

Business Angels: True Founders of Innovation

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Although an increasing amount of investors have gathered as networks, fairly little is known about the market for angel funding – its size, scope and the characteristics of the people that make the investments. It is interesting to get an understanding of the type of firms that attract angel funding. Are these mainly high-tech companies or can they be firms focused on purely on client servicing. A question most of us interests and has gained increasing attention over the last few years..

Most academics believe the root of entrepreneurship is situated in the heart of the economy (e.g. California - specifically: Silicon Valley- in the United States, the 8th largest economy in the world, contributing to 13% of the country's total GDP). The majority of entrepreneurs rely on capital funding from banks and venture capitalists. However, the last decade the concept of 'business angels' became more prominent. Business angels are investors looking for investment opportunities *while* actively participating in the start-up's strategy and plans besides providing mere financial support. This is also expressed in the assessment of new investment proposals (Landstrom, 1998) and the willingness to only benefit from 'psychic income' - income that pleases the mind. If business angels, or informal investors, are at the heart of economic growth - as stimuli of innovation - the key to funding innovative companies lies in the hands of governments and policy makers. Policy makers have the ability to steer the right funds to the appropriate parties and people on the one hand. The government has the toolkit to amplify opportunities for angel funding, increasing networks for start-up firms, and capital investments from third parties on the other hand. In addition, governments can incorporate so-called award programs that aim to help the best entrepreneurial ideas with cash grants, to stimulate creativity (innovation) even more. Support entrepreneurs with research and development centers, in which new ideas are initiated, and provide the building blocks for the creation of innovative products and services. Shifting policy towards a more investor-friendly environment helps emergent businesses get funding more easily, and effectively. This induces substantial cost savings for governments, while stimulating the economy at the same time. These matters can present the perfect solution for counter-attacking the negative side-effects of a potential recession. The big question, however, remains whether business angel funding leads to innovation.

This bachelor thesis is the final result of the International Bachelor in Economics and Business Economics (IBEB) program at the Erasmus University Rotterdam, the Netherlands. The author of this thesis has dedicated the last blocks of the third bachelor year to study the impact of business angels' on innovation amongst emergent firms. This thesis gathered information from several academic articles, found in the references section. In addition, the author conducted one interview with a private investor who made multiple business angel investments: the Chairman of De Investeerdersclub Mr. Keith Wallace. Mr. Wallace invests funds ranging from \$10.000,- to \$1 million.

Mr. J. Block is the skillful supervisor of Steven Lammertink and he has helped this thesis evolve into what it has become. Guidance throughout the entire writing process and extensively helping in organizing the set-up of the interview. The results of the interview are included as addition to this paper and should provide a useful extension to the academic literature. The interview also sheds light on the difficulties and practicalities related to business angel investments. Intuitively, the experiences of a professional in the investment industry forms a useful addition to the literature review but only reflects a very small part of the business angel market and its true reality.

Steven Lammertink

The financial crises of 2008 and its negative side effects, has put substantial pressure on investors whom, bounded by stricter regulations imposed by the government, face more challenges in investing. The lack of trust between banks, governments and citizens endorsed a situation in which confidence amongst consumers has to be restored again. Amidst the start-ups of new incumbent firms, innovation plays a central role in establishing and cultivating a thriving economy. In the United States, in the period 1979-1995, four million jobs were lost amongst the renowned Fortune 500 companies. Quite a remarkable finding, compared to the more than 24 million jobs created by the entrepreneurial economy due to a 200% increase in the number of emergent businesses (Freear *et al.* 1997).

The acquisition of financial support has gained increasing awareness amongst start-up firms and is the subject for debate amongst policymakers and government officials. However, due to the uncertainty involved in starting a business, entrepreneurs cannot simply turn to banks for loans and other funding options (anymore). Entrepreneurs usually receive help from family and friends but lack the necessary resources to retrieve venture capital. This missing link can be bridged by business angels.

Although an increasing amount of investors have gathered as networks these days, fairly little is known about the market for angel funding – it's size, scope and the characteristics of the people that make the investments. It is interesting to get an understanding of the type of firms that attract angel funding. Are these mainly high-tech companies or can they be firms focused purely on client servicing for instance.

Most academics believe the roots of entrepreneurship are situated in the heart of the economy (e.g. California - specifically: Silicon Valley- in the United States, the 8th largest economy in the world, contributing to 13% of the country's total GDP). The majority of entrepreneurs rely on capital funding from banks and venture capitalists. However, the last decade the concept of 'business angels' became more prominent. Investors looking for investment opportunities while actively participating in the start-up besides providing financial support, is expressed in the assessment of new investment proposals (Landstrom, 1998) and the willingness to only get 'psychic income' - income that pleases the mind. If business angels, or informal investors, are at the heart of economic growth (as stimuli of innovation), the key to funding innovative companies lies in the hands of governments and policy makers. Policy makers have the ability to steer the right funds to the appropriate parties and people on the one hand. The government has the ability to amplify opportunities for angel funding, increasing networks for start-up firms, and capital investments from third parties on the other hand. In addition, governments should incorporate (so-called) award programme's that aim to help the best entrepreneurial ideas with cash grants, to stimulate creativity (innovation) even more. Support entrepreneurs with research and development centers, in which new ideas are initiated, and the building blocks for innovative products or services are provided. Shifting policy towards a more investor-friendly environment helps emergent businesses get

funding more easily, and effectively. This induces substantial cost savings for governments, while stimulating the economy at the same time. These matters could present the perfect solution for counter-attacking the negative side-effects of a potential recession. The big question, however, remains whether business angel funding leads to innovation.

The relation between business angels, innovation and entrepreneurship is exactly the point discussed in this thesis. Unfortunately, relatively little is known about the size of the angel market. In the United States alone, the market was estimated to be at least five times bigger than the formal venture capital market (Wetzel and Freear, 1993), but the approximate size of the world market is unknown. Thanks to the interview with mr. Wallace, more information on the mysterious features of the business angel market were gathered. Features that would have not been available otherwise to students, whom can merely reflect on the academic literature. The interview should add another dimension to this thesis. The results in the interview should be studied with caution however, as they only represent a considerably small part of the entire business angel market.

Motivation

Steven Lammertink is a starting entrepreneur and the co-founder of Republish, he's a blogger at gettinrich.com and a Kauffman Global Scholar 2011. Republish (www.republish.nl) develops software for companies aiming to reduce the amounts of waste they create while using paper. Steven saw an opportunity for undertaking a business a year ago, during his study, when the concept of e-reading was introduced. He noticed the incompatibility of word/pdf. documents with eReaders and thought of a solution. Together with his business partner, Osric Caton, they started Republish. Steven won the EUREOS 24 Hour Business Game, is nominated for the Shell Livewire Young Business Award 2010 with Republish and won several other student competitions. He is also one of the nine students to be awarded with the Kaufmann Global Scholarship, a 6-month programme that takes scholars to MIT, Harvard, Stanford and Silicon Valley for gaining exclusive entrepreneurial insights. Steven was also selected to visit New York during the Kairos Global Summit 2010, supported by Carl Schramm, chairman of the Kauffman Foundation, an influential figure in the world of entrepreneurship and innovation.

Future opportunities challenge the founders of Republish in deciding whether or not to attract external funding. This makes it increasingly interesting in writing this bachelor thesis and learning from industry experts. This thesis will provide a parallel between the academic literature reflecting on informal risk capital and provide insight into the practice of investing through a summary of the interview results. Republish is currently in the process of attracting business angel investment(s) and this study enhances the benefits of acquiring the required funds for the author substantially. Entrepreneurs, on their turn, will benefit from some of the results that this thesis provides. After reading this document, start-ups can hopefully assess the requirements of involvement for business angels better while helping emergent businesses grow. The results in this thesis will also give entrepreneurs seeking external capital some idea's

of the incentives of business angels and the factors informal investors consider to be important when making assessments on entrepreneurs applying for funding. Innovative firms are the drivers of the economy and entrepreneurship forms the backbone of the world. This thesis is relevant for the views on entrepreneurship, informal risk capital in the form of business angels and its elements of innovation.

Research question

This thesis provides insight in the relation between business angels and innovation; reflecting on the differences between formal- and informal risk capital. A simple framework will be provided for the comparison of characteristics, similarities and differences of business angels through the results of the interview.

Research question

In what way and how do business angels, or informal investors, help emergent firms innovate and create synergies for inducing innovation?

This thesis has the following structure; the thesis starts with introducing the concept of innovation, elaborating on the different definitions the term has been given throughout the years and its relevance with respect to the drivers of angel investments. The exact definition of business angels, their decision-making criteria and types of investments will be discussed in section 3. Section 4 discusses the differences between business angels and venture capitalists followed by a section dealing with the ‘equity gap’, as a frequently cited topic in the investors literature. Section 5 discusses the structure and results of the interview. The final section concludes.

Literature used

The literature used was retrieved primarily from the databases of the Erasmus University Rotterdam and the library of the Erasmus University of Rotterdam. All literature in this database has an academic foundation and has been written by well respected professors and employee’s at research institutes and other universities, colleges and schools abroad.

The interview with mr. Wallace should provide insight into the true fundamentals of the investment world. Most of the literature (Angels and informal risk capital, Wetzel, William E., Jr, 1983 et al) argues that product development financing has not been given the attention it deserves and has therefore not enjoyed the relevant exposure required to make business angel funding a success. Risk capital is mentioned as an essential component of the growth and development of new ventures. The literature truly started reflecting the phenomenon of ‘business angels’ when William Wetzel studied their behavior in the beginning of the 1980’s.

A clear understanding of the factors that influence the dynamism and orientation of the innovation process is important for anyone concerned with the role of the government in promoting job-creation growth. Especially in a context of growing competition and globalizing markets. Since 1979, greater attention has been paid to small firms on account of their potential for generating jobs and economic growth. Innovation is particularly stimulated by small businesses and it is now widely accepted government policy that it is the main vehicle for recovery from recessions and will be the main provider of jobs for the next decade at least (Deakins, 1996).

This thesis studies the impact of business angels on innovation. A clear understanding of the factors that define innovation are therefore provided below. Business angels, for instance, might only make investment decisions based on the innovative capacity of a firm, which proves the relevance to this thesis. This section introduces the concept of innovation and provides several innovation measurement terms that are most common. Section 3 then provides insight in the definition of business angels and their investment criteria.

Definition

Innovation is the process of creating and developing new ideas that contribute to technological advancement for society or impede better facilities for the public. One of the first economists to give attention to innovation was Joseph Schumpeter. In 1930 he defined several definitions for the concept of innovation (see OECD, 1997, p.28):

- 1) Introduction of a new product or a qualitative change in an existing product
- 2) Process innovation new to an industry
- 3) The opening of a new market
- 4) Development of new sources of supply for raw materials or inputs
- 5) Changes in industrial organization

The most used definitions for innovation are both number one and two. These definitions are easier to measure; innovation is a two sided concept, as it can both lead to the commercialization of new knowledge on the one hand and the diffusion of existing knowledge on the other. The Oslo Manual, produced by the OECD (1997, 2nd edition) developed a database for innovation surveys and aimed at creating a benchmark. The Oslo Manual concentrates on the first two definitions of innovation set forth by the OECD. This manual, however, does not see minor incremental changes as innovation. This finding is in stark contrast with the fact that minor incremental changes may help economies thrive, emphasizing the importance of even the most minor innovative advances. The Oslo Manual provides proof for the statement that innovation is an invention which is commercialized on the market. Innovation involves pooling and

managing several innovative tasks, duties and incentives in a firm's daily operations and can be defined as being *distinctly* different from an invention. Innovation can also be defined as 'novelty entering into practice, from the invention phase of experimental research and development' (Steward, 1998). The belief holds that business angels can assist entrepreneurs in carefully connecting innovative products to patents, thereby indirectly stimulating innovation. This finding, of course, is the essence of this thesis and shall be reflected on in the conclusion as well.

Measurements of innovation

It remains particularly difficult to quantify a firm's innovativeness, due to the simple fact that no easy methods for measuring innovation are directly at hand. Extensive econometric models are used to perform this task, methods that move beyond the scope and purpose of this paper. Usually, several indicators are distinguished which most people relate to innovation: patents, licensing, Total Factor Productivity (TFP) growth and research and development (R&D) expenditures. The table below describes both input and output measurements of innovation:

Input measurements of innovation

Research and development expenditures¹. Even though most products from the research and development department do not make it to the market this measurement is worth mentioning. It also accounts for a substantial amount of absolute innovative activity.

Intellectual property statistics. Several institutions like the Melbourne Institute keep records of these statistics.

Acquisition of technology from others. Including patents and licenses. This measurement can also be referred to as an intermediate measure of innovation. However, in this thesis and for reasons of simplicity, this measurement will be referred to as input of innovation.

Output measurements of innovation

Company managers. This method gathers information regarding process/product innovations directly from the management of respective firms.

Other intellectual property (IP) indicators. Trademarks, copyrights and designs can also be mentioned as output measurements of innovation.

Percentage of sales from newly introduced and/or improved products.

¹ Systematic investigation or experimentation involving innovation or technical risk, the outcome of which is new knowledge, with or without a specific practical application of new or improved products, processes, materials, devices or services (ABS, 1996, 8104.0, 0.24)

**Training expenditures to educate employees
with new services and/or products.**

It should be emphasized that most of the research and development budgets, allocated to different entrepreneurial projects, do not end up as successful innovative firms. Nowadays, the most cited benchmark for innovation are still patents, even though the trend towards other measurements of innovation are winning substantial territory as well. It is assumed that most entrepreneurs wish to patent their inventions before addressing business angels and/or venture capitalists for funding. Entrepreneurship is evidently becoming a more important vehicle for translating scientific knowledge into incomes and jobs (Guinet, 1995).

However, patents can be very costly. With an average of 18 months duration until a patent is approved, and the request being published publicly, it involves risks for copycats to quickly 'invent' the same product. There also exists a sharp difference between a Dutch patent and an international patent. This limits the possibilities of entrepreneurs to really protect their inventions efficiently and at low cost. A recommendation can be made, in the case of software protection, to use a licensing agreement. Microsoft is a company that decided to license their entire Microsoft Office product for instance with extensive contracts. This substantially limits copycats opportunities for stealing Microsoft's products.

The aim of this thesis is to illustrate the concepts, relations and definitions of business angels and its connection with innovation. The definition that reflects the concept of the term ‘business angel’ properly is illustrated below.

Definition

“Business angels” play a key role in the risk capital market by providing seed capital for inventors, and start-up and growth capital for small, technology-based firms (Wetzel, 1983).

The main characteristics of business angels can be summed up in five points, provided below (Aernoudt, 1999) and (Landstrom, 1998):

1. They have an enterprise background and most have entrepreneurial and managerial experience (78% in the study by Landstrom, 1998);
2. They are persons aged between 35 and 65 years, and are generally not older as they wish to see how their investment is going to develop;
3. They have most often sold their own company, mostly under very advantageous conditions;
4. They are mainly interested in minority stakes; and
5. They are making an amount generally less than 25% of their total assets available for informal investments.

Origins of business angels

30 years ago the United States began a transition from a recession into a productive and innovative economy driven by entrepreneurship. This transition caused the early-stage equity market to evolve as well, due to the focus institutional investors have for later stage investments. The informal investment market now provides the major source of seed and start-up capital (Sohl, 1998).

A short introduction on the start of the business angel market is now given. The story involves inventor Alexander Graham Bell and takes place in the United States around 1874. Mr. Bell was the later founder of his future telecommunications company: Bell Telecommunications. Before starting his company, Mr. Bell eagerly looked for opportunities that could provide easier communication across greater distances. He deliberately consulted the bank for advice, seeking for support in his plans, who considered his idea and believed Mr. Bell was crazy. Boston Attorney Gardiner Green Hubbard and leather merchant Thomas Sanders of Salem, Massachusetts however, helped out and provided initial funding to Mr. Bell (Sohl, 1998). The funding led to the start of Bell Telecommunications, which proved to be an extremely

rewarding experience for Hubbard and Salem. Henry Ford received early-stage funding by the amount of \$40.000,- to start his automobile company, which grew into an enormous multinational by the name of Ford, which is still with us today. Even for Anita Roddick, who required a mere £4000,-, the bank was not willing to provide her with any money. Private investor Ian McGlenn, identified Roddick's business as a rewarding opportunity and offered her the required funding. This led to the start of The Body Shop, a big time (financial) success in the cosmetics industry. Jeff Bezos, started a website and database together with friends and went to venture capitalists who felt his idea was good, but not good enough. He later received \$8 million dollars in business angel funding and started the multi-million dollar revenue generating website Amazon.com. All examples of great successes thanks to the efforts of business angels - not venture capitalists, who usually claim the successful start of most equity-financed multinationals - .

These short-stories led to the ambition for most academics to begin studying the effects of business angels on industry phenomena. The first study in this respect, was conducted by William Wetzel (1983) and is generally acknowledged to be the first paper that confirms the existence of private investors (Sohl, 1998). Also, the history on small businesses and start-up firms has led to conclude that entrepreneurship is a strong driver of the economy. Since 1979, over 75% of net new jobs were created by less than 10% of small businesses (Birch *et al.* 1993). Sohl (1998) mentions that it is the Inc 500 of the nation, not the Fortune 500, that is the true engine of job growth. The difference between the two (Inc. 500 vs. Fortune 500) is that the Inc 500 is primarily focused on technological firms instead of mere revenue size (Fortune 500). The Global Entrepreneurship Monitor (GEM) (2001) acknowledges that economic growth is a function of “*two parallel sets of interrelated activities*” (Bygrave, Hay, Emily and Reynolds, 2003):

1. *“Those associated with established firms, and..*
2. *Those related directly to the entrepreneurial process”*

The related GEM (2001) conceptual model describes these interrelated activities and is included in the appendix.

In the period 1994-1998, high growth start-ups added 6 million jobs to the United States economy that added 7.7 million jobs in total. Start-ups have the potential to organize firms with relatively little impact on the economy to grow fast, leading to revenues approaching tens of millions while creating job opportunities at the same time.

Seed stage investments

The previous section described the strong benefits entrepreneurship brings to an economy, this section builds on that thought and describes the funding of companies in the very early stages of their existence (firms < 3 years of start-up), adding considerable emphasis to the ‘timing’ and ‘momentum’ of making an investment.

Business angels are well known for their investments in start-up companies. Investments in start-ups generally involve great amounts of risk. The risks involved, however, may subsequently lead to either great failure, but also, can lead to extraordinary successes. The investment decisions of informal investors are related to the investor’s knowledge of the industry or the entrepreneur (Shapero, 1983). A finding that is also supported by the Chairman of De Investeerdersclub, who mentioned in his interview that investing is more about the entrepreneur’s qualities and skills, rather than his plans for starting a company, including the associated background of the investor related to the entrepreneurs industry. This may lead to the conclusion that investors invest in the industries in which they were formerly employed or are most familiar with. Seed-stage investments and their importance to economies must not be underestimated. The figure below explains the initiation of business angel funding:

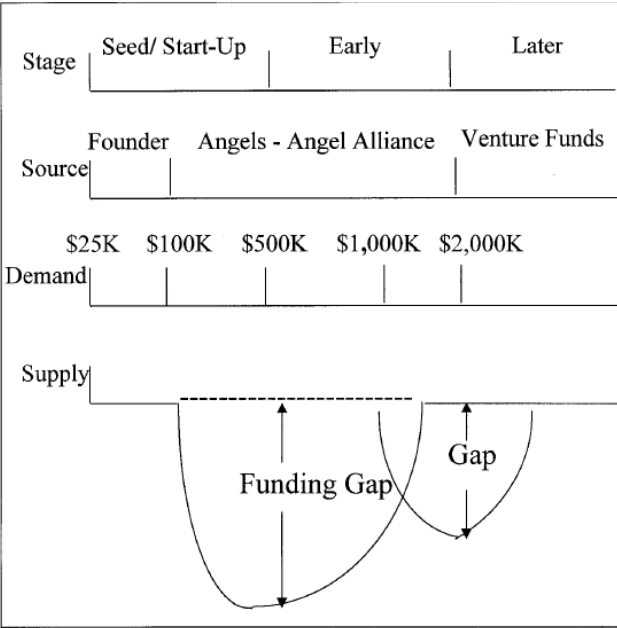


Figure 1: Equity capital for entrepreneurs²

This figure describes the different rounds of financing entrepreneurs face. The statement that business angels usually invest starting from \$100K is arguably incorrect however, when reflecting on the Dutch market at least. Generally, lower investment amounts are found in the literature. Most entrepreneurs start with initial funding based on accepting larger credit card debts, mortgages or a depletion of some left over savings account from a passed away aunt, or uncle for that sake. This stage usually involves product development and to a certain extent helps the entrepreneur start to study market opportunities. The next stage revolves around the depletion of money collected from friends, family and fools (‘FFF’, not described in figure 1). Relatives that share some kind of passion for entrepreneurship or friends triggered out of emotions in helping entrepreneurs succeed. The terms and conditions involved with these transactions are

² Section 5 discusses the (so-called) ‘funding gap’ in the figure.

not frequently mentioned in contracts or whatsoever, and only occasionally relatives conduct due-diligence. Due diligence is crucial however for investors and is very often the reason why potential investments backfire (according to Mr. Wallace). It becomes interesting however in the next financing round, which involves ‘angel funding’. The growth of an organization triggers the need for more cash and stimulates entrepreneurs to pitch their business idea(s) to private investors. Private investors decide whether or not to invest in a business, based on their (financial and future) assessment of the company. Studies have indicated that private investors are the major source for seed-stage investment (Wetzel 1983, Gaston and Bell 1988, Freear *et al.* 1995a). In the United States, the private investor segment is made up of approximately 2 million individuals with an individual net worth of \$1 million. The majority of these individuals are self-made millionaires and usually individuals with substantial business and entrepreneurial experience. Close examination of last year’s list of the 400 richest Americans (Forbes 1998) reveals that an estimate of 72%, nearly three in four, were first generation entrepreneurs (Sohl, 1998). (A first generation entrepreneur is an individual who believe true freedom can be achieved by starting a business.) Besides, there are strong indicators that this market is expanding substantially in the United States (Fenn *et al.*, 1995).

Reflecting on the figure above, a typical seed-stage business angel type of deal involves investments of around \$100,000 - \$1 million made by 6-8 individuals, which is something also seen on the popular show ‘Dragons Den’, which allows entrepreneurs to pitch their business idea in front of (most often) four business angels. In an interview the author of this thesis had with Rachel Elnaugh one of the first Dragon’s in the United Kingdom during the 2010 Global Entrepreneurship Week, Ms. Elnaugh mentioned the need a an entrepreneur for a mentor. A business angel can also be a potential mentor.

To grasp the size of the business angel market in investment volume, Freear *et al.* (1996) estimate that about 250,000 angels invest approximately \$10-\$20 billion each year in more than 30,000 ventures in the United States only. Co-investment schemes usually occur when angels invest in companies further from home and have a lower return expectation. This is consistent with most findings in the literature, stating that business angels have generally been regionally focused (Aernoudt, 1999), (Steier and Greenwood, 1999) and (Prowse, 1998).

Decision making criteria

The previous section illustrated a business angels perspective on the ‘act of investing’, the characteristics of these individuals and when business angels actually become relevant to a company’s success. This section describes some of the decision making criteria that business angels seek in prospect firms and contributes to the general understanding of what business angels look for in entrepreneurs. Informal investor studies date back to William Wetzel in the 1980s which led to substantially more academic research in later years. Landstrom (1998) describes several decision making criteria that have an influence on business angel investments. Landstrom conducted his research amongst 22 respondents in Sweden. The questionnaires consisted of 51 trade-off matrices which made the study considerably extensive. A ranking of general

decision making-criteria are provided in the table below, ordered by importance in percentages.

TABLE I. Ranking of general decision-making criteria

| Criteria | Importance (in %) | | |
|--|-------------------|---------|------|
| | Min. | Average | Max. |
| 1. Leadership potential of lead entrepreneur | 0.0 | 4.3 | 5.3 |
| 2. Market/sales capabilities of team | 0.0 | 4.2 | 5.1 |
| 3. Track record of lead entrepreneur | 0.0 | 4.1 | 5.1 |
| 4. Recognised industry expertise in management team | 0.0 | 4.0 | 5.0 |
| 5. Information available to investors on investment | 0.0 | 4.0 | 4.9 |
| 6. Organisational/administrative capabilities of team | 0.0 | 3.9 | 4.7 |
| 7. Degree of product-market understanding | 0.0 | 3.8 | 4.7 |
| 8. Financial/accounting capabilities of team | 0.0 | 3.8 | 4.7 |
| 9. Market growth and attractiveness | 0.0 | 3.7 | 4.5 |
| 10. Process/production capabilities of team | 0.0 | 3.6 | 4.5 |
| 11. Expected rate of return | 0.0 | 3.5 | 4.4 |
| 12. Ability to cash-out | 0.0 | 3.5 | 4.4 |
| 13. Uniqueness of product | 0.0 | 3.3 | 4.1 |
| 14. Relative familiarity of investors with industry/technology | 0.0 | 3.3 | 4.1 |
| 15. Ability to create post-entry barriers in market | 0.0 | 3.1 | 3.8 |
| 16. Ease of market entry | 0.0 | 3.0 | 3.7 |
| 17. Ability of investors to influence nature of business | 0.0 | 3.0 | 3.7 |
| 18. Importance of unclear assumptions | 0.0 | 2.9 | 3.6 |
| 19. Socio-economic usefulness of the product | 0.0 | 2.9 | 3.6 |
| 20. Strength of suppliers and distributors | 0.0 | 2.9 | 3.6 |
| 21. Market size | 0.0 | 2.8 | 3.5 |
| 22. Location of business relative to investor | 0.0 | 2.8 | 3.4 |
| 23. Ability to syndicate deal | 0.0 | 2.7 | 3.4 |
| 24. Sustained share competitive position | 0.0 | 2.7 | 3.3 |
| 25. Nature and degree of competition | 0.0 | 2.5 | 3.1 |
| 26. Likelihood of investor achieving non-financial benefits | 0.0 | 2.4 | 2.9 |
| 27. Time to break-even | 0.0 | 2.3 | 2.8 |
| 28. Degree market already established | 0.0 | 2.2 | 2.7 |
| 29. Time to payback | 0.0 | 2.0 | 2.5 |
| 30. Sensitivity to economic cycles | 0.0 | 1.8 | 2.2 |
| 31. Seasonality of product-market | 0.0 | 1.7 | 2.1 |
| 32. Scale and chance of later rounds of financing | 0.0 | 1.6 | 1.9 |
| 33. Number and nature of co-investors in deal | 0.0 | 0.7 | 0.9 |
| 34. Stage of investment required | 0.0 | 0.6 | 0.7 |

Figure 2: Ranking of general decision-making criteria

Some broad conclusions can be drawn from this extensive list of informal investor criteria. For starters, the characteristics of the investors are discussed. All the investors are men (not usually attributed to the term ‘angels’), aged between 45-65 years, with nearly half (42 percent) possessing an academic degree. 78 percent has management experience in small firms with turnover of between 0-20 million SEK (€0 – €2.14 million). Another finding is that close to all investors started one to multiple firms themselves and thus both possess substantial management and entrepreneurial qualities. These findings are in line with the study by Aernoudt (1999), except for the age-range, which was between 34-65. The discrepancy might be due to the different regional focus areas of the two studies.

General pattern in the criteria for decision-making

1. **Leadership** in a firm is the most important feature of informal investor's decision-making criteria and indicates substantial management and entrepreneurial experience should be present in the company.
 - a. Basically, criteria 2-4 can all be included under the term 'leadership', as they all relate to the composition of the management team.
2. **Firm potential** or 'market attractiveness' denotes pattern number two. Understandably, investors look for a firm that have considerable market affinity and therefore easily has the ability to adapt to changing market circumstances. This includes the "uniqueness of a product" criteria, which can be placed under the term: "market growth and attractiveness".
3. Another finding is that the "**ability to cash-out**" criteria generally does not have a top ten place in this list and thus does not comply to the general public's image of business angels with respect to merely benefiting financially from investments.

To capture the relevant decision making criteria over a period of time is fairly difficult. There are remarkably little studies attempting to bring out the nuances in informal investors' decision-making criteria. Most studies do not consider investing as a process in which decision-making criteria vary in the course of time (Landstrom, 1998). Another criteria that influences the decision to invest is the opportunity for syndication. Over the last years a substantial increase in the amounts of business angel networks was observed. Chairman of De Investeerdersclub, Keith Wallace, manages one of these business angel syndicates and frequently organizes events which allow start-up firms to pitch business plans in front of several informal investors, or 'informals' as Mr. Wallace refers to them.

Entrepreneurial firms are those with a vision for growth, while also having a strong focus on innovation, being able to bear great risks while adapting to changing market circumstances continuously (Wetzel and Freear, 1996). In the UK, Deakins (1996) discovered that these high growth small firms are rare, amounting to 3-4% of all start-ups, while Storey (1996) indicates that it is exactly this 4% of all start-ups that provide half of the employment out of all surviving firms in ten years time (Van Osnabrugge, 2000). This section explores the differences and similarities between informal and formal venture capital, and provides the reader with insight into what the two types of investors can mean for entrepreneurs.

Differences and similarities

Luckily, two types of funding parties exist, business angels and venture capitalists, which fund high growth firms in the hope of profiting from financial returns, or other benefits (Van Osnabrugge, 2000). The concept of business angels was introduced in the previous section. Venture capitalists, on the one hand, are those parties – usually professional investors of institutional money – that tend to invest in more mature companies with amounts ranging from at least \$1 million and larger. Comparing venture capitalists with business angels, the perception both parties have regarding investments are remarkably different. Both parties possess distinct and different views on investment projects. Formal investors value financial outlooks of investments far greater, as they usually represent other investors money. Business angels, on the other hand, may also want to contribute to an entrepreneurial society while investing. In assessing the financial profits a project brings about, venture capitalists consequently make a thorough financial analyses about firms and business plans and make a judgement based on these results. Business angels usually enjoy some form of involvement in a company, either passive or active, driven by the belief in the entrepreneur and the capacity to run a business. Formal investors project the objective of making financial profit as a benchmark while business angels weaken this criteria. Business angels have the opinion that psychic income helps benefit from an investment for a far greater amount than merely the driver of financial profit does. Business angels rather put their money on the jockey, than on the horse (e.g. venture capitalists).

The market for venture capitalists consists of funds that are managed professionally. These funds usually explicitly own the shares of several multinational companies or other firms that are publicly listed. Typically, companies are often rather big and generate substantial amounts of revenue a year. Parties that participate in these funds are mainly and foremost institutional investors. These large companies, or institutions hope to achieve higher returns by participating in these funds compared to other options the market has to offer. The organized private equity market aims at buying a majority of ownership shares of a firm while at the same time acquiring several positions at the board of directors, leading to substantial

coverage in management positions of the respective firm. The formal investment market has a rather different approach than the informal investment market on a number of points.

- The informal investment market has an entirely different approach to making investments. This approach differs substantially compared to formal investors and is far less ‘aggressive’.
- Informal investors are usually accredited individuals or networks of individuals that try to invest in firms and want to bring these to the market.
- The ownership and acquisition of firms is usually divided over several informal investors rather than in a single fund, which typifies the situation of the formal investment market .

On top of these markets (with the largest share of funds) is the public equity market which deals with firms aiming primarily at Initial Public Offerings (IPOs) and other mergers and acquisitions which come with high transactions, sometimes billions of dollars.

To give a short illustration of what has just been discussed, see the table below:

| <u>Table 1.</u> | <u>Comparison of formal and informal venture capital</u> | |
|------------------------|---|-----------------------------|
| | <i>Formal investors</i> | <i>Informal Investors</i> |
| Perception | Analyze the business | Believe in the entrepreneur |
| Focusing | Product-market (the ‘horse’) | Entrepreneur (the jockey) |
| Stage of investment | Development | Seed, early stage |
| Expected return | Return 35-45% | Challenge, return 20% |

The amounts of capital invested by business angels differ substantially from the venture capital market. Business angels tend to invest amounts ranging from \$10.000 - \$1 million dollars. The formal risk capital sector tends to make substantially higher investments, ranging from \$2 million dollars to as high as \$100 million dollars. Accordingly, formal risk capitalists look for a return ranging between 30 -35% (Manigart et al. 1998). Compared to business angels this is relatively high, who settle for a return of 20% (NEBIB, 1998). Formal investors generally retreat from seed investments, product developments and the financing of research. For example, seed capital represented about 0,9% of the venture capital market in 1997. Remarkably, estimates in the UK and the US suggest that business angels fund an annual amount of two to five times more money to entrepreneurial firms than the venture capital industry (Wetzel, 1987, Freear *et al.* 1997, Mason and Harrison, 1993), which most people probably wouldn’t have thought at first.

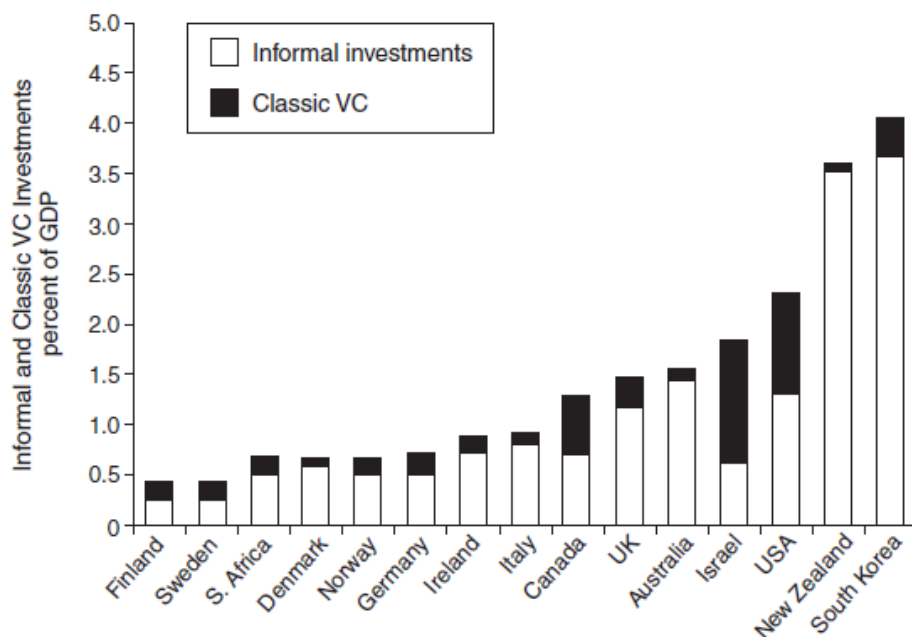
Based on studies by Wetzel (1983) and Mason and Harrison (1993), van Osnabrugge (1999) wrote:

“the BA [business angel] market in UK and the USA is the largest single source of risk financing for entrepreneurial firms, exceeding the institutional VC industry (Mason and Harrison 1996). In fact, estimates in the UK and the USA suggest that BAs fund an annual amount of two to five times more money

to entrepreneurial firms than the VC industry³ (Wetzel 1987, Freear et al., 1997, Mason 102 WILLIAM D. BYGRAVE ET AL. and Harrison 1993) it is 'guesstimated' that BAs fund between 30 – 40 times the number of entrepreneurial firms financed by the formal VC industry (Wetzel and Freear 1994).”

(Bygrave, Hay, Emily and Reynolds, 2003)

To illustrate the popularity of business angel investments, and its relevance to the entire investors climate, see the figure below:



Classic venture capital comprises investments in seed, early, start-up, and expansion stage companies

Figure 3.

Domestic Informal and Classic venture capital investments as a proportion of GDP(2000)

Nearly all countries, except for Israel, have business angels investing considerably more than venture capitalists have done. And although an increasing trend for business angel investments has come about, most of the academic literature seems to under-appreciate some of the methods and techniques of funding start-ups by business angels. Most success stories previously ‘claimed’ by venture capitalists find their origins in business angel funding however. On the contrary, venture capitalists depend on business angel funding in order to purposefully select those companies that have the potential to form great successes in later stages. This is usually the case because admittedly, after initial-stage funding, venture capital takes over. This transition from angel funding to venture capital explores and defines the firms that have been

³ The claim that business angels (BAs) fund an annual amount of two to five times more money to entrepreneurial firms than the VC industry is not correct according to (Bygrave, Hay, Emily and Reynolds); what Van Osnabrugge (1999) meant is that the venture capital industry invested considerably less than in the peak of the industry, in the year 2000.

labeled as potentially successful by angels. Basically, business angels conduct research for larger venture capitalists, while benefiting from smaller amounts of profits compared to venture capitalists. Although business angels deal with larger uncertainty and therefore larger risk when financing start-ups, financial return is not the most important pillar for making good investments. So both investors are interrelated and one naturally precedes the other in the investment scheme.

In addition, a more practical look on the differences between informal and formal investors is given by Mr. Wallace:

“If you see the term sheet of venture capitalists normally they’re putting in from anything to two million upwards so they’ve got shareholders and they have to justify expenditures too. So they require control over reporting that you have to make reports to them and they take up probably a formal seat on the board. Does the informal do that, sometimes. Sometimes the informal can even be the director of the company but the role of most venture capitalist firms is normally to take a seat on the board and also to evaluate on a monthly basis how their investment is going, what their return is likely to be which period and does that work in terms of the fund they set up and the shareholders they have there. And if that does not then they normally have certain very set tools to either remove the director and put in a new team of people. It is a much more formal and much heavier tool a VC has but for the amounts of money they’re putting in and the ownership structure it needs to be.”

Innovation and informal risk capital

This section introduces the concept of innovation and its relation to informal risk capital. The relevance of this section relates to the importance of innovation in a company’s product or service, as these firms are more likely to get business angels attention. Start-ups benefit from angel risk-taking, but so do venture capitalists, who rely on angel funding to help start-ups develop and use angel funding as a mechanism for sorting among the countless new start-ups that in later stages, seek venture capital. Without angels, the venture capital model could not exist in its current form (Ibrahim, 2008). Even more importantly, without angels our entire innovation-based economy- which relies on start-ups’ successes and has produced over 12.5 million jobs and up to eleven percent of the gross domestic product in the United States recent years- would be in jeopardy.⁴ In addition, during the Kairos Global Summit, New York, 2010, the current president of the Kauffman Foundation, Carl Schramm, mentioned that innovative entrepreneurial firms should be more strongly supported both financially and technically compared to previous years.⁵

⁴ Robert E. Grady, Testimony before the U.S. House Committee on Education and the Work Force, 2 (Mar. 11, 2004) (explaining that venture-backed firms employed over 12.5 million people and in the year 2000 accounted for approximately 11% of the U.S. Gross Domestic Product).

⁵ A statement he made during the Kairos Global Summit, New York, 2010.

Equity gap

Despite the tremendous growth in risk capital investments in STBF's (Small Technology-Based Firms), there is a continuing perception that "gaps" exist in the capital markets for smaller firms, and this raises questions about the vigor of any "age of entrepreneurship" (Wetzel, 1983). Though such gaps have not been convincingly documented, the capital gap folklore maintains that there are shortages of product development financing for technology-based inventors, of start-up financing for STBF's that fail to meet the criteria of professional venture capital investors, and of equity financing for closely held STBF's that are growing at a faster rate than internal cash flows can support (Wetzel, 1983). Angels, however, build the gap between credit card debts, family and friends money and venture capitalists. Besides, since the time William Wetzel wrote his influencing paper on business angels and their existence, a lot has changed. His remark however, was evident, and to a certain extent still is today. As estimates of the business angel market currently represent the largest pool of risk capital in the United States for instance, angels play an essential role in financing many firms. Accordingly, formal venture capitalists tend to look for larger investments at later stages in the firms existence, thereby inducing a so-called "second" equity gap. Due to this trend, business angels increasingly win importance with start-up firms and their financing role, in both early stage and second round phases (Aernoudt, 2005). The so-called "second" equity gap here is due to the shift of venture capitalists from smaller investments to larger amounts, leaving business angels and private investors with a larger space for investments.

This equity gap leads to an important conclusion, one that is especially relevant to government's policy makers. Government policies should be focused both on the supply- and demand side and combined with a cultural change. Governments should look at innovative ways to stimulate business angel financing rather than coping with market failures by bureaucratic subsidy schemes (Aernoudt, 2005). This in contrast to the standard so deeply embedded in our culture; governments focus on providing access to finance too much, forgetting about the demand side of entrepreneurial interests, purely concentrating on the supply side of capital.

One can say innovation is inherently driven by business angels due to the financing of a start-up and the constant provision of knowledge to entrepreneurs. It cannot, however, be claimed that business angels are the leading factor resulting in innovative activity. Business angels, form a part of the chain leading to innovation and most definitely stimulate and reward firms with true innovative ideas and thoughts. The most prominent relation between a business angel and innovation lies in its interrelatedness. One can't flourish without the other, innovation needs money and money drives innovation – to a certain extent.

Conducting interviews with professionals can provide very useful insights in the results mentioned in the literature, while extracting a very useful framework for comparative analyses. This interview has been recorded with the permission of Mr. Wallace and should provide an extra dimension to the results of the academic literature. Although the initial setup was to interview a minimum of three private investors, due to the recording requirement and the purpose of this study, only one volunteer participated.

Interview composition

The setup of the interview is included in the appendix and has been structured according to four general subjects:

- I. Introduction
- II. Profile of the investee in relation to innovation
- III. Goals of the investor
- IV. Operational aspects of business angels

The aim of the interview is to get insight and confirmation of the results found in the academic literature. Expectations with respect to these interviews have been structured under these four pillars and provide a useful framework for structuring business angel investments into categories.

Subject

- **Keith Wallace, Chairman De Investeersclub.** De Investeersclub consists of individuals, or informals, all willing to invest in an ‘informal’ setting. The fun and pleasure of making investment deals with one of the most important criteria at hand. De Investeersclub is always looking for entrepreneurs or investors who are willing and able to join the club or want to pitch their business idea to the informals.

Interview summary

Interview with Keith Wallace, Chairman of De Investeerdersclub.

Keith Wallace works for himself primarily but is also the chairman of de Investeerdersclub. De Investeerdersclub is in the first year of existence and made 7 investments in one year. Mr. Wallace finds it difficult to determine which investments have been successful, some have been successful in good publicity.

Right now there are three investors looking to invest in one company. This comes out of a deal-making dinner which we have 6 times a year, entrepreneurs pitch and maybe something comes out of it. It is due diligence state now and it is very difficult to tell how many of those deals they can do. Due diligence has said 'no' to many start-ups. Mr. Wallace can't think of a company that didn't have at least one follow-up with one of the investors.

Mr. Wallace: *"When the due diligence is done you can sometimes see that the deal is not quite that good."*

Mr. Wallace's background

How long have you been a business angel?

I believe I am more an entrepreneur who sometimes invests, and I believe the term business angel is a wonderful one but he has only been investing since 2000. I made money with some rather good consultancy work and was able to invest in a start-up who dealt with internet technologies. They went to the States during the time of the internet bubble.

What attracts you to making investments in other companies?

Well, I think it's the fun element of it, it is investing in people who really have passion to do something. When you are investing money and sometimes time and effort into an investment you are working with someone who's driven. That is so different than working in a regular organization where people get paid. Entrepreneurs and the team around them, especially in the starting stages, tend to be exceptionally driven and fun people you can put effort, time and money into it. If it doesn't work you're not that pissed.

You mentioned that you are an entrepreneur before you invested (he still is), what types of businesses do you invest in?

Umm.. look for something that he has a little bit of understanding in. It is really a fit with the entrepreneur. Over the last years he has stepped out of a few companies which have been successful, however, the majority has been unsuccessful. There is still a passion to do more however.

Would you always say, for instance, that investing is more about investing in the jockey and not so much about the horse?

Yeah, I have seen a lot of really good plans. And I have seen very few truly good entrepreneurs. The entrepreneur is the one that makes the plan happen.

So what defines a really good businessplan?

A really good businessplan for me is that it is short and is something the entrepreneur understands and is a 'moving' document. That it changes when new ideas come in, that the entrepreneur changes the 'true' proposition and how it is being offered. I like to see a plan that has just one viewpoint, but it can change. I like to see a plan that sketches out what some of these changes could be or if there are threats of the environment how they're going to deal with those threats. It needs to be more than a SWOT analysis.

What should a potential investee's profile look like?

What should it look like?

Do you look for firms that have patented their product or present a true innovation?

I'm really on the small end of the market in the investments that I make. So I look for someone that has an idea and is very grounded and knows how to bring it to the market. I don't want to have an idealist, I don't want to have a dreamer I want to have someone who's able to carry something out. And really that is what I'm looking for. Someone that maybe requires some coaching in order to get into the right direction but afterwards you can just point at something and the entrepreneur is just going to 'fire with all cylinders'.

What are some of the amounts you have invested?

Well I think that one of the lowest investments I made was a 1000 euro's. But you know, that can climb up depending in what a company requires. I tend to cut off when we're getting in at Euro 20.000 or so, and I work with business partners that put in about half a million in different things. And I tend to put time in and they put more money in. Sometimes you get a very good mix in that way.

What are some of the investors criteria that you adhere to when making an investment?

Criteria is a very set word. I want to have a good entrepreneur. I want to have a realistic plan. And I want to make sure the entrepreneur is grounded in networking people that can allow him to achieve what he wishes. I think when those elements are there, that there is also a good possibility that I can afford to do.

Quite often you hear about ideas that already exist for instance but other entrepreneurs present them in different ways. Can you mention anything about the role of innovation?

Well I think that innovation is exceptionally important and even in a 'me-too' idea. Actually, innovation can be the thing that gives you your competitive advantage. And that is what you are always looking for. It doesn't matter that something exists in a way, in many instances that proofs that there is a market for the product. It is how you're looking at the market. The innovation can state that the market can be addressed in a different way that can actually create money and an opportunity for the company. So, innovation I

think is key to most things but it is very difficult to actually put innovation into being something quite specific. Innovation is just using your smarts, looking at the market and going aha...there's an opportunity.

Before making an investment do you have any specific knowledge of the capabilities of the entrepreneur?

Yes. Because you spend time with the entrepreneur. You don't spend, certainly any money in someone when you know what the entrepreneur is thinking of. You need to be able to also let them work without your expertise on their own before committing any time into it because you want to see what the entrepreneur can achieve. There should be a piece of time between seeing the plan of the entrepreneur and entering into a group thing relationship, or a relationship where in effect you're opening some doors or providing some set advice on which area's to target and being there for the entrepreneur.

What would be the main goal for an investor when undertaking an investment, would that be purely about financial return or is it a matter of personal satisfaction?

The financial reward is a very big issue; it is not the principal issue I think. You're putting your money and your time in something because you want to see it happen. And there needs to be a financial reward attached to it. However, if you look at most start-ups, they don't succeed. So, you are going to lose your money on something and that is always painful. It always results in slight bad feeling because you believed in something and you believed in the entrepreneur and they believed in your advice but it doesn't go well. That can create sour interpersonal relationships.

So financial return is a prerequisite but it is also that you actually have some fun with the entrepreneur. Why do you do it? You can get a better return if you put your money in some other area's of investment but these days that is a bit more difficult. But it is about actually enjoying that process. So your role is in helping things happen, to allow the entrepreneur to achieve what they put on paper and that can be a relationship in many ways. I know some of my business partners can be very hands-off by saying oke we come into the board meeting every three months and hit the entrepreneur around the head for not having achieved what he should have achieved and then look at the resources to allow them to achieve something in the next quarter. Or it can be a very hands-on relationship where they beat the entrepreneur up every day for not doing what they require or it can actually be a pair of hands to help. There are certain times where an entrepreneur needs some assistance and help and if a company is running well there is no reason if you can't say look im working with someone and I really put a lot of time in this and I'd really like you to be in a meeting with me. But that doesn't tend to happen until the entrepreneur is being successful. So the role of a business angel is to put in perhaps some money, perhaps some time, certainly effort and the knowledge of how to avoid the mistakes that are being made. I think that is the biggest thing an informal brings into a company. Normally we made the big mistakes and you want to try and stop the entrepreneur to stop happening the same thing to him but most entrepreneurs are stubborn and as much as an investor can hit you on the head and say please don't its going to hurt the day that you find there is no money on the bank account and you can't pay your staff, you're getting a bigger beating from everyone at that point.

So sometimes an entrepreneur has to feel pain and have to make their own mistakes and there's a point in time where you as an informal have to go I need to take a step back and let you make this error because it is going to teach you a great deal.

But would you even take that step back when you invested quite a lot of money into a company?

Well I have seen some statistics especially from the states and other European markets where it says that the initial investment that an investor makes is only about 20% of the total that he will commit to the company. And if you're looking at it in those terms in the beginning sometimes it is better to say: oke I'm going to let you sweat, there will be no money on the bank account and you're gonna be not sleeping at night putting regular effort in thinking of really innovative ways to cope without money. It doesn't really matter about how much money you have on the bank you don't have to spend things. I mean you should still be innovative. And I think that's a lesson that most entrepreneurs need to make. That it isn't the role of the investor to say what it's okay Steven I'll give you some more cash now and we will solve this problem. Basically its really unpleasant; you have to come you have to go 'I need more money'. And then you have to put a new deal together, you want more money and the investor wants more shares and something new. I think that is the humility of the entrepreneur. Yet a few years ago I did a training for new investors and each one of them who was sitting in that room had been sitting in a department of a bank where basically the bank was saying: 'we either auction off some of your furniture or we think of a deal how you pay back the loans you owe us. So I think most of the entrepreneurs have also been going through that pain. Period. It is just about getting real and learning lots of lessons in life. And I think that is also a two-way relationship because the entrepreneur is bringing a great deal of zest, zeal and love for a company into something. And that makes me happy, to be part of those meetings. I mean there is a possibility of earning a lot more money doing other things but would it make me as happy, probably not...

So what is the time horizon for making an investment, when do you require a financial return?

Mmm... That's tough. Because it depends how much you really like the entrepreneur. And I have seen investments in the past where you want to remain in for years because you have been enjoying it. But, I'm always told that it is between three and five years but one investments I did with some business partners a while ago; we actually stepped out after 18 months with a 300% profit on our investment. That was enough, we lost confidence in the entrepreneurs at that time so to exit wasn't a big issue. And we made a big profit so there was nothing wrong with that. But I think it's just looking at the circumstances and seeing if you can make a deal that works for both sides. And that's the bit that a lot of entrepreneurs don't get, that it is not to them to suggest when the money is going to be paid back. It could be one of the investors to say you know you're taking such different steps than I'd like to see that I need to be able to divest myself in this. I think in the past I remained in some things for too long, especially with effort not so much with money that I should have taken a step back from. And I'm continuing learning lessons too.

What return do you require when exiting an investment? Does that differ really per situation?

It does, it's a people's business. The standard statistics are about 10 times initial investment in a period of 3-5 years. As I said before, 300% was interesting for us at the time we exited [out of the previously mentioned company] and I'd like to stick around on the right investment until I have made a thousand times my initial inset just as I would like to put a thousand euro's in to own 10% of Microsoft. In fact, not very likely to happen, I prey for it. Lot more chance that winning the lottery but it's a personal decision each time and it is whether you continue to believe in the entrepreneur and the business who it now is and the investors who come on board. Because after the informal sphere you might have 4 or 5 new rounds of investment. You have outlived your purpose because the entrepreneur now deals with people who have a couple of million in their backpocket and they would be very happy to put it in so they don't like playing with you anymore. They're more of an irritant and at that point you can use that irritance to make a good deal and exit and you know, when you are raising another round the easiest thing to do is to say well intial investor can be bought out for X and then we have to raise another million. That for some people is interesting.

Is that usually the way it goes?

Well we had one investment a while back where the founders themselves raised money to buy out our share because they wanted to maintain ownership of 50% of their company. Is it usual for new money to come in and buy out existing shareholders? No. But everything is possible if you want to get rid of an irritant.

Could you give a concrete example of how you helped a firm or start up innovate?

I think by sitting down and talking with them and finding out what they thought the market was, what they thought their featured product of portfolio could be and to look at how those things can come together. I don't think as an investor your role is ever to go in and tell the company what to do. It's more about trying to get more out of them to brainstorm on far tangence and see what they take of that into their own vision. Because in the end of the day it has to remain the vision of the entrepreneur. It has to remain their effort that goes into it and the innovation does come from the market does come from new trend and it's about keeping your eyes and ears open. I think it's just the discussion of that and the sharing of some of those things that allow the entrepreneur themselves to come up with. Innovative way of either saving money or accessing a new market.

So even though as an investor your giving money and knowledge usually, its up to the entrepreneur of what he makes of it?

It has to be. We did an investment a few years back with a company I was involved in at the time and an amount of money was made available and the entrepreneurs weren't doing anything with it. And you just get bored; and they got bored as well and we decided to end that investment. Yeah, we lost a bit they lost a bit. And that was okay. Innovation is a double edged sword; if others innovate you become obsolete quite quickly. That's why you really need a driven entrepreneur. To actually make sure that the innovation is

being built in by themselves that they should be looking at all sources of information that they ask themselves does this change the way our proposition makes money. That's what a great entrepreneur does and as an investor you can go in and say I heard this and that and what you really want is for the entrepreneur to go and say that is very true but and to be able to counter any argument you bring in. Cause that's a good entrepreneur. Someone who becomes a good investor in the future.

In what way do you feel that venture capitalists differ in their approach to steering entrepreneurs in what they have to do?

It is a very different role. If I look at where we started with investments I had half a sheet of A4 paper as my investment agreement with a company. With my second one it went up to three pages and we kind of stayed there until I invested together with some business partners we put in a lot more money than I did and we went up to about 6 pages. If you see the term sheet of venture capitalists normally they're putting in from anything to two million upwards so they've got shareholders and they have to justify expenditures too. So they require control over reporting that you have to make reports to them and they take up probably a formal seat on the board. Does the informal do that, sometimes. Sometimes the informal can even be the director of the company but the role of most venture capitalist firms is normally to take a seat on the board and also to evaluate on a monthly basis how their investment is going, what their return is likely to be which period and does that work in terms of the fund they set up and the shareholders they have there. And if that does not then they normally have certain very set tools to either remove the director and put in a new team of people. It is a much more formal and much heavier tool a VC has but for the amounts of money they're putting in and the ownership structure it needs to be.

Thanks for this interview.

Main Findings

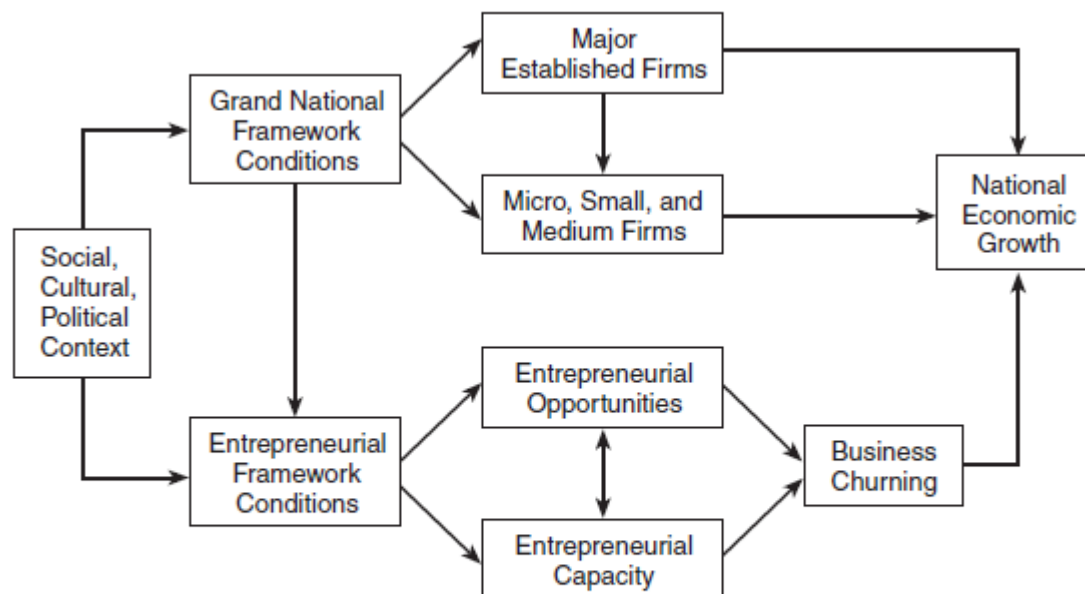
1. Mr. Wallace repeatedly mentions the fact that business angels care about the entrepreneur behind the business. Informal investors do not only care about the money, but much more about the 'fun element' of making an investment;
2. Standard statistics require a return on investment of 10 times the original investment in a period of 3-5 years;
3. Innovation is a double edged sword. Meaning that innovative activity can on the one hand stimulate the economy while it also helps other businesses become obsolete, which, on the other hand, does not necessarily lead to more welfare;
4. The relationship between a venture capitalist and an entrepreneur is far more harsh than with a business angel. Venture capitalists stick to investor assessment paperwork of more than 15 pages and basically always take a seat on the board of directors. Business angels not necessarily.

This thesis elaborates on the relationship between business angels and innovation. The paper's relevance lies in the inherent importance of entrepreneurship and innovative activity in stimulating economies. The points mentioned in this paper reflect on the differences and similarities between formal and informal investments. As mainstream perception still credits formal investors as being the main contributors to a company's success, the results in this thesis stress otherwise. This is useful due to the implications of government policies with respect to companies that are funded with smaller amounts than regularly through venture capital. Also, on a micro-level, innovative firms attract angel funding far more easily. Innovative activity is protected in most cases by a patent which also contributes as a tool in attracting investors.

The accompanying interview was set-up in such a way that it would trigger the prospect in providing true insights into the world of informal investments. The practicalities Mr. Wallace shared illustrate the needs of businesses on a micro level, and should be collected by government officials to redirect policy to an investor climate more friendly than these days. The ideas mentioned in the academic literature, together with the results of the interview form a useful tool to place both academic and practical solutions together in a complete framework for stimulating entrepreneurship through angel funding.

Starting a firm is both a challenge in finding the right product the market needs at that moment, but also on growing a firm through attracting external funding. However, due to the rigid tax system in the Netherlands, investing small amounts becomes increasingly difficult. Product developments through R&D spending should help create the foundation for creative environments leading to new innovative products. But do these environments ever succeed to launch products truly used by the masses? Business angels, in that respect, probably possess a better instinct for assessing creative ideas good enough that might also make it to the market. It remains, however, a risky business. As nine out of the ten investments usually fail to become truly successful. Like Mr. Wallace puts it: *'If others innovate, and they do, you become obsolete quite quickly'*. Resulting in the need for both a culture that stimulates entrepreneurship and the drive to become successful both personally and professionally. Inherently leading to innovation.

Figure Global Entrepreneurship Monitor (2001):



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Figure 1. The GEM conceptual model.

Interview outline:

Interview

The composition of the interview is illustrated below. This approach is central to successfully extracting knowledge from the interviewee's. Each of the different topics outlined below are related to innovation and, of course, business angels. The results of the interview are incorporated in the next section of this thesis.

Interview Business Angels' impact on Innovation

Dear sir/madam,

The purpose of this interview is to provide insight into the relation between business angels and innovation. The bachelor thesis I am currently writing investigates the ways informal risk capital may or may not promote innovation. With innovation I mean patents, licenses, software development or other inventions that might lead to new innovations.

Name:

Datum:

Organization:

Function:

Investments p/year:

Total investments:

Questions:

Introduction

1. How long have you been a business angel?
2. What attracted you to become a business angel?
3. What was your previous occupation before becoming a business angel?
4. What types of businesses do you invest in as a business angel?

Profile of the investee in relation to innovation

5. What should a potential investee's profile look like? Do you look specifically for firms who patented their product, developed prototypes and have proof of sales?
6. What are some of the investor's criteria that you adhere to when making an investment? Do innovative firms have extra leverage compared to non-innovative firms?
7. Before making an investment; do you have specific knowledge about the capabilities of an entrepreneur?
 - a. To what extent do you want to feel comfortable with the entrepreneur when investing in his/her business?

Goals

8. What is the main goal for a business angel when undertaking an investment?

9. Do business angels per definition provide more than merely money – active involvement, knowledge, networks - when making an investment, thereby inducing innovation.

Operational aspects of business angels

10. What is the time horizon of a business angel?
11. What return do you require when exiting an investment?
 - a. What trade-offs do you make when exiting an investment
12. How do you help a start-up innovate?
 - a. In what way do venture capitalists differ from business angels in promoting innovation?

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