Thirty Years Of Business Angel Research

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1. Business Angels - Definitions

• “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.”
  – High net worth
  – Investing their own money
  – Directly
  – Time and expertise
  – Unquoted companies
  – Financial gain
2. Research challenges

• Data difficulties
  – Private activity, investors can chose to be anonymous
  – No lists for sampling
  – Reliance on samples of convenience and snowballing
    – potential biases
  – Limited availability of secondary data (Harrison et al, 2010 – form 88(2) data)

• Definitional muddles
  – GEM and ‘informal investors’
3. An Overview of the Field

• The body of literature on business angels, and the number of active researchers both remain small in comparison to the amount of scholarly activity on (formal) venture capital – even though angels play much more important role in funding the start-up and early growth of businesses.

• The literature lacks theoretical foundations: need for more theoretically informed research if the study of business angel investors is to lose its Cinderella status.
continued

• Can group the literature as follows:
  – ABC studies
  – Investment process studies
  – Public policy studies
  – Market organisation studies
3.1. Pioneers


- Replications in the USA
  - Tymes and Krasner (1983)
  - Gaston (1989)

- Replications worldwide
  - Canada – Riding et al;
  - Europe (UK, Sweden, Norway, Finland, Germany, Scotland: Mason and Harrison, Landström, Reitan and Sørheim, Brettel, Stedler and Peters, Paul et al;
  - Australia and New Zealand: Hindle and Wenban, Infomatics;
  - Asia (Japan, Singapore)– Tashiro, Hindle and Lee;
  - Latin America (Argentina and Chile) – Pereiro, Romano

- All of these studies take an “ABC” focus
3.2. Profiling angels

- Male
- 45-65 years old
- Successful cashed-out entrepreneurs
- Well-educated

- Few comparative studies of angels and non-angels: but who are the appropriate comparators
- Some recent studies on women business angels (Harrison and Mason, Sohl, Becker-Blease, Amatucci)
Typologies mask the heterogeneity of the angel population: several classifications of angels

- Gaston (1989): 10 types – criteria?
- Coveney and Moore (1998): entrepreneur, income seeking, wealth maximising
- Sørheim and Landström (2001): lotto investors, traders, analytical investors, business angels
- Lahti (2011): classification of investments (strength of due diligence; level of involvement)
- Focus on specific types of angel: (i) most active investors (Kelly and Hay); (ii) ‘takeover and turnaround artists’ (Visser and Williams)
- Regional variations in angel characteristics (e.g. Scotland)
4. Investment Process – “second generation studies”

• Several discrete stages can be recognised (similar to VC investment stage model)
  – Deal origination
  – Deal evaluation: initial screening; detailed investigation
  – Negotiation and contracting
  – Post-investment involvement
  – Harvesting
continued

• Agency theory used as the theoretical framework. Key assumptions:
  – Economic rationality
  – Opportunism, resulting in adverse selection and moral hazard
  – Fiet (1995) adds that every investment decision also includes market risk
4.1 Deal origination

• ad hoc approaches
• chance encounters
• key role of informal personal networks
• for ad hoc investors, the entrepreneur may be known (e.g. client, supplier, neighbour
• professional sources are less significant
• the most active investors place less reliance on ‘public’ sources of deal flow
• The various sources of deal flow differ in their effectiveness (yield rates)
• Investing in referrals from trusted associates is an obvious way to minimise adverse selection: “even if the principals of the firm are unknown to the investors, if the investor knows and trusts the referral source risk is reduced” (Riding et al, 1995)
4.2 Deal evaluation

• Initial screening:
  – ‘Fit’ with personal investment criteria
  – Prior knowledge of industry, market, technology
  – Ability to add value
  – Quick screen to derive initial impressions – aim is to filter out the ‘no-hopers’:
    • Verbal Protocol Analysis (Mason and Rogers)
    • Approach is negative and cynical (three strikes and you’re out)
    • Rejection based on accumulation of factors rather than single deal killer
    • Market and entrepreneur are crucial at this stage
    • Scepticism about financial information
    • Emphasis on intuition and gut feeling
Other applications of VPA

• Mason and Stark (2004): comparing how bankers, business angels and venture capitalists evaluate an opportunity

• Smith, Harrison and Mason (2010): angel learning
• Detailed evaluation
  – Less research on this stage
  – Amount of effort varies: still intuition and gut feeling are prominent, not much sophistication
  – Importance of people factors increases
  – This state ends when investor decides whether or not to negotiate a deal
  – Conjoint analysis (Landström, 1998): leadership qualities is most important criteria
  – Reasons for not investing (Feeney et al, 1999): shortcomings in management and the business
  – Reasons for investing (Feeney et al, 1999): management ability PLUS growth and profit: i.e. a business that shows growth potential and a management team capable of realising the potential
• The emphasis on the entrepreneur reflects the view of angels that agency risk is more of a threat than market risk (Fiet, 1995). “Compared with venture capital investors, business angels place much more importance upon screening entrepreneurs than deals for market risk.”

• Entrepreneurs do not have the tools and resources to evaluate market risk. Instead they evaluate agency risk – whether the entrepreneur is reliable, trustworthy and competent – and if so, rely upon them to manage market risk.
• Lahti (2011): angels may have multiple motivations for investing.

• Classification of types of investments (based on amount of due diligence and involvement):
  – Gambles
  – Conventional
  – Due diligence driven investments
  – Professionally safeguarded investments
4.3 Presentation issues

• Importance of ‘the pitch’ to attract investors
  – Mason and Harrison (2003)
    • weaknesses in the content, structure and clarity of the presentation were the main reasons for rejection
  – Clark (2008)
    • “The study found a clear and significant statistical relationship between the business angel’s perception of the quality and content of the entrepreneur’s presentation and their decision whether or not to pursue an entrepreneur’s investment opportunity”
4.4 Negotiation and contracting

- Only around 5% of investment opportunities that angels receive reach this stage
- Three main issues
  - Valuation
  - Structuring of the deal (share price, type of shares, size of shareholding, timing)
  - Terms and conditions, including the role of the investor
- These are major lacunae in IVC research
- Half of the negotiations end in failure (Riding et al, 1993) – mainly due to valuation issues
- Valuations – textbook approaches don’t apply for new and early stage businesses: valuations are imprecise and subjective. May & Simmons (2001): “the truth about valuing a start-up is that it’s often a guess.” Earnings based approach is the most common formal approach used.
Angels draw up contracts as a matter of course to protect investments: aim is to align the interests of the entrepreneur and investor:

- Kelly and Hay (2003) examine what are negotiable and non-negotiable issues
- Mason and Harrison (1996) assess perceptions of fairness
- But do investors invoke the contracts to protect their interests? Landström et al (1998) suggest that the purpose of negotiating a contract is less a protection mechanism per se, but rather a means by which mutual behaviour expectations of all parties can be clarified
- Involvement of professional advisers – limited
- Time to make decisions: under three months in 85% of cases
4.5 Post-investment involvement

- In line with agency theory expectations, angels play an active role in their investments
  - Various roles
  - Can help in raising additional finance
  - Involvement influenced by geography and performance
  - Motivation for involvement is not monitoring:
    - angels are ‘offering help’, not ‘checking up’
    - Derive fun and satisfaction from this involvement
    - Relationship with entrepreneur is more positive and trusting than the adversarial one suggested by agency theory
continued

• Perceptions of the value and usefulness of the contributions
• But limited research on the impact of the hands on involvement: does it enhance business performance?
  – Is involvement related to fire-fighting or home-runs?
  – Methodological challenges
  – Similar themes to those addressed by VC research
• Review by Politis (2008)
4.6 Harvesting

• Few angels are able to reduce risk through building a diverse portfolio

• Only four studies of investment returns:
  – Lumme et al (Finland) 1998
  – Mason and Harrison (UK) 2002
  – Wiltbank and Boeker (US) 2007
  – Wiltbank (UK) 2009

• Mason and Harrison (2002) study:
  – 40% loss (34% total loss)
  – 13% break-even/bank account returns
  – 23% with returns in excess of 50% IRR
  – No difference in returns profile for technology and non-technology businesses: have the risks of technology been overstated? Are BAs better able to mitigate the risk than VCFs?
continued

• Wiltbank (2009)
  – 56% failed to return capital
  – 9% generated >10 times capital
  – Overall return is 2.2 times: 3 years to fail; 6 years to win
  – Holding period just under four years
  – IRR = 22%
  – Investor expertise, specific industry experience and due diligence all linked to superior returns
  – Significant follow-on investment associated with less successful investing
continued

• What types of investments are likely to be more/less successful
  – UK results not clear
• What types of investors are more/less successful?
• Comparison with VC returns
  – UK study suggests that VCFs have much greater losses (64%): does this reflect their ruthlessness with their ‘living dead’ investments compared with BAs?
• Time to exit: median of 4 years
• Method of exit: trade sale is the most common; IPOs are a small minority
5. Economic Impact

• “An active informal venture capital market is a pre-requisite for a vigorous enterprise economy” (ACOST, 1990)
  – How big? How much?
    • Scale: some fairly crude estimates of scale of business angel investing: amounts invested; number of investors; uncommitted money; pool of virgin angels – e.g. Gaston, 1989; Mason and Harrison, 2000
  – Investment characteristics
    • Size of investments and stage of business development
    • ‘hands on’ involvement – ‘smart money’
    • Geographical characteristics: (i) “angels live everywhere” (Gaston); (ii) majority of investments are local: Avdeitchikova, 2010; Harrison et al, 2010
    • Role of business angels in emergence of technology clusters
6. Public Policy Focus

• Two main forms of support
  – Business angel networks (BANs) – response to evidence of high search costs of angels and entrepreneurs and frequent unsuccessful outcomes: mixed assessment
  – Tax incentives to improve the risk-reward balance: e.g. UK’s Enterprise Investment Scheme

• Recent interventions
  – Amendments to securities legislation
  – Investment readiness
  – Angel academies
  – Co-investment schemes

• Need for impact evaluation
7. Evolution of the Angel Market

• 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 deal flow, to a more organised market place in which angel syndicates are becoming increasingly significant.

• This evolution has gone further in the USA than in Europe

• Advantages of syndicates: better deal flow, superior evaluation and due diligence, ability to make more and bigger investments, social attractions

• Generic model: see May and Simmons; May and O’Halloran

• New actor: the angel group ‘gatekeeper’ (Paul et al, 2010)
continued

• Significance of the emergence of syndicates:
  – Reduction in sources of inefficiency
  – Stimulated the supply side: attractive to HNWIs who
    would not become independent angels
  – Filling the ‘new’ equity gap
  – Ability to provide follow-on funding
  – Ability to add value is greater
  – Greater credibility with VCs

• Very little research on the operation and
  activities of angel groups
8. Conclusion

• IVC is a significant source of funding of entrepreneurial businesses

• Its significance is often overlooked in the academic and practitioner literature which continue to emphasise VCs

• Research challenges
  – Invisible population – no directories of angels or lists of investments
  – Reliance on small scale snapshot samples unsuited to statistical analysis
  – Use of samples of convenience
• Research agenda
  – Longitudinal studies of the angel market: (i) taking the angel as the unit of analysis; (ii) the investment as the unit of analysis. Also need to build in the effect of time and time-specific environmental conditions
  – Government intervention: is it required? Does it work? Need more evaluation studies
  – Shift from focus on individual investor to angel groups:
    • Are they attracting new investors to the market, or existing independent angels?
    • Investment approach and decision-making
    • Will they experience the same upward drift in minimum investment?
continued

• Market trends and angel investing
  - Data on investment trends in visible market
  - New players: ‘super angels’
  - Relationships between angels and VCs: is it still a relay race or is there a bifurcation of the market
  - Co-investing
    - Investment strategies: e.g. early exits

• New issues
  – Angel learning
  – Angel identity
  – Emotions and investing
continued

• Still many areas where we need “to put boundaries on our ignorance”: e.g. altruistic investors, women BAs, the angel career concept (Politis and Landström), valuation and contracting stages, post-investment stage – conflict, value-added, rates of return

• New methodological approaches (including new data) to provide new insights or challenge existing understanding: e.g. use of Dragon’s Den tapes (Maxwell et al 2011 JBV)

• Agency theory is limited in the BA context – alternative theoretical perspectives needed