, 1996). 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 (1996) 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.

**Post investment involvement**

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, 1996). 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 (2003b) also 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 is also influenced by the age and performance of the business, with angels more involved at particular stages of business development and in crisis situations.

However, in contrast to what agency theory would suggest, 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'. 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).

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, 1996). 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, 1996). 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). 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.

**Harvesting**

Returns from angel investing are highly skewed. A UK study reported that 40% of investments made a loss (34% a total loss), and another 13% only achieved 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% (Mason and Harrison, 2002b). US research has reported that the average investment returned 2.6 times the investment, 48% returned more cash than was invested and that 7% returned more than 10 times the amount invested (Wiltbank and Broeker, 2007).

The UK study 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, 2004). The US study reported that high returns were associated with the length of due diligence, industry experience and participation, while low returns were associated with follow-on investments (Wiltbank and Broeker, 2007).

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 (Lumme et al, 1998). In the US the average holding period is 3.5 years (Wiltbank and Broeker, 2007). A trade sale (i.e. sale of the company to another company) is 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, are the most common exit routes for investments with little or no value (Lumme et al, 1998; Mason and Harrison, 2002b).

## THE CHANGING NATURE OF THE ANGEL MARKET

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). Nevertheless, solo investors still dominate the market.

There are currently estimated to be over 250 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 (the Angel Capital Association). The same trend is also clearly evident in the UK although at an earlier stage.

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). Groups typically range from 25-75 members. Syndicates take various forms but in the most common type of model a manager or a core group of members will screen the deal flow and select the companies which are invited to pitch to members. Members then 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. 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. 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 and enables syndicate members to achieve greater diversification by exposing them to more investments than they can make directly through the syndicate (May and Simmons 2001; May, 2002)

The emergence of angel syndicates is of enormous significance for the development and maintenance of an entrepreneurial economy.

- 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, whereas angel syndicates are generally visible and are therefore easier for entrepreneurs to approach.
- 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. Other attractions of syndicates are that they enable individual angels to invest in particular opportunities that they could never have invested in as individuals, achieve diversification, and offer the opportunity to learn from more experienced investors.
- 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. This has resulted in the emergence of a new equity gap 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 venture capital in this range.

- They have the ability to provide follow-on funding. 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 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.
- The ability of angel groups 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.
- Angel syndicates have greater credibility with venture capitalists. Venture capital funds often have a negative view of business angels and may therefore avoid investing in deals in which angels are involved (Harrison and Mason, 2000). 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.

The tantalising issue is whether the essence of angel investing will be lost with the growth of professional angel groups as they take on more and more of the hallmarks of venture capital funds.

**WEB RESOURCES**

Angel Capital Association: North America's professional alliance of angel groups which brings together many of the 265 angel organizations in the United States and Canada to share best practices, network, and help develop data about the field of angel investing. www.angelcapitalassociation.org/

British Business Angel Association (BBAA) is the National Trade Association for the UK's Business Angel Networks and the early stage investment market and is backed by the Department for Business, Enterprise and Regulatory Reform (formally the Department of Trade and Industry). www.bbaa.org.uk/

European Business Angel Network (EBAN) comprises National Federations of BANs, networks with a national, regional and local coverage and other interested entities having a direct involvement in promoting informal investment in Europe. www.eban.org/

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