Facilitating Business Angel investments

Signe Viimsalu[1] provides a different modus to avoid insolvency of SMEs in Europe

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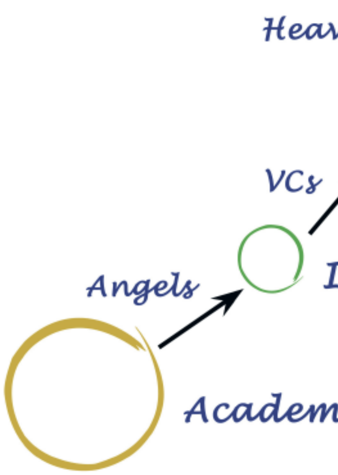
Access to finance for new, innovative small and medium-sized companies involves both debt, which is a common source of external funding among entrepreneurs, and equity finance.

During the recent economic recession, support by the financial system for companies, particularly for new ones, disappeared. Even before the recent financial crisis, banks were reluctant to lend to small and young companies due to their perceived riskiness and lack of collateral. In addition, the aversion to risk and the lack of exit opportunities for investors have remained issues and have continued to strain sources of seed and early-stage capital. The financial crisis widened the existing market failure at the seed and early stage with bank lending to falling start-ups and venture capital firms moving to later investment stages where risks are lower. However, there should be co-operation between various sources of capital available for SMEs in Europe. The current market situation with a lack of capital from traditional financial sources seems to affect the business angel market and influence future policy development. The changed economic scene means that business angels must be able to take companies through more rounds of financing since traditional follow-on investment rounds are often unavailable.

> “BUSINESS ANGELS ARE OFTEN EXPERIENCED ENTREPRENEURS”

Why are business angel investments important and need promotion?

Business angels, who are often experienced entrepreneurs, have become increasingly recognised as an important source of equity capital at the seed and early stage of company formation in Europe. It is remarkable why individual investors would involve themselves in anything so risky such as financing the valley of death in a company's lifecycle and helping its team where an insolvency situation may be faced practically every day. As it could take 6-7 or even more years to make an exit, a bigger portfolio is necessary for mitigating risks. Understanding which incentives would encourage and support business angels' activity in Europe is important, given their relevance to the economy. With fewer venture capitalists investing at the early stage, the equity-funding gap between individual angel investment and venture capital has grown dramatically. Given this scenario, entrepreneurs are faced with a significant financing gap. Therefore, business angels are a growing part of the investor spectrum that is partially filling the financing gap for SMEs. So far, business angel investors have sought to fill this gap by investing with other business angels through groups and syndicates, increasing the total deal size for companies seeking early-stage financing. According to EBAN, formal venture capital operators invest a minimum of €2,500,000 in companies, which leaves a market gap or failure in smaller amounts of equity. Individual business angels invest between €20,000 and €250,000. The average amount invested per individual in Europe is €80,000 and up to €250,000, depending on the business type and the region. These amounts can increase when business angels co-invest with other investors or through a co-investment fund.[2] In many countries business angels constitute the largest source of external funding, after family and friends, in newly established ventures.[3]



This non-institutional equity finance of business angels, which is still relatively untapped in Europe compared to the US, where the business angel market is five times larger, could become an essential driver to build more high-growth SMEs.[4] In addition to the money they provide, business angels play an important role in providing strategic and operational expertise for new companies as well as social capital.[5] Companies backed by business angel investors have been important contributors to economic growth and creating new jobs. In the US, estimates suggest that approximately 250,000 new jobs were created in 2009 by firms supported by business angel investment, representing all in all 5% of new jobs in the United States.[6] Young firms in the US have improved performance and consequently an increased probability of survival with angel financing and growth of 30-50% on average.[7]

Indeed, for policy makers to intervene in a market, there often needs to be evidence of a market failure. While it does not qualify as a market failure, in the survival rate of the start-ups and SMEs there is a clear financing gap in the seed and early-stage life cycle and this causes much potential to be strained and wasted. Of course, there are many ways to then tap into that potential and make it an asset. Just one method is encouraging private high net worth individuals (business angels) with business knowledge to divert their assets into these start-ups. A forceful argument for policy action to this end relates to the potential positive spillover effects of angel investment.[8] According to the OECD, the public policies for promoting business angel investments include both supply and demand-side measures. On the demand side: investment readiness for entrepreneurs, and developing the entrepreneurial ecosystem. On the supply side: tax incentives, co-investment funds, support to angel associations, networks or groups, and the training and development of angel investors.[9] In addition, in certain European countries, guarantee scheme measures have also been developed, which cover part of the risks taken by the business angels.[10] Policy makers in some countries have sought to address these market gaps through both demand and supply-side measures, although mostly the latter.

Supporting national angel associations, networks and groups

According to the OECD, the areas in which policy makers have acted to develop the business angel financing market include the provision of support directly to national angel associations or federations as well as networks and groups to help cover operating expenses. National angel associations and networks can help raise awareness regarding business angel investments, which in addition to entrepreneurial ecosystem is another critical step in building the market.[11] EBAN states that the European Commission encourages business angels and business angel networks (BANs) to increase their visibility and raise awareness among entrepreneurs and policy makers. National federations bringing together national or regional networks exist in most European countries. These federations are usually umbrella organisations and are

> IT IS REMARKABLE WHY INDIVIDUAL INVESTORS WOULD INVOLVE THEMSELVES IN ANYTHING SO RISKY SUCH AS FINANCING THE VALLEY OF DEATH IN A COMPANY'S LIFECYCLE

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> BUSINESS ANGELS ARE CONSIDERING INVESTING IN PROPOSITIONS IN DIFFERENT COUNTRIES IN ORDER TO EXPLORE OPPORTUNITIES WITH GOOD GROWTH POTENTIAL

not in direct contact with entrepreneurs or investors. The main mission of federations consists in promoting the economic role of business angels and their networks with public authorities and collecting information about the venture capital market.[12] Unlike business angel groups, which consist entirely of angel investors, business angel networks include in addition to angel investors also service providers and other non-investors.

As for recent angel investment activity trends amongst business angel networks and groups, it should be noted that business angels around the world have started to co-operate and use remarkable IT solutions. One example is a software platform called Gust.[13] Gust provides the global platform for the sourcing and management of early-stage investments. It is endorsed by the world's leading business angel and venture capital associations, and powers over 1,000 investment organisations in 65 countries. Another example of making use of IT in angel investment activities is through crowd-funding platforms, which offer raising seed and start-up capital. For instance, AngelList[15], a platform for start-ups, connects start-ups with investors and entrepreneurs. Other examples are Crowdfunder[16], Invesdor[17], etc., where investors can invest small amounts of equity in seed investments via the Internet and usually a 5% success fee for the hosting site applies. On the negative side, however, there are often no types of due diligences and 'checks and balances' for investors who are willing to invest. The same concerns can arise for online business angels networks where the network acting as a hosting site may not be undertaking any background checks and due diligences on the investee company before it is registered and promoted to investors[18]. The European Commission has stated that even though the emergence of new sources of funding that employ social media are still at an embryonic stage, the potential risks of such funding and the fragmented European regulatory environment along national lines for cross-border platforms are among the emerging challenges which pose issues for entrepreneurs, platform providers and investors alike.[19]

Encouragement of cross-border deals

While there has been increasing talk about cross-border deals, the reality is that most angel investments are still local. Historically, based on national policies, the majority of business angel investment has been restricted to national level (usually the target companies have to be incorporated in the same country), with few cross-border investors investing into a different country. However, there seems to be a tendency towards change. Business angels are considering investing in propositions in different countries in order to explore opportunities with good growth potential. Investors are becoming more aware that companies with very high growth potential are not always based in their own country of residence. Even start-up businesses are becoming more globalised; particularly in the high-tech sector.[20] Yet, business angels are still reticent in doing so as they often invest under different laws from their own country's. But there is potential in this area and it is considered good practice to stimulate cross-border activity by the sharing of investment propositions to encourage such activity. Cross-border deals are only possible when the necessary trusted relationships are in place, when there is sufficient knowledge about the other market and the legal and tax systems permit deals to be done under similar terms. There is some evidence on transnational investments in Europe when the fiscal, legal and regulatory environments have been right and human challenges met, such as language skills, knowledge of other markets, building rapport etc. Business angels will only invest in a cross-border deal if a trusted local lead investor exists in the country of the target portfolio company.[21] At the moment, the more prevalent cross-border deals tend to be in local communities situated near borders in which relationships have been built over time. That said, efforts continue to be made

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to build international networks and contacts to facilitate future cross-border deals.[22]

Summary

A healthy and well-functioning entrepreneurial ecosystem is critical for successful angel investing and for the market to grow. It is important to learn from other experienced countries, but not to simply copy-paste the existing models. A co-operation between various sources of capital is needed. There should be a coordination of public efforts and the right efforts should be taken at the right phase of business angel market development. The entrepreneurial ecosystem should encourage and motivate experienced entrepreneurs to take high risks and become active business angels who would rescue start-ups from the valley of death. It is also crucial to shape the educational system and national culture in favour of an entrepreneurial risk-taking, sales mentality and innovation prone attitude. This includes at least such market players as incubators and accelerators, besides business HUBs and entrepreneurial skills training. However, the main actors in building the business angel market must be business angel investors themselves. ■

The full version of this article can be found in Santen. van Offeren (Eds.) Perspectives on International Insolvency Law: A Tribute to Bob Wessels. Kluwer Deventer, 2014.

Footnotes:

1 Signe Viimsalu, BA, mag.iur, Ph.D is a co-chair of INSOL Europe's EECC.

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9 OECD (2011), op. cit,. p. 95..

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11 OECD (2011), *op.cit.*, p. 116.

12 EBAN, Business Angels - Summary Brief on Private Informal Venture Capital Players Information for Public Decision-makers, Entrepreneurs and Virgin Angels on the Role of Business Angels and their Networks - European Good Practices, Brussels. http://www.eban.org.

13 http://www.gust.com.

15 https://angel.co.

16 https://www.crowdfunder.com.

17 https://www.invesdor.com.

18 European Commission (2012), *op.cit.*, p. 30.

19 European Commission (2012), *op.cit.*, p. 7.

20 Carr, M. MACC-BAM, (2011). *op. cit.*, p. 11.

21 European Commission (2012), *op. cit.*, p. 26.

22 OECD (2011), *op. cit.*, p. 77.

> **"THE ENTREPRENEURIAL ECOSYSTEM SHOULD ENCOURAGE AND MOTIVATE EXPERIENCED ENTREPRENEURS TO TAKE HIGH RISKS AND BECOME ACTIVE BUSINESS ANGELS"**