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Managing Business Angels as investors for SMEs in an STP's Accelerator

Roundtable 2

Business Acceleration and Incubation

Author:

David Rowe (david@warwickenterprise.co.uk)

Warwick Enterprise, United Kingdom

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Executive summary

As wealth creation through business has grown so has the number high net worth individuals (millionaires). The rapid rise in the numbers of these individuals is occurring all around the globe with the spread of the market economy approach to economic development. So, just as there was an explosion of high net worth individuals in the USA from the 1950s onwards and in some parts of Europe from the 1990s, so now there is a similar explosion occurring in India and China and other emerging market economies.

The common trait of such individuals is that they are good at business; they like business and many take a pleasure in working with entrepreneurs who they think have a good idea. The help to entrepreneurs can take the form of mentoring but a more natural instinct is for such individuals to invest their own money in these young companies in the hope of participating in another profitable business activity. However, in addition to making an investment they also provide business experience and contacts to help their investee. When this happens the investor is known as a Business Angel.

This paper is about how an STP, and particularly an STP with an accelerator programmebuilt into its incubator, can tap into this substantial source of investment opportunity. The methodology proposed is based on experience and some important research into the factors that make for successful Business Angel investments.

Background

What follows is based on some hard won observations from operating a Business Angel Network (BAN) over a period of nearly 20 years at the University of Warwick Science Park together with some research results of Business Angel investment behaviour and the financial returns they secure from their investments. These inputs of experience and research provide the ideal background from which to draw conclusions about how best to establish and operate a BAN if it is to be effective from an STP perspective i.e. more tenants / clients secure the investment they need, then grow and generate more rental income to the STP while also generating more jobs and wealth for the local economy.

While the experience and research come from the UK, the lessons are largely universal. Certainly, local culture and business practice will alter how a business angel network should be operated, but the fundamental motives of high net worth business people taking an interest in fostering interesting new business opportunities are much the same in any culture – certain opportunities excite them and they want to be involved in a meaningful way. Similarly, entrepreneurs starting a business with growth potential are much the same anywhere in the world, if they have a business idea with significant potential for growth and they do not have sufficient capital to take those ideas forward to the point at which the business can be net cash generating, then they are usually open to the idea of taking investment from someone else.

The way that business angels behave within different countries is undoubtedly influenced by factors such as: security offered by contract law (as a safeguard when trust fails);the taxation treatment of the funds they invest; the taxation of capital gains they derive from the investment and the burden of regulation imposed by a state on investment and business development.With good contract law and an advantageous tax regime, business angel activity is open and transparent, where the opposite is true it is more likely to be less visible - but it will still happen.

Most business angel activity is not organised in any way. It simply happens by chance or by a high net worth individual using their networks to identify businesses they can invest in. A typical example involves investment along a supply chain. If a business owner recognises that one of their suppliers has a new product or service that they can embody in their own business to create competitive advantage, then there is a strategic case for the customer partner to invest in the supplier. The customer may then invest to help their supplier to further develop their product or service thereby improvingthe competitive advantage of the customer company. This type of investment is occurring all the time and does not require the use of formal Business Angel Networks (BANs) to help the investment to happen.

However, in other cases where the investing business person and the company requiring the risk finance are not otherwise known to each other, then BANs can provide an invaluable brokering service helping to bring both sides together. The BAN movement is growing rapidly across Europe moving from 99 BANs in 1999 to 240 by 2007, with the UK, Germany and France leading the way but with most EU Member countries now increasingly involved (EBAN, 2008). European BANS delivered nearly €150m of client investment in 2007.

In the USA business angel investment is estimated to be about $20bn per year and in the UK about €0.4bn per year (Mason and Harrison, 2010). So, whichever of the statistics areused as an indicator of business angel activity, it is significant and represents a market opportunity for BAN brokerage services.

Making a Success of Being a Business Angel

Business angel investing carries high risk but performed correctly it can bring high rewards. Understanding the reality of what types of good practice can lead to business angels securing good financial returns is essential to the design of any successful BAN.

One of the more powerful recent pieces of research conducted in this field was sponsored the UK's National Endowment for Science Technology and the Arts (NESTA, 2009) and showed that:

- 56% of business angel investments failed to return the original capital invested
- But 9% generate more than 10x the original investment capital
- Overall in the UK 2.2x the original capital is returned and since the average holding of a business angel investment is 4 years this equates to an IRR (internal rate of return) typically of 22%
- Over 50% of investments are for "seed" and start-up capital, which means that much of business angel investment is targeted at the stage of investment which is generally the hardest for a young business to secure from any other source – which in turn makes it of considerable interest to accelerator owners and managers to help the growth of their clients. As shown in other research (Rowe, 2011), supporting this type of growth can be economic for STPs. Furthermore, this latter research shows that one of the services that delivered significant client business growth outcomes boosting STP revenue is access to finance, which importantly included business angel finance.
- However, in the UK the average investment by a single business angel is only €46,000 although the spread can be from as little as €10,000 to over €1,000,000 in a few cases. Given this relatively low average investment value and the fact that most companies are seeking larger amounts of investment, BANs have found a valuablerole bringing business angels together into syndicates where several angels invest in a single company. The net result is that as a result of BAN syndication activity in the UK the typical business angel investment is €140,000 – 175,000.

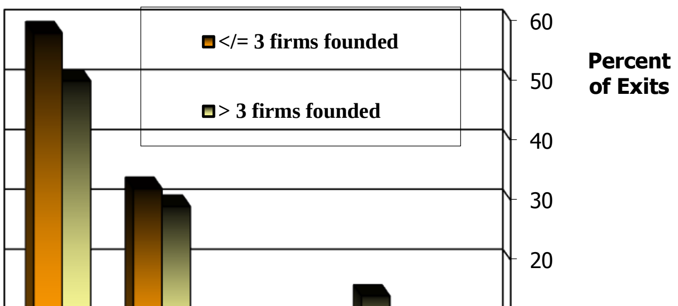
Not only did the NESTA research reveal the investment values and returns achieved by business angels it also showed how different investment behaviours influenced the financial returns. Figures 1 to 4 below clearly show that if business angels follow a few relatively straightforward rules, which will undoubtedly hold good universally, they can significantly:

- Reduce their risk of making poor performing investments and, at the same time;
- Enhance their chances of securing more of the higher yielding investments

In more detail, the statistics show that Business Angel investors that:

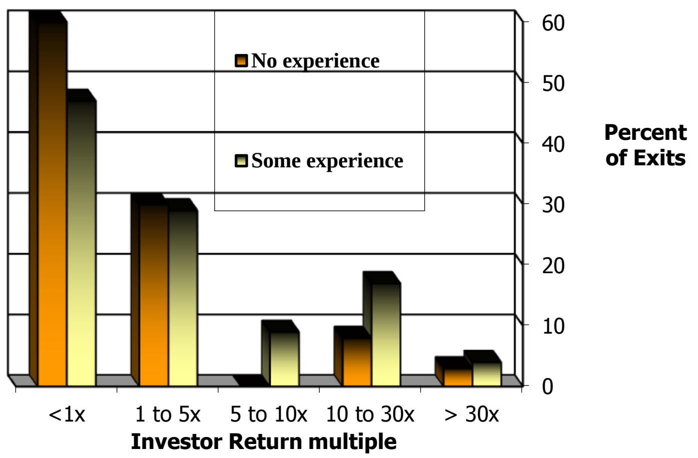
a. Have experience of enterprise start-up themselves, slightly reduce the risk of having low performing investment but massively increase their chances of having returns of capital in the highest performing 10-30x and 30x + categories.

Figure 1 Investor's Enterprise Experience



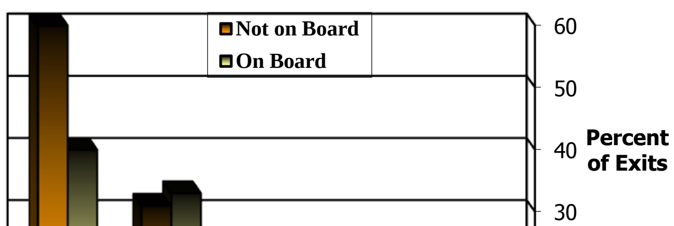
b. Invest in markets or industry sectors that they know well, again they reduce slightly the risk of having low performing investments but significantly increase their returns in the mid-range 5-10x and 10-30x return categories.
c. Undertake thorough "due diligence" before they invest significantly reduce the numbers of investments that fail to return the original capital while significantly boosting the mid-range returns as in b. above.
d. Play an active role in assisting the management team or Board of their investees. This category of behaviour shows some mixed outcomes which are not fully understood. Participating as part of the management team did little to enhance investment returns but taking a role a non-executive director significantly lowered the number of investments that failed to return the original capital while substantially boosting the two highest categories of returns as at a. above.

Figure 2 Investor's Industry Experience



If Business Angels follow these rules then on average they improve their financial returns on their business angel investments from an internal rate of return(IRR[i]) of about 22% to 35%. In effect by following these rules they reduce the number of failures and underperforming investments and increase the proportion of businesses that produce well above average returns. In older market economies around the world these are considered good returns. Indeed the performance matches that of many venture capital funds, which, while they seek higher returns of 50 – 60% often only secure returns of 30 – 40%.

Figure 3.Investors Involvement with the Board of the Investee Company



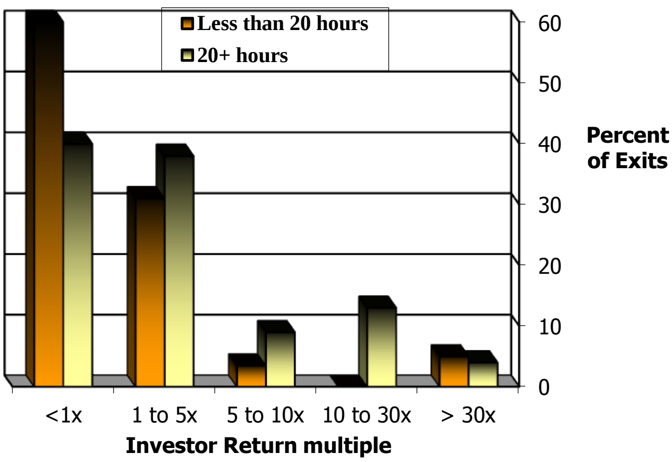
The Design and Operation of a Business Angel Network

This research has significant implications for the way in which a BAN is designed and operated when taken in conjunction with the typical behaviour of Business Angels. The following paragraphs bring together this research and practical experience over 15 years of developing and operating “Minerva”, the business angel network of the University of Warwick Science Park. The value of a Business Angel Network to an STP, particularly where the STP has an accelerator programme, such as that operated by the University of Warwick Science Park is:

- The greatly improved access to risk finance this affords young and promising business clients of the STP;
- The ability to ramp up the skills and experience of small, incomplete management teams with the time and energy that Business Angels are often prepared to provide to their investee companies;
- The much greater understanding this give the STP management team about the state of the private equity investment market which in turn enables them to provide better advice to their clients
- The undoubted marketing benefit that having an in-house BAN brings in attracting high calibre new business ventures and entrepreneurs to an STP’s accelerator programme.

Before returning to the question of how to work effectively with Business Angels, some of the issues relating to regulation and working with the small businesses and entrepreneurs who form the client base of an accelerator programme need to be addressed first.

Figure 4 Extent of Investor’s Due Diligence



The regulatory environment

In most developed and some developing economies there are very strict rules about providing investment advice to potential and actual investors. As a BAN operator there is a risk that approaches made by BANs to business angels with opportunities for investment could be seen as advice, which is subject to regulatory control. There are two ways of ameliorating this risk:

1. Become licensed under the relevant financial services legislation. This is the safest route to take but, in the UK at least, it is very expensive and time consuming indeed, and would make it virtually impossible to operate a BAN economically.
2. Establish strict rules of engagement with business angels. They have to become business angel members of the BAN, and accept that any formal information about potential investees provided by the BAN does not constitute advice or a prospectus to invest. The way that written information is cast must also be clearly differentiated from that which is normally provided in an investment prospectus. Furthermore, the rules of the BAN must require that any negotiations over an investment only take place between the prospective investee company and the business angel. By taking great care over what is provided and said to member business angels, the need to become licensed can be avoided.

Helping the client Company or prospective investee

For most start-up, early stage or SME business raising equity finance from a business angel through a BAN will be the first time they have sought risk capital from a third party. Most of such businesses therefore have a great deal to learn. It frequently comes as a surprise that most business angels really are looking for a significant financial return on their investment. Furthermore, business angels are expecting the management of the company to be able to talk about the manner and timescale under which they, the angels, can gainfully exit. Business owners also forget that in addition to the equity participation that they are looking for, they are also securing the involvement of someone who probably has much longer and broader business experience than anyone on the management team. It is very important they should be looking to secure skills which complement and add to those that the management team already has if the value of the business is to be increased.

Helping start-ups and other SMEs to understand all these issues is a critical role for most BANs. They have to alert and train the prospective investee companies about all of the issues that an angel investor is likely to raise with them. Furthermore, in many cases the management team will have to present their ideas to a group of potential angel investors. To make this a positive and rewarding experience many investee company managements need to be trained how to deliver all the salient issues accurately and quickly during a typical 10 - 20 minute “pitch session” during which they have to get across all the key points about their company and its products or services and the investment potential of the company.Potential investors may be listening to 5 - 10 other “pitches” during the same day. This process of training and preparing the management team from a prospective investee company is known as “Investment Readiness” and is described more fully at Reference 3 (Rowe, 2005). There can be little doubt that a good investment readiness service should form a part of any worthwhile accelerator programme, since many of these clients will be requiring risk finance at an early stage in the development of their business.

Interestingly, investment readiness training is a highly positive way of discouraging weaker companies from pursuing equity investment. During investment readiness training most of the weaker companies quickly start to realise for themselves that they are not ready for 3rd party equity investment of any type. However, they also often discover alternative ways of taking their company forward. This considerably reduces the pressure on a BAN management to promote these businesses to their community of business angels.

Thus, in many ways a good investment readiness service considerably enhances the productivity and investment performance of BANs. Where a Business Accelerator in an STP operates some form of investment readiness service, even if is only mentoring from suitably qualified risk finance experts, this immediately makes the client companies in the accelerator more attractive to business angel investors. These investors also realise that an accelerator environment produces a steady stream of investment opportunities so linking an accelerator programme with a BAN makes considerable sense for both the BAN and the accelerator’s client base.

Beyond preparing the management of prospective investee companies the other key services that a BAN needs to undertake for its investee clients are:

- Preparation of an outline of the investment opportunity presented by each client that can be circulated to each of the business angels registered with the BAN
- Organisation of opportunities to meet with Business Angels. This can happen in two main ways:
    - Establishing a regular pattern of meetings where between 10 and 30 Business Angelsattend to hear the presentations (pitches) by the prospective investee companies. An important part of these sessions is the time set aside after the formal presentations for the companies and business angels to meet face to face and get to know each other and discover whether or not there might be a match of interests. If there is mutual interest the BAN can help in setting up further meetings, several usually being required before a formal offer to invest is made.
    - Some BANs are now supplementing live pitch sessions with short on-line web based presentations. This can work as a complement to the live sessions but there is no good evidence that they can replace the formal pitch meetings. Even more advanced is the use of “Telepresence” and similar technologies to present companies to investors in another country – which a few STPs are working on.
    - A BAN manager usually gets to know the specific types of investment that most interests each of their active investing business angels. Once this happens and a new investee company presents an opportunity that matches one of these natural interests then a meeting can be arranged ahead of a pitch session.
- In some cases business angel investment is not appropriate for a company that has approached the BAN. If the investment is more likely to suit a venture capital company, most BANs will be well enough connected to this market to assist a company. However, where Bank finance is most likely to be the only relevant third

party investment, then handing the client onto other agencies is usually necessary to avoid the BAN from becoming overloaded with non-mission critical activity.

There is no doubt that in much of Europe and North America the “pitch” sessions have proven to be the most effective and efficient way of bringing business angels and potential investees together. It is also culturally accepted because contract law is strong so that confidentiality agreements can be signed and detailed information transferred between the parties in full knowledge that the Courts will uphold the rights of the owner company if the investor infringes the terms of the confidentiality agreement.

In countries where the protection of information, patents, design rights and copyright information is less strong,business angel activity would be harder to organise, but by no means impossible. In these situations the natural caution that exists between business people who do not know each other requires that time is spent establishing a personal relationship – before a business relationship is even contemplated. Trust has to replace the contract. It is a much slower process and in pure economic terms less efficient, nevertheless it has worked in many countries for centuries.

In all probability such countries may find that the personal matching process described above is a better way of starting a business angel activity that would be culturally more acceptable to business angels and potential investees alike.

Recruiting and Working with Business Angels

The process of recruiting and working with business angels takes up a significant proportion of BAN management time. This time has to be devoted wisely. A BAN manager has to learn quickly which individuals are serious about making investments, the level at which they wish to invest and how large a portfolio of investments they are looking to create. It is not usually appreciated that business angels do not have an endless appetite for investing. Most are looking to secure a portfolio of investments in small companies over a period of 2 – 3 years, and unless their wealth from other sources substantially increases in that period, they will then withdraw from the angel investment market for a time. This means that BAN managers have to be constantly recruiting new active business angels. The induction training for new business angels described below is one way of attracting new investors, but undoubtedly the most important source of new angels is word of mouth, which in turn depends on a BAN achieving good results and then promoting successes in relevant media.

Given the evidence that most business angels prefer to invest no more than about €20 - 75,000 in a single investment, BAN managers need to set up syndicates of like-minded business angels to secure sufficient funds for typical investments which are normally in the range €100 – 750,000. Syndicates work for a number of reasons, not least because business angels in a syndicate are often encouraged to invest when they can see that others like them also believe in the prospects for a particular company. It also means that they can invest without having to be directly involved in each company because another member of the syndicate, whom they trust, takes a position on the Board.

Syndicates can work in two ways, but in each case it is usual for one member of the syndicate to lead an evaluation of a prospective investee:

- In the first method of working an entire syndicate takes a view on a particular investment and then if a majority vote in favour of investment the entire syndicate invests.
- More usually, a lead syndicate member will put the case to the other members and each then decides individually whether or not they wish to participate in the investment round.

Whichever method is chosen, it is usual for the person who leads the investigation into a particular investee company to take a position on the Board of Directors of that company when an investment has been made (This often coincides with the person who had a strong interest in the investee business from the start, often because of relevant experience).

The most important mistake for BAN managers to avoid is presenting to business angel investors either weak businesses or good businesses that do not know how to present their case. Business angels quickly drift away from BANs that make these mistakes. This further demonstrates the importance of strong investment readiness services.

While many of the business angels attracted to a BAN will be experienced investors, for others it will be a new experience. For this reason some BANs run occasional business angel training days to help newcomers to understand all the issues that they need to take into account when investing. This can include helping them to understand:

- The forms of legal shareholder agreements they should consider when subscribing for shares in a private company. These agreements can, for example, restrict how the investment funds are to be spent, prohibit other shareholders from changing the constitution of the company so as to disadvantage the new investor and providing for certain conditions where the investee can buy back the shares.
- The tax breaks for Business Angel investments and how to secure them. Although most business angels will tell you that the tax breaks do not give them the reason to invest, it certainly helps if an investment fails or if it is spectacularly successful. So tax breaks tend to increase the level of funds that Angels are prepared to put at risk.
- The research results that show how investment behaviour can influence the financial returns achieved by business angel investors.
- The experience they need to look for in their financial and legal advisors who will be helping them with the formalities of making investments.

Recovering the Costs of BAN Services

The principal way of recovering the costs for BAN services is a success fee levied on the companies that it has helped to successfully secure business angel investment. The fee range is typically 4 – 6% of the capital raised. It is essential that a legally binding agreement for the payment of these fees is established before any business angel is introduced to a client Company. It is far from unknown for business angels and investees to work together to try to avoid paying the fee – so binding agreements are essential.

The other sources of income for a BAN are:

- Membership fees for the business angels. Whether or not a BAN can sustain a case for charging these fees will depend largely on its reputation.

- Application fees for prospective investees. These are usually fairly modest fees levied mainly to deter speculative / non-serious interest.
- Fees for operating investment readiness training services. In some cases these costs can be supported by grant from relevant public sector agencies.
- Grants from public sector bodies that support SME activity will sometimes help to establish and operate a BAN, particularly in communities that are not already covered by a BAN.
- Event income, such as for the "pitch sessions" is usually the minimum necessary to cover the costs of running the event so tends to have no effect on the overall finances of the BAN.

An economic model for a basic BAN

Table 1 below identifies the approximate incomes that a successful BAN could be expected to achieve once it has developed its network of business angels and secured a favourable reputation amongst the business community in its region. These income estimates are based on the activity levels that a single experienced and effective BAN professional, with appropriate support, could be expected to achieve in an average fair market.

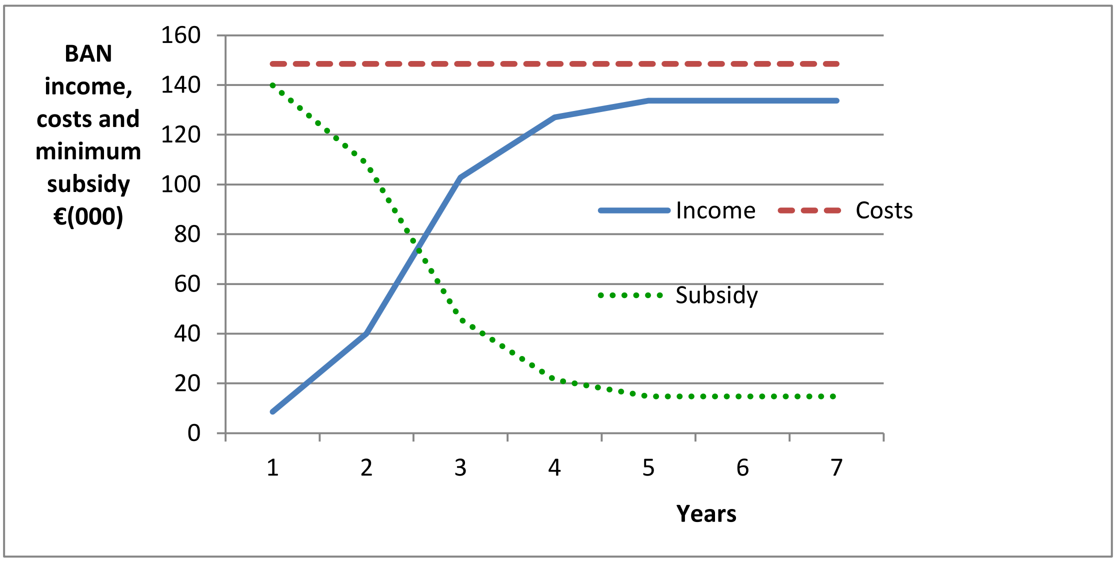
Table 1. Basic Incomes and Costs for a fully supported single professional BAN

Sources of Income		Low Estimate €000	High Estimate €000	Average €000
Success Fees	***Fee rate***			
4-6 investments each average €180k pa	5%	36	54	45
2-3 investments each average €600k pa	4%	48	72	60
Subscriptions from Business Angels	***€ / subscription***			
40 – 60 Business Angels	180	7.2	10.8	9.0
Investee Application Fees	***€ / applicant***			
40 – 80 applicants	120	4.8	9.6	7.2
Investment Readiness Course Fees	***€ / trainee***			
45-80 trainees net contributions to BAN	200	9	16	12.5
Total Income		105	162.4	133.7
Operating Costs				
Total Costs for 1 professional BAN operator including support staff and operating costs		132	165	148.5
Subsidy Required				
Implied minimum subsidy required		27	0	14.8

Thus, a hard working BAN professional operating in a fair market could be expected to come close to coveringtheir costs once they have established a credible track record. If any grant funds are available at all to help cover direct BAN costs then a better than break even position can be anticipated.

However, when a new BAN is established it takes time to establish its credibility with potential investors and investees alike. Experience at the University of Warwick Science Park indicated that it takes 2 – 3 years to establish credibility and about 9 months before the first investment is made. Using these parameters the build-up of income and the implied subsidy requirement has been modelled and is presented in Figure 5.

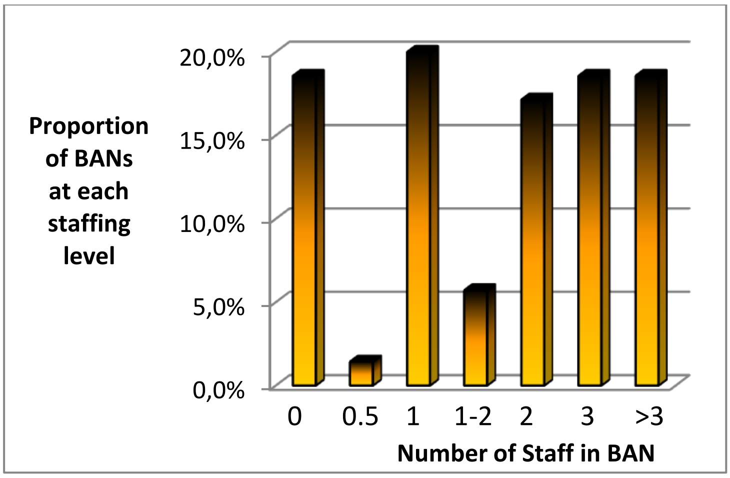
Figure 5. A model of the Build-up of Incomes and Costs for a new BAN, identifying the Subsidy or Grant Support Required



However, it has to be accepted that from time to time investment activity does decline and when it does the number of deals that can be closed will fall and so will the income. This is when an STP has to consider whether it should step in and support its BAN through a difficult period to secure the longer term benefits the BAN can bring. The argument for an STP to provide a subsidy for this type of activity is explored in more detail in Reference 5.

Data from the European Business Angel Network at Reference 2 (EBAN, 2008) shows that 75% of all European BANs received grant support from the public sector but equally 90% generated at least some of their income from charging fees to either, or both, client companies and business angels.Within Europe, the fact that grant support is so clearly widespread suggests that it is reasonable to base a development plan for a new BAN service in these countries on the presumption that public sector grant support will be secured.

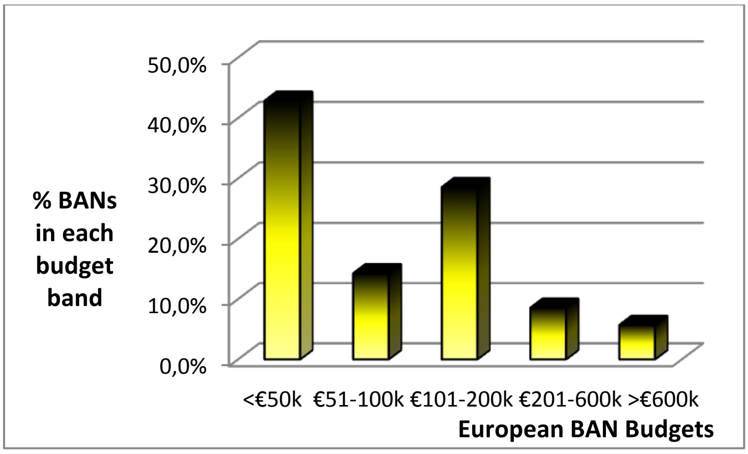
Figure 6 Staffing of European BANs



After EBAN Statistics Compendium 2008

The information in Table 1 for the budget requirements of a BAN is also consistent with the data from EBAN which is summarised in Figures 6 and 7 which show respectively the distributions of staff numbers and budgets for European BANs.

Figure 6 European BAN Annual Budgets



After EBAN Statistics Compendium 2008

Conclusions

Putting the research results and experience together suggests the following key conclusions for setting up and operating a business angel network to support an STP's accelerator programme:

a. A BAN can help increase the breadth of an Angel investor's portfolio by organising Angels into syndicates, where only a lead Angel takes a direct involvement in the company.
b. BAN operators have to discriminate between business which are investable and those that are not. They can increase the number of investable propositions by helping their clients to become "investment ready", those that cannot present a good case must be kept away from the BAN's Angels or risk losing them.

c. Even very wealthy Angels like the idea of limiting their exposure to each of the businesses they invest in. They do this by keeping the amount they invest quite low. In the UK it is typically €20 - €75,000, which makes syndication desirable to reach the level of investment required by the typical investee companies to found in a successful accelerator. However, occasionally an Angel will want to invest alone and is prepared to make the entire investment needed.
d. Angels have a limited period while their appetite for investment is high. Once they approach their investment limit for this type of asset they may remain as Members of the BAN, but they cease investing. This means that BANs are always looking for new Angels and in some cases these new Angels need some educating as to how they might best approach the task of investing. Again syndicates are a good way of inducting new Angels. But also important is: making them aware of the research results, the basics of the styles and types of shareholder investment agreements, and the rules that have to be observed to secure the tax breaks.
e. Making a BAN financially self-sustaining usually means charging the investee companies a success fee. This is usually a modest percentage of the investment raised. In Europe many BANs also receive some subsidies (EBAN, 2008).
f. There has to be a forum through which Angels are introduced to potential investees. In the USA and Europe this is largely achieved through "pitch sessions" where the companies give a short presentation of their business and the investment opportunity to a gathering of the Angels in the BAN. After these pitches there is an opportunity for Angels to meet privately any of the companies they might be interested in. However, this is a culturally sensitive aspect of BAN activity and in some countries different approaches might be employed in bringing companies and Angels together.
g. There are many synergies between the risk financing needs of typical businesses found in a good accelerator programme and the type of investments that Business Angels are seeking to invest in. Therefore,aligning a BAN with an accelerator programme makes good sense.
h. It is difficult to make a BAN financially self-sufficient from success fees alone, so some form of public sector grant and / or a subsidy offered by a host STP is often required. There is significant evidence that within Europe at least, grants are frequently secured. The case for an STP offering a subsidy is the increased exposure to more and faster growing prospective clients that is brought by a BAN / Accelerator combination.

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[i] IRR – internal rate of return – the compound interest rate at which the net present worth of an investment balances to zero.