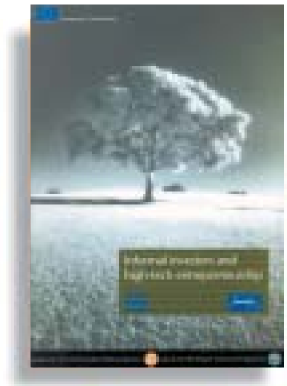
3.3

Informal investors and high-tech entrepreneurship



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Study led by: MCS (United Kingdom)

Key findings

- The start-up of a new technology-based firm (NTBF) is often financed by the founder, friends and family, with the help of bank loans. Loan guarantees may help, but as the firm grows, the risk often outgrows the bank's limits. As institutional venture capitalists do not like to invest sums of less than about €400,000, business angels fill the "equity gap".
- Business angels are wealthy individuals, who support a growing firm with advice and contacts, not just cash. They tend to invest between €15,000 and €400,000, with most investments falling below €80,000.They may be grouped into six types depending on their experiences and preferences.
- There are about 200,000 business angels in the USA, investing some €55 billion. In Europe they are rarer: the UK has 18,000, and France and Germany a significant number. In southern Europe, start-up funding tends to come from friends and family, and outside investors are distrusted.
- Business angels will typically sell their investments to a venture capital company, which will support the company till it can be sold to an established company or be floated on a high-tech "new market".
- Business angel networks and business incubators can encourage informal investment by improving information flow. Even so, many business angels will base their investment decision primarily on their judgement of the personality of the entrepreneur.

Figure 3.7

Business angels – characteristics, investment criteria and expectations

Type	Entrepreneur	Corporate	Income seeking
Characteristics	The most active and experienced angel	Companies (or directors) making angel-type investments	Active individual investors, but with lower level of investment than other types
Wealth and level of investment	worth over €1.6m, with annual income over €167k. Invest over €837k	Almost 40% of survey group had invested over €837k in new ventures	30% of group worth less than €167k. Invest €40-84k
Investment objectives	Financial gain, but also fun and satisfaction	Financial gain, but this is often less than earned by individual angels	Create a job for self and financial return
Main criterion for investment	Personality of company founder	Personality of founder or manager	Personality of founder or manager
Investment location	Not important	Prefer to invest close to location of angel	Not important
Other factors	More open than other angels to investing outside own field of experience	Own experience in sector is important	

Policy context

The availability of seed and early-stage venture capital is a major concern to innovative high-growth companies. New technology-based firms (NTBFs) have assets which are largely intangible, and are perceived to be very risky, so raising finance is often difficult beyond the early stages. However, **NTBFs are vital to economic development**, and show rapid growth and high added value. They lead in product innovation and job creation: between 1991 and 1995 they showed 15% growth in employment, compared to 2% in the top 500 companies in Europe.(1)

The typical growth phases of a company (see section 3-1) start with the first concept and decision to set up the company, funding typically being raised from banks by the founder, family and friends. With growth, continued high cash needs bring the business face to face with **the equity gap** – the stage before venture capitalists (VCs) are interested in a relatively small, high-risk investment. Equity finance of less than about €400,000 (£250,000) is very difficult to obtain. At this stage, with banks often unwilling to accept the company's risk/asset balance, **the most likely source of support is from informal investors**, known as business angels – wealthy individual entrepreneurs who are able to contribute both equity and business expertise. Loan guarantees (see section 3.2) are also important, and many governments have introduced loan guarantee schemes to underwrite finance to small companies.

Given further growth into profit, venture capitalists (VCs) will become interested in investing capital. VCs expect to exert substantial influence on the running of the company, and commonly take over the stake of business angels. They are corporate investors, able to provide large-scale equity finance to companies they believe promise high rewards. Their backing will see companies through take-off, leading ultimately to flotation on one of Europe's new high-tech stock markets.

Bank debt attracts many entrepreneurs in the early stages, because it allows them to avoid sharing control of the business. But it involves giving the banks some security, and assets are mainly intangible at this stage. In contrast, **equity finance is provided in relatively small amounts by business angels, and in large amounts by VCs**.

Banks, business angels and venture capitalists are complementary sources. Bank funding and informal investors often cover the first 2-3 years and raise up to €10 million. VCs step in at 2-3 years with sums in the region of €5-25 million, and if the company is successful, flotation might be expected at around 5-6 years.

The role of informal investors

Business angels help to meet the needs of NTBFs by contributing funds and raising the creditworthiness of the company. They also complement the existing managers' technological knowledge with advice on commerce, marketing and management. Finally, they can help prepare business plans, strategy and accounts.

Business angels' individual investments vary between €15,000 and €400,000, but most tend to invest less than €80,000. The survey confirmed the operation of **six types of business angel** with different styles and objectives.(2) Figure 3.7 summarises the features of the different types.

The UK has the most developed informal investor market in Europe with 18,000 active and potential investors, currently investing €800m in 3,500 businesses. Germany and France also have active angels, but in other member states they are much rarer. The USA has between 150-250,000 individual business angels, providing over €55 billion to American enterprises, including €17 billion to high-risk, early stage firms.

Wealth maximising	**Latent**	**Virgin**
Private individuals with several investments in new ventures	Inactive for past three years, but having made at least one investment before that	Not yet made an investment in an unquoted venture
80% of group worth over €837k. Invest €40-167k	50% of group have over €167k available for investment; some much more	Less funds than all other angel types, but this not felt to be a restriction
Financial gain and job for self	High financial return and job for self	Higher return than from stock market; also job or income for self
Personality of founder or manager	Personality of founder or manager	Personality of founder or manager
Not important	Strong preference for venture close to angel	Prefer to invest close to location of angel
Opportunities for co-investment; access to knowledge of other investors	Clearly available exit routes	25% say own experience in sector is important

Informal investing is typical of the capital economies of the US, UK, Australia and Canada. In many southern European states, small companies are financed from family sources and bank credits – an outside creditor with influence is less welcome. Aversion to risk is strong, and in many countries bankruptcy is viewed as a disgrace, whereas in the US proposing a new venture after bankruptcy is taken as a brave effort to start again with the benefit of knowledge gained. Also in the US, much more investment by all angel types is made on grounds of social responsibility than in Europe, where only corporate angels take this viewpoint.

Key issues for informal investors

Business incubators are able to help start-up companies at their most vulnerable time. Often situated near universities, incubators typically provide workspace and services at preferential rates. They also give access to expertise on such topics as taxation, intellectual property, finance and markets. Incubators often house a cluster of companies in a particular technology sector. Young companies in this environment are able to make important business contacts who will reinforce their growth. Typically companies are able to leave the incubator within a few years.

Incubators can help reduce the information gap between the low-visibility technologist-entrepreneurs and potential informal investors. The emphasis of incubators on timely access to finance may be one of the reasons for their higher success rate than science parks.

Entrepreneur is matched to investor either informally, through angels' business contacts, through **business angel networks**, or through business introduction services such as ***www.gate2growth.com***, supported by the European Commission. Some angels prefer informal contacts, especially if their decision to invest rests mainly on the personality of the entrepreneur. More formal networks are run either by the private sector, for instance by accountancy firms (without a fee but with the promise of 'due diligence' work), by the public sector (for instance local authorities or training and enterprise agencies), or by profit-making networks charging both sides. Figure 3.8 shows the advantages and limitations of using business angel networks.

A **business plan** is one of the most effective ways to show a potential informal investor why the venture is worthwhile. Consensus has developed on what should be in the plan - the executive summary is the most important, and often the only part that is read by potential investors. The plan must be concise, realistic and able to attract and hold the interest of the potential investor.

After the entrepreneur and potential investor have explored the deal possibilities, the entrepreneur may be reluctant to give up control of the company. A good personal understanding between the two is essential if the relationship is to work – an expert facilitator can help to take the company through to the next phase of growth.

In Europe the proportion of formal and informal venture capital going to start-up companies is small compared to the USA. American investors are a mix of institutions and small private investors, and the emphasis is on **high-tech start-up companies**. US small investors have easy access to tax breaks, so millions of individuals put about 5% of their money directly into small stocks. This investment gives US start-up companies a much more flexible source of funding than those in Europe.

In the EU the focus has moved much more toward developing and exploiting technologies. Here most investment capital is under the control of institutional fund managers. A number of schemes, particularly in France and the UK, offer tax privileges for individuals on investments in the ordinary share capital of private companies. The UK's Corporate Venturing Scheme encourages larger firms to invest in small growth companies, allowing tax relief of 20% on investment in unquoted companies worth under €25m. In 2000, the UK government also cut capital gains tax, benefiting angels who prefer capital gain on exit from a company to dividend income.

Figure 3.8

Advantages and limitations of business angel networks

Advantages	Limitations
Provide easier access to potential investors than an individual search	May be too localised and passive, so limited in the number of investors participating
Provide a pool of experience which benefits less-experienced investors and entrepreneurs (some provide training)	May lower their acceptance thresholds for venture proposals to attract enough investors
Stimulate demand for private equity finance, by promotional actions	May need to improve quality of screening of proposals
Preserve privacy of investors, protecting them from unsolicited demands	Angel network officials not able to offer advice or recommendations due to legal liability
Improve quality and reliability of information moving between investor and entrepreneur	Many angels are very independent and reluctant to join a formal network
Provide a forum for discussion	Financing of network may need public support as unlikely to cover costs from fees
Able to interact with business incubators and with technology commercialisation officers of universities	

Four EU initiatives support venture capital funds for early stage technology investments:

- The Equity Programme of the European Investment Fund (EIF) supports high-tech innovative SMEs;
- The European Investment Bank's European Technology Facility (ETF) finances national initiatives to help young high-tech companies;
- The ETF's Start-up Facility invests up to €10m in venture capital funds to provide equity or other risk capital to innovative start-ups;
- The I-TEC (Innovation and Technology Equity Capital) scheme supports venture capital invested in technology-based, high-growth SMEs.

Other EU initiatives also give indirect support to the early-stage growth of this type of company, including the European Regional Development Fund, Europartenariat, the Fifth RTD Framework Programme and the European Social Fund.

Business angels and venture capital companies both need to have an exit route from a company, so as to release their investment and any profits. It may not be easy for an angel to withdraw before the company reaches stock market flotation, so possible routes should be considered in the business plan. While flotation is the most common exit in the USA and Canada, **in Europe sale to a trade competitor is more common**. Flotation is best suited to companies with substantial profits and turnover growth, or exceptional potential. A trade sale costs less than flotation and is more appropriate if the company is unlikely to reach the size needed for successful flotation. Figure 3.9 shows data on typical angel deals.

Until recently, companies could be floated on the new high-tech stock markets such as the Alternative Investment Market (AIM) established by the London Stock Exchange, Nasdaq Europe (the successor to EASDAQ), EuroNM (a joint venture between the "new markets" in Amsterdam, Brussels, Frankfurt, Milan and Paris), and the London-based TechMARK. However, it would seem that the IPO (initial public offering) window will effectively remain shut for the foreseeable future.

(1) *Coopers and Lybrand,* Economic Impact Surveys of the US and Europe*, 1996.*
(2) *Coveney, P. and Moore, K.* Business Angels: securing start-up finance*. John Wiley, New York, 1998.*

Typical angel deals

Figure 3.9

	Entrepreneur	Corporate	Income-seeking	Wealth maximising
Average total investment	€276,000	€340,000	€38,000	€86,000
Average initial investment	€186,000	€252,000	€27,000	€33,000
Average number of rounds of investment	2.0	1.7	1.5	1.75
Average number of co-investors	2.3	1.3	3	2.5
Average size of equity stake taken (%)	38	51	20	n/a
Average annual rate of return achieved (%)	61	8	n/a	n/a

Source: Coveney, P. and Moore, K. Business Angels: securing start-up finance*. John Wiley, New York, 1998.*