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Italian Business Angels Network Association

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CONFERENCE ON ANGEL INVESTMENT RESEARCH 2016

Emerging trends in the Early Stage Financing Industry: the growing role of Business Angels Networks

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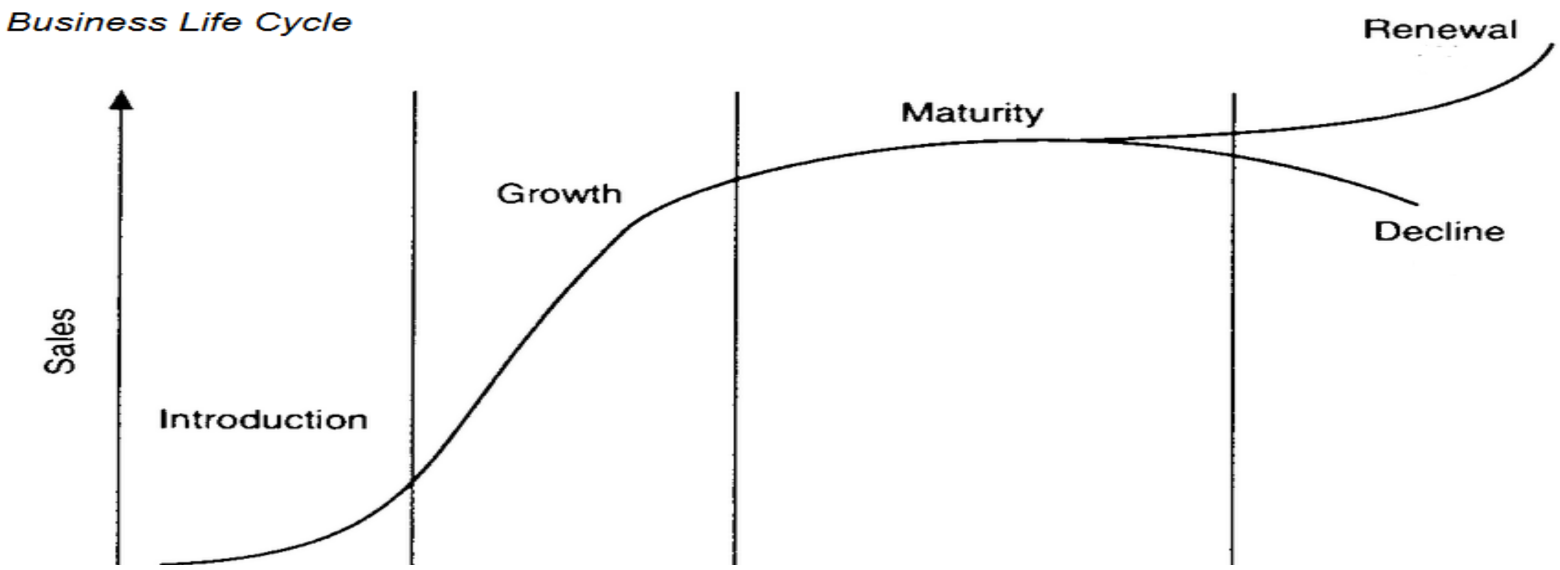
AGENDA

- Startups and the Early Stage Financing Industry
- The Main Actors in the Early Stage Financing Industry
- Boosting Entrepreneurial Ventures and Filling the Equity Gap: Open Issues and Policy Suggestions
- The Research on Business Angels Networks (BANs)
- IBAN's scientific research:
  - ✓ objectives and research questions
  - ✓ first relevant findings about BANs
  - ✓ publications
  - ✓ next steps

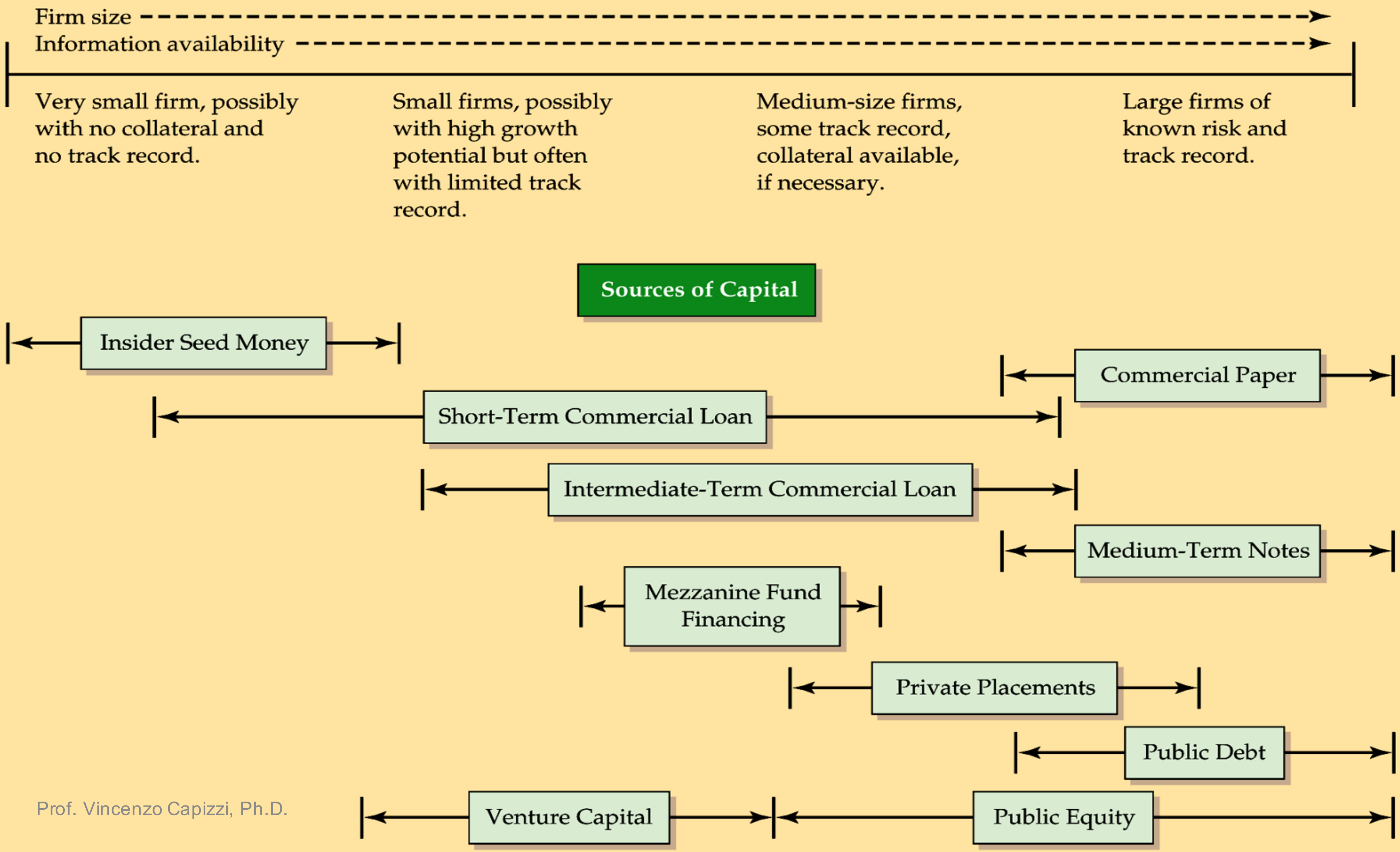
The Early Company Life Cycle (1/3)



- Making reference to the well known framework of the Company Life Cycle, in the introductory stage we find the potentially most profitable and riskiest investment opportunities: **startups.**
- Most relevant issues and source of risks:
  - ✓Incomplete management team
  - ✓Production/Distribution Process not yet tested/optimized
  - ✓Patents for proprietary technology not yet received (just started the filing process)
  - ✓Brand loyalty not yet built
  - ✓Low volume of revenues, negative/limited profitability margins and cash flows
  - ✓Low bargaining power and competitive positioning
  - ✓Low information disclosure aptitude

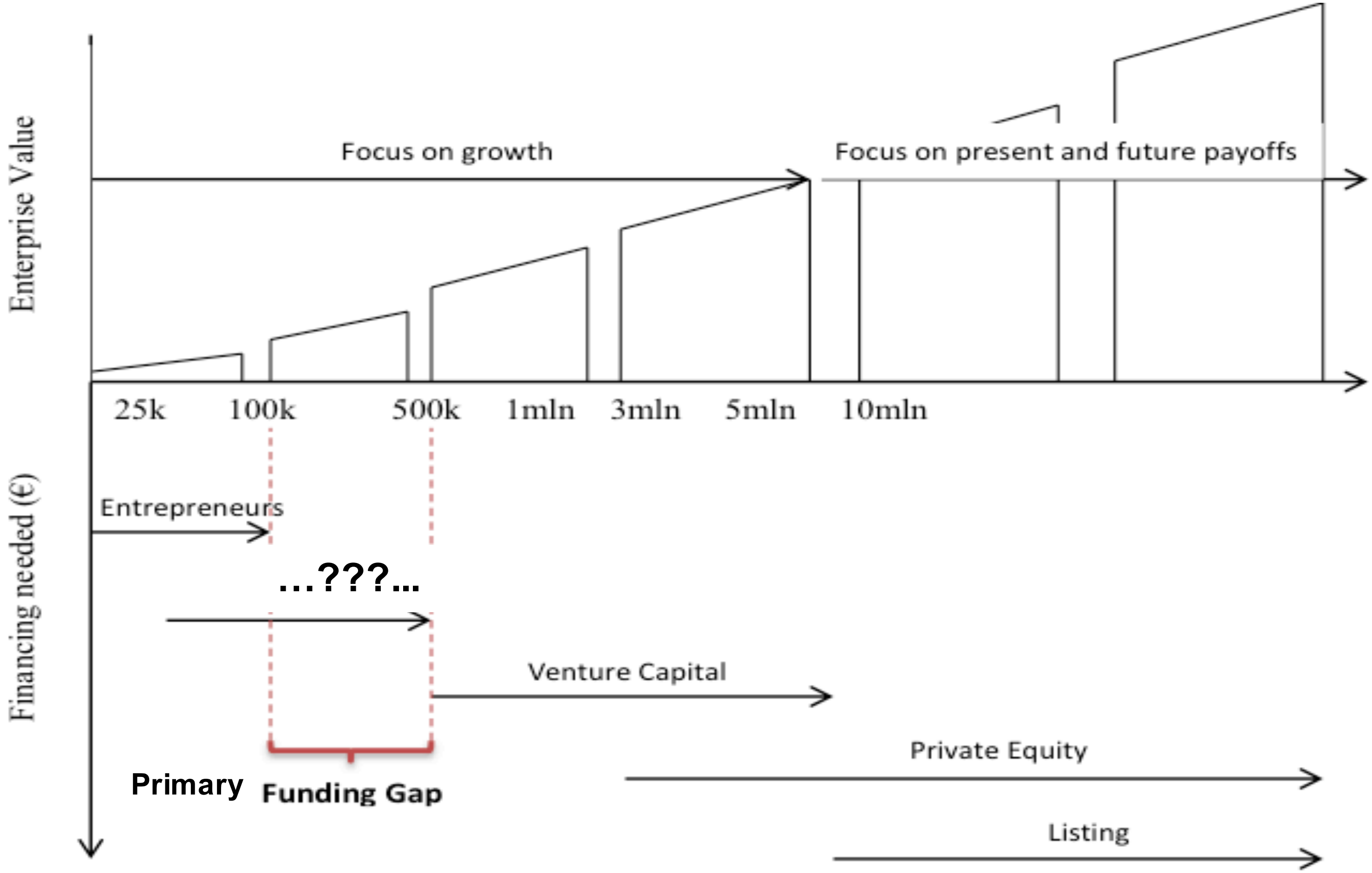
The Early Company Life Cycle (2/3)

The relationship among **life cycle**, **firm size, fundraising policies**, **financing contracts** in the theory of corporate finance: a matter of **information asymmetry** and **default risk**



The Equity Gap Issue (1/2)

- **The "equity gap" (or "primary funding gap") refers to that size of startups' funding needs usually neglected by venture capital investors because of its intrinsic lower IRR and innovation potential.**
- Between entrepreneur's equity injection – eventually coupled with family & friends' capital – and venture capital average investment there are the typical financing needs of the large majority of crucial actors of a given economic and social system: **SMEs.**



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The Main Actors in the Early Stage Financing Industry: Features and Investment Policies

The followings are the most relevant and actually operating actors in the **early stage financing industry**

- Crowdfunding Platforms
- Science/Technology Parks
- Business Incubators & Accelerators
- **Business Angels**
- **Business Angels Networks (or Groups, Syndicates, Clubs)**
- Venture Capitalists
- Not Investing Actors

… and there is as well a relevant role for Banks, Financial Institutions and Public Authorities in the Early Stage Financing Industry

That’s the eco-system for startups

Business Angels and Business Angels Networks (1/5)

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- **Business Angels** are private investors, also called **informal investors** (or **informal venture capitalists**), who invest on an individual basis in unlisted small and medium sized enterprises (SMEs).

- Differently from the other actors of the early stage financing industry, they don't focus just on seed and startup investments: their intervention can allow young as well as mature small companies to grow and innovate/optimize/refocus their business models

- They are often businessmen and women who have sold their business, and provide not only **finance** but also their **experience**, their **business skills**, their **relationship network** to the entrepreneurs with whom they are in contact.

  What makes it specific the intervention of many business angels is their willingness to concretely support the entrepreneur also in his operating and managing activity: in fact, many angels think at themselves as "**co-entrepreneurs**".

- Surprisingly, despite the low attention paid by both researchers and policymakers, on an overall basis, **the amount of capital intercepted and invested by business angels is very close to venture capitalists' ones.**

	USA		**EUROPE**	
	Angel Investors	Venture Capital	Angel Investors	Venture Capital
Invested capital	24.8$ bn	29.6$ bn	5.5$ bn	7.3$ bn
Number of investors	298.000	548	n.a.	108
Total deals	71.000	4.050	18.500	1.344

Source : US ACA (2014), EVCA (2014), EBAN (2014)

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Business Angels and Business Angels Networks (2/5)

- **Business Angel Networks** (**BANs**), **Business Angel Syndicates** (**BAS**), **Business Angel Groups** (**BAGs**) are either formal or semi-informal association of angel investors aimed at facilitating the matching of investment demand and supply: they institutionally create links among angels, attract prospective investees to angels and match both parties for deals.

  Such networks come in a number of forms: some are structured as formal associations or federations of BANs on a national basis, while others are set up on a regional or local basis; some other networks resemble “investment clubs” (sometimes exclusive ones).

  Some angel networks are focused on a certain **industry** or **technology** or **market**.

- For singular and individual prospective, BANs provides relevant benefits and, among them, the most important is **co-investment**, that allows each member to share the entrepreneurial risk. We can assume that the perceived risk to bargain with an investee firm in a sector far from his/her own background is high and a co-investment offer a possible solution to go beyond the first barriers (***tested research hypothesis in the Italian market***).

  Also, there is a **knowledge sharing** effect, in that individual investors who are member of an angel networks usually can support startups with advices or services far from their background and competencies.

  Another major advantage provided to single investors by BAN is the volume and quality of **deal flows** and this is essential in the informal market where angels find it difficult to learn about prospective deals ad originate investment opportunities.

- BANs’ major operating tool consists in **dedicated platforms** where both business angels and early stage firms can contact each other. This kind of platform can work through the net, magazines or organized events. Besides, the networks give startups direct access to a new source of finance alongside with bank financing and risk capital.

Business Angels and Business Angels Networks (3/5)

European Business Angels (1/2)

- Angel investments in Europe increased to **5.5 billion Euros** in 2013, a growth of 8,7% from 2012, remaining the main financier of European startups.

- Within the visible market, the **United Kingdom** continues to be the leading country with 84,4 millions invested in 535 companies. **Spain** comes second with 57,6 million Euros of investment followed by **Russia** with 41,8 million Euros.

  Furthermore it's worth highlighting smaller players such as **Estonia**, country with a recently created first business angel network (BAN) which led to 4,7 million Euros of investment, making it the top performing country when comparing the investment per GDP ratio.

- The main sector of investment is **ICT** (32%), followed by **biotech & life sciences** (10%), **mobile** (10%) and **manufacturing** (10%). The majority of the targeted companies (87%) are in early stages, notably startup, seed and pre-seed stages.

- Despite the existence of many international investment networks, **cross-border investment remains marginal** with 96% of the deals taking place in the country of the investor ("proximity" business?).

Source: EBAN, Statistics Compendium 2014

Business Angels and Business Angels Networks (4/5)

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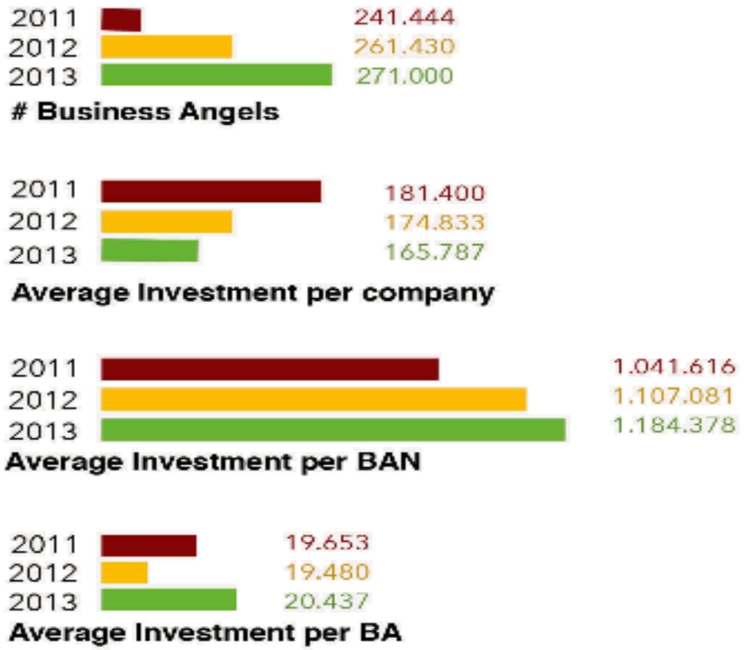
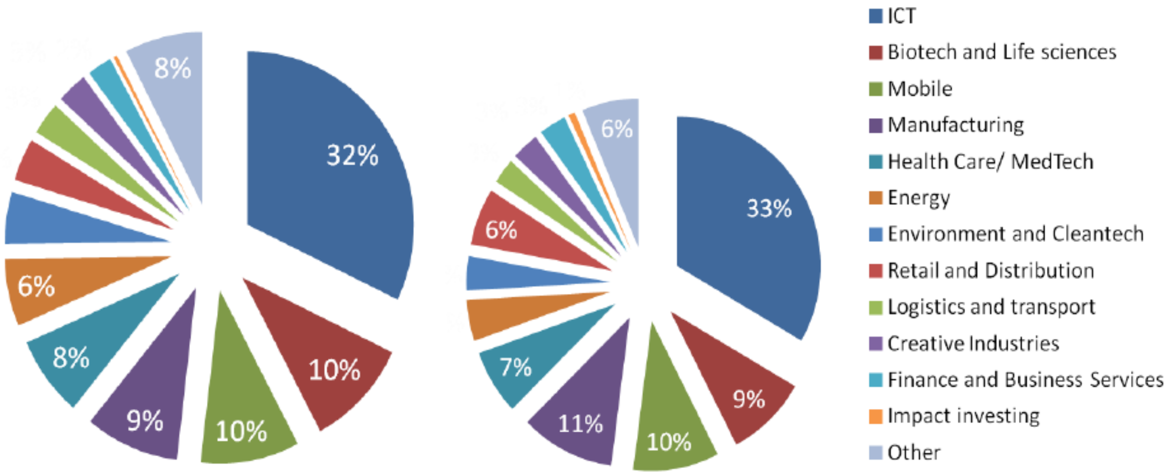
European Business Angels (2/2)



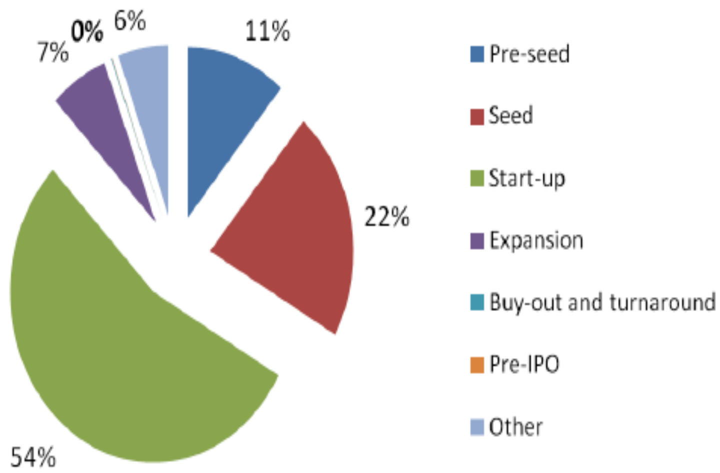
Break down of angel investment by visible and non-visible market; Investment values in million Euros.

	2011	2012	2013
Visible market	427	509	554
Reported by BANs or Federations	298	330	431
Investment by non-reported BANs	129	179	123
Share of visible market	*9%*	*10%*	*10%*
Non-visible market	4317	4590	4989
Total Investment	**4.744**	**5.099**	**5.543**
# Investments	26.158	29.130	33.430
# Jobs created	154.597	178.813	184.170
# Business Angels	241.444	261.430	271.000

Sectors distribution in 2013 by investment amount (left) and number of deals (right)



Investments by investee's development stage



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Source: EBAN, Statistics Compendium 2014

Business Angels and Business Angels Networks (5/5)

- Anticipating an issue referring most of all to literature and empirical research, when it comes the turn to disclose country and international data about business angels and business angels networks, it is crucial to highlight the **relevant sampling and measurement issues** affecting the significance and reliability of the data and statistics themselves.
- By definition, all rigorous analysis have to preliminary deal with these issues and clearly disclose the subjective choices and/or limitations affecting their underlying data collection, sampling and processing activity.
- Mason in numerous articles over last 20 years and many relevant contributors - among them, in alphabetical order, Aernoudt, Bygrave, Carpentier, Christensen, Collewaert, Harrison, Ländstrom, Manigart, Morrisette, Mitteness, Shane, Sohl, Sudek, Suret, Wetzel (all cited in Capizzi, 2015, *Venture Capital*, Vol. 17, Issue 4) – faced the sample and measurement bias when trying to investigate the **visible** and **invisible** market for business angels.
- The growing interest on **BANs**, from the one hand, has been generating a widening stream of research contributions dealing with **investigating objects easier to map and monitor**, due to the formal/semi-informal structure of these associations; from the other hand, the risk is to fail considering the different nature of business angels when compared to BAN and hence, to start losing interest on research programs focused just on the relationship between informal investors and the success and growth of new ventures

Venture Capitalists (4/8)

Main differences between Angel Investors and Venture Capitalists

Characteristics	Angel Investors	Venture Capitalists
Background	Former entrepreneurs	Finance, consulting, some from industry
Investment approach	Investing own money	Managing a fund and/or investing other people's money
Investment stage	Seed and early stage	Range of seed, early stage and later stage but increasingly later stage
Investment instruments	Common shares (often due regulatory restrictions though)	Preferred shares
Deal flow	Through social networks and/or angel groups/networks	Through social networks as well as proactive outreach
Due diligence	Conducted by angel investors based on their own experience	Conducted by staff in VC firm sometimes with the assistance of outside firms (law firms, etc.)
Geographic proximity of investments	Most investments are local (within a few hours' drive)	Invest nationally and increasingly internationally with local partners
Post investment role	Active, hands-on	Board seat, strategic
Return on investment and motivations for investment	Important but not the main reason for angel investing	Critical. The VC fund must provide decent returns to existing investors to enable them to raise a new fund (and therefore stay in business)

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Boosting Entrepreneurial Ventures and Filling the Equity Gap: Open Issues and Policy Suggestions

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- Early stage financing is an opaque industry with sample biases and methodological issues in identifying and analyzing its main actors: BA and BANs.

  Could it be possible, leveraging on the existing research centers, to create initiative aimed at making them exchange their datasets, methodologies and analysis at a regional, national and international level? (No need just for more studies and researches but for better quality studies and researches)

- Banks have a number of business and non-business reasons for looking at the early financing industry.

  Could it be possible to leverage on banks' distribution networks, using their branch and subsidiaries as "virtual" crowdfunding platform and "virtual" incubators/accelerators, creating relationships between potential entrepreneurs and investors as well as sharing financial education and mentoring potentialities?

- Stimulating startups implies fostering the **culture for entrepreneurship**.

  Despite the overwhelmingly imbalance toward "business administration" undergraduate and postgraduate programs, "entrepreneurship" can be taught either at the university level or at the job training level.

- It is difficult to stimulate startups creation without an **holistic approach** to the early financing industry and without considering the potential benefits coming from the reciprocal interactions among each others.

  Crowdfunding platforms, business incubators and accelerators, business angels and angel networks, banks and financial institutions, mentors and advisors, regulators and policymakers should be thought as an "ecosystem for startups". This could help boosting financial innovations in order to fill the equity gap (for instance, designing new "financial securities" issued by the "ecosystem" itself or designing new contracts for startups with a specific contribution given by each actor of the "ecosystem").

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The Research on Business Angels Networks (BANS) (1/2)

- In order to be able to provide further stimulus to policymakers, professionals and entrepreneurs, academic research has to continue increasing its focus on one major actor of the yet under-investigated early stage financing industry: **business angels networks (BANs).**
- Actually, it is possible to identify at least 6 relevant streams of contributions dealing with BANs

1. Contributions investigating the **structure**, **operations** and **functioning** of angel groups (*cfr*., among the others, Aernoudt *et al*., 2002; Mason, 2006; Sohl 2007, 2012; Paul and Whittam, 2010; Mason *et al*., 2013; Gregson *et al.,* 2013).
2. Contributions investigating the **decision making process** of angel groups, with particular reference to **evaluation criteria** and **determinants of rejection** in investment valuation (*cfr*., among the others, Sudek, 2008; Brush *et al*., 2012; Mittness *et al*., 2012; Carpenter and Suret, 2015; Croce *et al*., 2016).
3. Contributions investigating the **BANS' exit process** (*cfr*., among the others, Peters, 2009; Geron, 2014; Mason and Botelho, 2016).
4. Contributions investigating the **performance of invested companies** (*cfr*., among the others, Chua and Wu, 2012; Kerr *et al*. 2014; Alemany and Villanueva, forthcoming).

The Research on Business Angels Networks (BANS) (2/2)

5. Contributions investigating **financial contracting** and **monitoring mechanisms** set by angel groups (Ibrahim, 2008).
6. Contributions investigating **value provided by angel groups to business angels** (*cfr*., among the others, Knyphausen-Aufseß et al., 2008; Romani *et al*., 2013).

- Unfortunately, though not surprisingly, results from the empirical analysis are not unambiguous and are affected by sample bias and methodological issues.
- Furthermore the heterogeneity in the research methodologies (questionnaire-based surveys, interviews, meta-data analyses through verbal protocols, conjoint analyses) significantly influences the possibility to implement comparative analysis among the major contributions
- Much more effort and coordination is required at a worldwide level to investigate the "**BAN black box**" and identify reliable best practices from both the governance and the management standpoint.

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IBAN's scientific research: objectives and research questions

- ✓ Every year IBAN promotes a Survey-based investigation in order to analyze the Italian informal venture capital market, mapping both sides of the investments: the business angels (investors) and the start ups (financed firms).
- ✓ Data collected on an annual basis feed a database used to perform rigorous empirical analyses, thus contributing to the intense actual debate at the political and regulatory level dealing with the relationship between angel financing and entrepreneurship.
- ✓ Among the major research goals of the empirical analysis there is the identification of the **determinants of the performance of Italian Business Angels' investments**. The database encompasses the details of the divestitures from 2008 to 2013 (*cfr*. Capizzi, 2015).
- ✓ Other research questions cover the following topics:
  - ✓ Determinants of investment strategies
  - ✓ Analysis of contractual constraints and capital protection policies of Business Angels
  - ✓ Analysis of the performance of angel-backed firms compared to venture-backed firms
  - ✓ Identification of clusters of business angels with different utility functions and investment behaviors

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IBAN's scientific research: first relevant findings about BANs

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- ✓ **An ongoing research is trying to investigate the contribution provided by BANs to the performance (using as proxy the survival rate after 3 years) of a sample of about 250 Italian startups.**

- ✓ First preliminary results provide seemingly robust evidence that:
  - ✓ **BAN membership increases the survival rate of angel-backed companies**
  - ✓ **BAN membership stimulate syndicated investments**
  - ✓ **BAN membership affects both unit size and risk aversion of angel investors**
  - ✓ **BAN membership negatively affects hard financial contracting with entrepreneurs**
  - ✓ **BAN membership makes it significant the relationship between experience and performance of angel-backed companies**

IBAN's scientific research: publications

- Capizzi V., Giovannini G., (eds.), *Business Angels e Informal Venture Capital in Italia*, Bancaria Editrice, Roma, 2010.

- Capizzi, V., *What drives the return of Business Angels' investments? An empirical analysis of the Italian informal venture capital market*, **GSTF Global Business review**, Vol.1 No. 2., 2011

- Capizzi, V., *Determinants of Business Angels Investments: an empirical analysis of the Italian informal venture capital market*, working paper presented at "Innovation and Entrepreneurship World Conference", Singapore, 2011

- Capizzi, V. e Tirino, G., *Business Angels and Informal Venture Capital in Italy: emerging trends and investment policies of Italian Business Angels,* AIFA Research, SDA Bocconi, 2011

- Capizzi, V. e Tirino, G., *The informal venture capital market in Italy: in search for the determinants of business angels' IRR*, "World Finance Conference", Rio De Janeiro, 2012

- Capizzi, V., *Linear and nonlinear determinants of the performance of informal venture capitalists' investments. An empirical analysis*, "**Journal of Governance and regulation**", Special Conference Issue, April, 2013.

- Capizzi, V., *The returns of business angels investments and their major determinants*, "**Venture Capital: An International Journal of Entrepreneurial Financ**e", Issue 4, 2015.

IBAN's scientific research: next steps

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- ✓ Increase of the scientific activity: submission to international journals and participation to conferences;
- ✓ Constitution of a European think tank (BAE) and building of a European database;
- ✓ Comparison of the results in different countries;
- ✓ Feasibility study of a **IBAN Observatory**, with appropriate sponsorships;
- ✓ Creation of a "Pan-European" BAE Observatory, in order to perform comparative analysis and offer policy suggestions at an European level.