Business angels

This section explores the role of business angels in financing prototype development and market demonstrations. It provides a full characterization of business angels (types, motivations, activities they support) and explores the advantages and disadvantages of using them to finance the second stage of the innovation process. The section finishes with a discussion of the policy interventions that can encourage and support business angel activity.

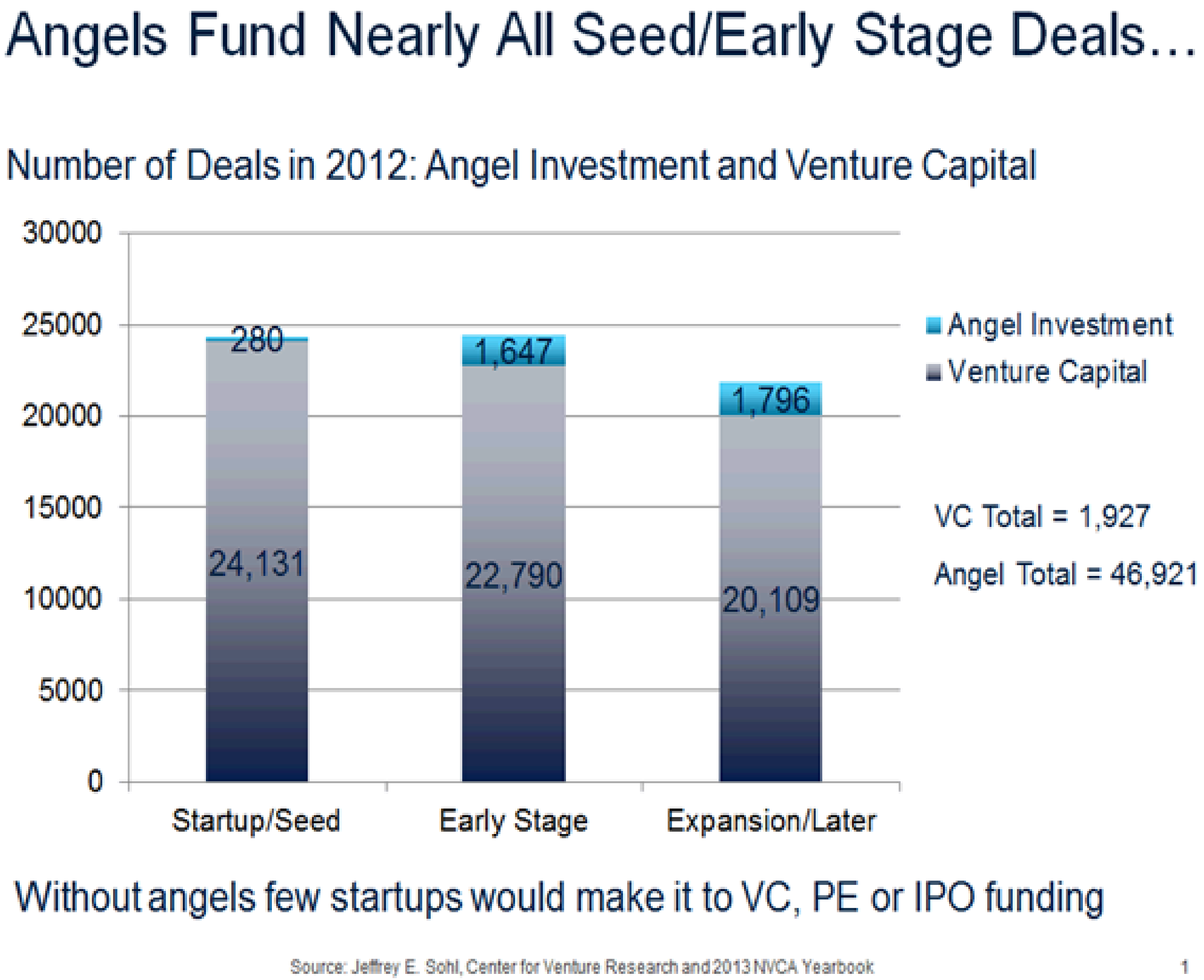
What it is. The informal venture capital market is composed of wealthy individuals, called business angels, who invest their own capital in young, unquoted firms. Business angels do not have familial or institutional connections with the firms they finance. Rather, they are generally successful business people and entrepreneurs who look for attractive investment opportunities in a segment of the market that is not covered by institutional investors. Thus, business angels fill an “equity gap” between the money entrepreneurs can raise from family members or other internal sources, such as their own savings or personal borrowings , and the investment venture capitalists may provide.

Characteristics. There are different types of business angels (see Van Osnabrugge and Robinson 2000 for a compendium of classifications). Some are former senior management people who are looking for new jobs. Others are experienced entrepreneurs who want to enlarge their investment portfolios. Still others make a hobby of investing, typically in small amounts, in several firms at the same time. Finally, some business angels are altruistically drawn to projects with a social development aspect.
Business angels have basically three motivations (Van Osnabrugge and Robinson 2000): (1) obtaining financial returns, (2) participating in the development process of the ventures they finance, and (3) satisfying altruistic feelings by, for example, transferring experience and knowledge to amateur entrepreneurs. Financial considerations are not always the top priority, since business angels often enjoy hands-on participation in the projects they finance and helping their local economies to grow. In addition, they can provide mentoring and advisory services, as they often have deep knowledge of the markets in which they invest.

Business angels need to be relatively patient (Freear, Sohl, and Wetzel 1995) and willing to take on risk and accept the possibility of illiquidity over a long investment period. They are accountable only to themselves because they invest their own money and therefore have strong incentives to undertake thorough due diligence prior to investment. The most active angels, the so-called “dealmakers,” rely more on private than public sources of information about the quality of investment opportunities. They also use networks of contacts they have developed to learn about potential deals (Kelly and Hay 2000).

Business angels invest in startup firms and early-stage ventures (Van Osnabrugge and Robinson 2000; Sohl 2006). According to Van Osnabrugge and Robinson (2000), “They are the largest sources of risk financing for entrepreneurial firms, vastly exceeding the institutional venture capital industry.” For example, they provide approximately 80 percent of the seed and startup capital for high-tech firms (Sohl, Van Osnabrugge, and Robinson 2000). Recent evidence shows that business angels’ activity increased during the financial crisis of 2008–9, while venture capital and lending activities decreased (Mason and Harrison 2013).

Business angels are often involved in smaller investments than venture capitalists (Robinson and Van Osnabrugge 2000). Mason (2006) writes that “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 will make investments of £500,000 and above.” Their investment activity typically focuses mainly on the second stage of the innovation process, although they also invest in commercialization and scaling up (the third stage) in sectors with relatively limited funding requirements. Compared to venture capital, they invest small amounts but in a much wider range of businesses (see figure 2).



The trend has been fueled by the widening of the equity gap, as venture capitalists finance larger ventures. A characterization of angel groups in the United States by the Kauffman Foundation shows they include no more than eighty people, and their members invest between US$25,000 and US$100,000 in each deal. There are at least two models for running angel groups; the member-led model, which is run by a member or a committee, and the manager model, run by a professional manager.

Networks play a matchmaking function between angel investors and entrepreneurs, although they do not invest directly themselves. They help make the investment process more efficient by connecting angels wanting to invest with other players in the local ecosystem (incubators, VCs, development agencies, banks, stock exchanges, and so forth) and, most importantly, with entrepreneurs looking for capital.

Groups tend to be more overtly focused on investment opportunities. Some take the form of clubs to whom potential investors pitch, after which the participant investors decide on an individual basis whether they wish to invest. Some groups also undertake due diligence on behalf of their members. And some groups operate pooled investment vehicles (sidecar funds), using funds raised from members. These funds then invest alongside individual investors and allow angels to spread their portfolio risk.
Advantages and disadvantages. Projects that have been backed by business angels are more attractive to formal sources of funding than non-backed projects, as angels reduce informational asymmetries and thus play an accreditation role. According to Madill et al. (2005), technology firms in Ottawa backed by informal private investors were better able to raise capital from venture capitalists. The authors found that 57 percent of angel-backed firms were able to get funds from

venture capitalists, compared to only 10 percent of non-backed firms. The evidence supports the view that business angels reduce informational asymmetries and make entrepreneurs more likely to succeed.

Using business angels to finance a company can have disadvantages, however. Angels tend not to have the volume of funds to continue reinvesting in later stages of capital-intensive businesses , so entrepreneurs have to seek other funding that potentially dilutes the angels' holdings. For entrepreneurs, significant transaction costs can be associated with managing a range of small angel investors. Angels are also not always informed investors (even if they believe they are), nor do they necessarily bring relevant business knowledge to the table.

Policy interventions. Governments have put into place several types of interventions to encourage and support business angel activity, such as tax incentives, co-investment funds, and network support (one example is Malaysia, discussed in Box 3). Some of these interventions are of a permanent nature (to address the externalities market failure), while others are only temporary (to address coordination failures until a vibrant business angel community becomes self-sustaining).

1. Tax incentives: They aim to increase the supply of investment into innovative businesses by providing different forms of tax relief to investors. They apply to angel investors but sometimes also to larger corporate investors, and they may have unforeseen beneficiaries as well, such as supporting crowdfunding activity (as for instance happened with one of the UK schemes). Tax incentives take a number of forms:
    - "Front end": When an investment is made in an "eligible" business, a concessional rate or credit can be claimed.
    - "Back-end": When a holding equity in an "eligible" business is sold, any profits are either tax-free or have a reduced rate of capital gains tax applied to them.
    - Roll-over or carry-forward relief on capital gains: These enable investors who sell holdings in "eligible" businesses to reinvest in different "eligible" businesses without paying capital gains tax on those profits.
    - Young, innovative company schemes: These typically provide tax relief and a reduction in social charges for young firms that have a demonstrated innovation focus (for example, the French J*eune Entreprise Innovante* scheme).

Box 3. Malaysian Business Angel Policy
The Malaysian government has established the Cradle Fund, a unit of the Ministry of Finance that seeks to create an ecosystem to support a strong and innovative business building environment for technology entrepreneurs in Malaysia. Cradle provides funding and advisory support to entrepreneurs but also provides support to the Malaysian Business Angel Network, which is responsible for the accreditation of individual angel investors and angel investor clubs, for creating awareness and training for angel investors, and for monitoring angel investment statistics in Malaysia. Cradle also administers the Angel Tax Incentive, which is designed to help technology-based startups in Malaysia raise funding by offering tax incentives to accredited angel investors who wish to invest in young high-growth or high-technology companies. Source: http://www.cradle.com.my/faq/ [1].

2. *Capacity building and networks support*: Interventions may focus on improving investment skills or on supporting the infrastructure of both business angel networks and business angel groups. Sometimes governments have helped establish networks and supported them until they became self-sustaining.
3. *Co-investment schemes*: Governments can also co-invest with angels in innovative businesses, either via pooled angel investment vehicles or with individual angel investors. These schemes differ from venture capital schemes in that they are "deal by deal." The mechanism is generally for government to "accredit" particular angel groups that can prove they have robust due diligence processes and good financial backing. The government then co-invests when these groups decide to invest in particular deals. Compared to a traditional venture capital fund, this model offers some advantages for policymakers, as it encourages a range of different entities to assess and invest in companies. This gives greater choice to entrepreneurs seeking funding and, potentially, a wider geographical spread of sources of investment capital. One of the best-known and most copied examples is from Scotland (see Box 4).

Box 4. The Scottish Co-investment Fund
In 2003, the Scottish government developed a co-investment fund that partners with existing private funding entities, such as angel investors, venture capital firms, and syndicates, to inject additional capital into targeted underfunded markets. The SCF follows the lead of its private sector partners by allowing them to make all of the investment decisions and provides matched funding on the same terms, up to a limit. The fund was designed as a way to address the equity gap while keeping the public sector intervention minimal. By relying on their partners to make the investment decisions, the SCF does not have to devote as many resources to conducting due diligence. It addresses the needs of early-stage businesses, providing matched investments between £100,000 and £1,000,000. Investment deals using SCF funding are limited to SMEs based principally in Scotland. Each must be from an approved business sector, have fewer than 250 employees, and have less than £16 million in net assets. The fund has a target rate of return of 20 percent. The SCF seems to have increased the capacity of the equity capital risk market, both by enabling partners to increase the size of their deals and by attracting new investors into this space (more so with the angel community than the VC market). Source: Beattie and De Vroey (2014).

Table 5 provides a summary of observations regarding equity investment instruments.

Table 5. Design and implementation observations—equity investment instruments

Instrument	Observations
Business angel co-investment schemes	- Business angel co-investment schemes encourage the development of a wider investment base, which gives greater choice to entrepreneurs seeking funding. This base is more likely to have a wider geographical spread than formal venture capital, as angel groups are invariably regional in focus. - These schemes generally operate at the seed stage, which has few other private sector

	sources of innovation capital. The downside is that successful investments can need later-stage capital, so policymakers must ensure the availability of later-stage growth capital that can make follow-on investments. - The model "outsources" the due diligence on deals to the business angel groups, so policymakers need a robust mechanism to assess and accredit this investment capability and be certain this standard is maintained. - These schemes have relatively low management costs compared to formal funds, while still benefiting from the investment judgment and know-how of private investors who put their own money into deals. - This assessment capability is highly specialized, so governments need to develop or buy specialized capability to make the assessments and manage these types of schemes rather than relying on career bureaucrats. - These schemes can be criticized for co-funding deals that angel investors would have funded anyway, and for the reported tendency of some angels to "keep" the best investments for themselves while referring the "lower-quality" investments to the co-investment schemes.	
Tax incentives for investors in innovative businesses	- Front-end tax concessions (where investors get a benefit the year they invest) are preferred by investors, as they provide an immediate tax benefit based on how much is invested, regardless of returns. - Setting the concessional rate is a key issue, as too low a rate will simply not induce additional investment, while too generous a rate will drive tax minimization behavior and result in poor-quality investing. - Back-end tax concessions (where investors receive their benefit when an investment is sold) have less impact in inducing additional investment, first, because investors have to wait (often several years) to see any returns, and, second, because they may not see returns if the investment does not grow. - These incentives are often combined with angel investment initiatives to provide incentive for early-stage investment activity. They can help encourage successful entrepreneurs to reinvest in innovation rather than in other, less risky markets (such as property). Given the rise of self-funded and self-managed investment/retirement around the world, tax incentives can be an avenue for innovative young companies to tap this market. - These incentives leave the investment decisions in the hands of the investors, so they	

	can indirectly encourage the upskilling of investors. - Investors are usually well educated and wealthy and thus more likely to engage in tax minimization. So, as with any tax concession, care needs to be taken in design and implementation of these incentives, bearing in mind that they will only be effective in environments where tax is being collected from this target market in the first place.

Related Link: Government support for private finance for innovation
Financial market regulation
Tax treatment
Individuals
IP and markets for finance

Source URL: https://www.innovationpolicyplatform.org/content/business-angels?topic-filters=12205

Links
[1] Source:%20http://www.cradle.com.my/faq/