Understanding Business Angel Networks

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Motivation and project outline

Over the last few decades the creation of new successful entrepreneurial ventures has become an increasingly important engine of economic growth and prosperity. Such ventures need to resort to external sources of finance to sustain their fast-paced growth trajectories, and venture capital has traditionally been the main source of capital for these companies, especially at their early stages of formation. However, since the collapse of the "dot.com bubble" this channel of external finance has turned more towards financing later stage ventures. This is largely due to pressure from institutional investors ("limited partners") that have been disappointed by the poor returns earned on many early stage venture capital funds.

As a result a 21st century "entrepreneurial equity gap" has emerged, whereby formal sources of entrepreneurial finance (Venture Capital) are leaving areas where they have so far been dominant. An interesting response has then emerged in both the US and Europe, as informal investors (Business Angels) have taken up the opportunity to fund entrepreneurial ideas at early stages. While Business Angels have long been active investors, in the last decade or so they have provided increasing amounts of financing, and have become the dominant player in early stage venture financing.[1]

Despite the enormous amounts invested, and the increasingly crucial role they play, we know extremely little on the economics of these investors. Largely this is due to the difficulty to obtain reliable data. Available studies are mainly descriptive (e.g., the work of Harrison and Mason in the UK), or policy oriented (see Shane (2008)). Very few academic studies have appeared so far. Notable exceptions are Kerr, Lerner and Schoar (2011) and Goldfarb et al. (2012). These papers focus on different aspects related to the performance of companies financed by business angels. They obtain data from two prominent angel networks and from one defunct Silicon Valley legal firm.

Our project aims at breaking new ground by looking more broadly at how the emergence of business angel networks affects the provision of early stage finance. In particular, we want to study how different organizational structures of angels' networks affect how finance is provided.

[1] While precise estimates are not available, reports suggest angel investing to reach possibly even 20 USD billion in the US (Sohl (2011)) and 5 to 10 EUR billion in Europe (EBAN (2011)). These sources suggest over 200,000 may be active Business Angels in the US and about half in Europe.

In fact, angel networks are organized in a variety of ways. These range from less sophisticated, government-sponsored ones that mainly aim at putting in contact investors and entrepreneurs, to more sophisticated networks where there is specialization between 'active' Angels, who engage in due diligence and monitoring, and 'passive' Angels that provide only money. Some angel networks also choose to remain less visible and work by co-optation. Other Angels even choose to work independently without any publicity.

We think that understanding the consequences of such heterogeneity can shed light on which organizational structures are more effective in supporting companies that need early stage finance and in facilitating access to additional sources of later stage finance, including venture capital.

Specifically, we will study how different network structures attract angels with different characteristics, like experience, education, and approach to investing. We will then look at how networks differ in terms of due diligence, contracting, and monitoring of companies. We will exploit variation across networks but possibly also across angels (with different characteristics) within networks, in order to understand the relative importance of organizational structure and individual characteristics. Finally, we will look at how network structures relate to different paths of follow-on financing and company outcomes.

We believe the results of this study would also have important policy implications, in terms of assessing the effectiveness of public involvement with angel networks.

Data description

We plan to do this by means of an online survey that we have designed and implemented on a pilot basis with four prominent UK angel networks with different organizational structures and degree of sophistication. The survey is user-friendly. It can be easily and quickly answered anonymously, and consists of three main parts: (i) the business angels' profile, (ii) the investment process and (iii) the contracting, monitoring, and outcome of portfolio companies. Up to now we have collected 62 usable answers from individual angels, including details of 99 of their portfolio companies.

Even at this very preliminary stage, we can document some new, interesting stylized facts about respondents, investment practices, follow-on financing patterns, and portfolio company performance:

1) Angels are middle aged, well educated, and fairly active investors. They are more often entrepreneurs and businessmen than technology people. They often venture outside sector they have experience in.

2) Syndication is practiced by half of the angels in our sample. In most cases this is done on a deal-by-deal basis, but some angels also use investment

clubs. Sharing risk and providing companies with adequate financing are the main motivations for syndication, while a relevant minority of angels prefers not to syndicate to preserve anonymity. Syndication within clubs is associated with the use of contracts specifically drawn for each deal, and with a more active involvement with companies. Syndication also has implications for deal outcomes: syndicated deals are riskier and possibly less successful, but we need more data to reach a firm conclusion.

3) Angels often co-invest with venture firms, among other co-investors. The presence of these professional investors has tangible effects, as it is associated with more protection from dilution, probably reflecting angels' fears, more rights to control the company, probably reflecting venture firms' desire for control, and also a less active involvement of angels.

4) Interestingly, networks' organizational structure is associated with different types of follow-on financing. If a company is financed by a sophisticated network, it is more likely that a venture capitalist will provide financing in the next stage.

Most of our respondents provided the names of most of the companies they financed, so we can obtain more detailed company-level information, including company accounts. We are already matching the survey data with company-level information from Company House.

Current state of the project

We have already conducted our survey on a group of angel investors that belong to four prominent UK angel networks. So far we have 62 usable answers from individual angels, including details of 99 of their portfolio companies. We are currently involving several more networks in the UK, Scotland, and Germany, through their respective associations, and we are going to meet with them soon to define the implementation of the survey. We hope to be able to collect the data by September, and process them in time for the final conference.

References

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