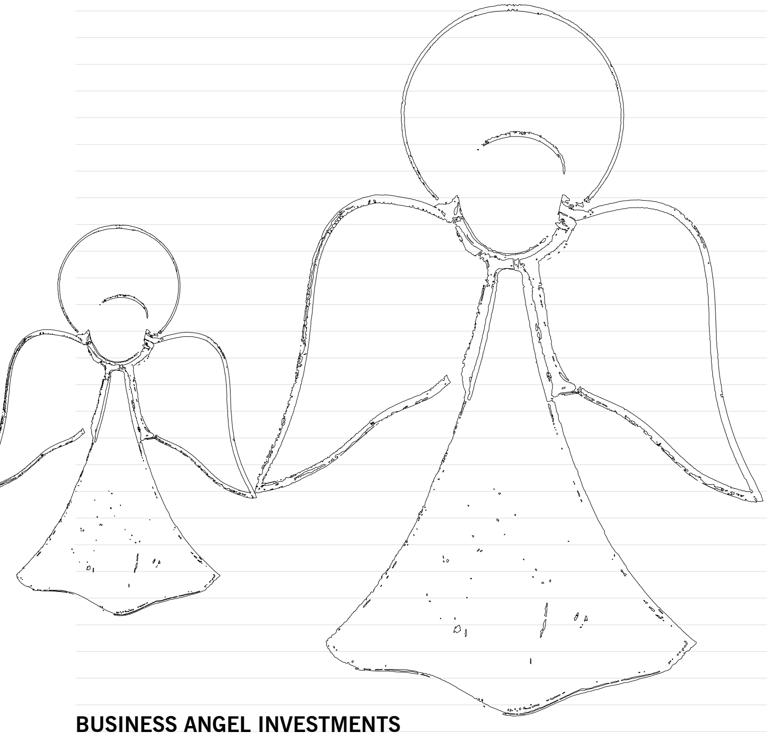
BEING AN ANGEL

RELEVANT TO ACCA QUALIFICATION PAPERS F9 AND P4

Business angels are an important source of finance for smaller businesses. This article looks at the role that business angels play in providing finance, the way in which they approach making an investment, and the financial and non-financial returns that may be expected.



BUSINESS ANGEL INVESTMENTS

Business angels are normally interested in businesses with high-growth potential and with owners who are committed to realising this potential. This means that 'lifestyle' businesses, where owners are not focused on maximising returns, are unlikely to be of interest. In pursuit of high returns, business angels are normally prepared to take high risks. They will usually take an equity stake in a business but may also advance loans as part of a total financing package. In some cases, they may even offer a loan as an alternative to an equity stake, although this is less common.

Business angels are usually prepared to invest somewhere between £10,000 and £250,000 in a business, but larger sums may be made available through a business angels syndicate. A UK study undertaken in 2000–2001 found that the majority of investments made by business angels were below £50,000 (see reference 1). Most equity investments are for a minority stake in a business but where a syndicate of business angels is providing significant amounts of finance, a majority stake may be taken.

Business angels help to plug the 'equity gap' that many small businesses experience, which falls between the equity that the owners are able to raise themselves and the minimum level of equity investment that private equity firms are normally prepared to consider. Business angels tend to invest in early-stage businesses but may also invest in more mature businesses, such as those seeking finance for expansion, management buyouts, or business turnarounds.

While business angels are recognised as a significant source of finance for small, unquoted businesses, the exact scale of their investments is difficult to determine. This is because they are under no obligation to disclose how much they have invested. It has been estimated, however, that in the UK, the investment made by business angels in start-up businesses is eight times that made by private equity firms (see reference 2).

PROFILE OF A BUSINESS ANGEL

Business angels tend to be wealthy individuals who have already been successful in business. The majority are entrepreneurs who have sold their businesses, while the remainder are often former senior executives of major organisations, or business professionals such as accountants, lawyers, or management consultants.

Business angels invest with the primary motive of making a financial return, but non-financial motives also play an important part. Research suggests, for example, that business angels often enjoy being involved in growing a business and may also harbour altruistic motives, such as wishing to help budding entrepreneurs or wanting to make a contribution to the local economy (see reference 3).

Business angels often seek an active role within the business, which is usually welcomed, as the skills, knowledge, and experience that business angels possess can often be put to good use. Involvement typically includes providing advice and moral support, providing business contacts, and helping strategic decision making. This active involvement may not simply be for the satisfaction of helping a business to grow. By having a greater understanding of what is going on, and by exerting some influence over decision making, business angels may be better placed to increase their financial rewards and/or reduce their level of investment risk.

Research suggests that business angels tend to invest in businesses within their own locality. This may be because active involvement may only be feasible if the business is within easy reach. Unsurprisingly, business angels also tend to invest in business sectors in which they have personal experience. One study, for example, revealed that around a third of business angels invest solely in business sectors in which they have had prior work experience. Around two-thirds of business angels, however, have made at least one investment in a business sector with which they were unfamiliar (see reference 3).

USING AN ANGEL

Business angels are an informal source of finance and are not encumbered by bureaucracy. They can be flexible and decisions can often be made fairly quickly, particularly if investment is made in a business sector with which they are familiar. Although they will expect returns from their investment to match the risks involved, they may be prepared to accept a slightly lower return than would a private equity firm, in exchange for the opportunity to become involved in helping the business grow.

Business angels vary considerably in the extent to which they wish to become involved in the activities of a business. At one extreme, they may simply want to become 'sleeping' partners, while at the other, they may want to become as involved as the business owner. It seems that the majority of angels do seek a 'hands-on' approach but do not seek a total commitment. A survey of 48 business angels in Wales found that 63% intended to take an active role in any business in which they invested, and intended to spend a mean of 4.85 days per month with each business (see reference 4).

However, the degree of involvement must suit both parties, and so must be agreed before the investment is made. Failure to agree on an appropriate post-investment role for the business angel is one of the most common 'deal-killers' (see reference 4).

THE INVESTMENT PROCESS

It was mentioned earlier that business angels can make decisions quickly. This does not mean, however, that finance is always made available to a business overnight. It has been suggested that four to six months may be needed between the initial introduction and the provision of finance (see reference 5). Various stages must normally be completed before the business angel is satisfied that the investment is worthwhile.

Following the initial introduction between the business owners and business angel, the business plan and financial forecasts will normally be reviewed. This will involve close scrutiny of the validity of key assumptions and of the quality of the information used. This is then likely to be followed by a series of meetings to help the business angel gain a deeper insight into the business and to deal with any concerns and issues that may arise. During these meetings, the business angel will also be assessing the quality of the management team as, ultimately, the success of the investment will rest on their energy and skills.

Assuming the business angel is satisfied with the information gained from the meetings, negotiations over the terms of the investment will then be undertaken. This can be the trickiest part of the process, as agreement has to be reached over key issues such as the value of the business, the precise equity stake to be offered to the business angel, and the price to be paid. The research evidence suggests that failure to reach agreement with the owners over a suitable price, and over the post-investment role to be played by a business angel, are the two most common deal-killers. One study has shown that business angels may make four offers for every one offer that is finally accepted (see reference 6).

If a price can be agreed between the parties, due diligence will then be carried out. This will involve an investigation of all material information relating to the financial, technical, and legal aspects of the business.

FINANCIAL RETURNS

Table 1 shows the results of one study that examined the internal rates of return (IRR) from 128 investments made by business angels in the UK (see reference 7).

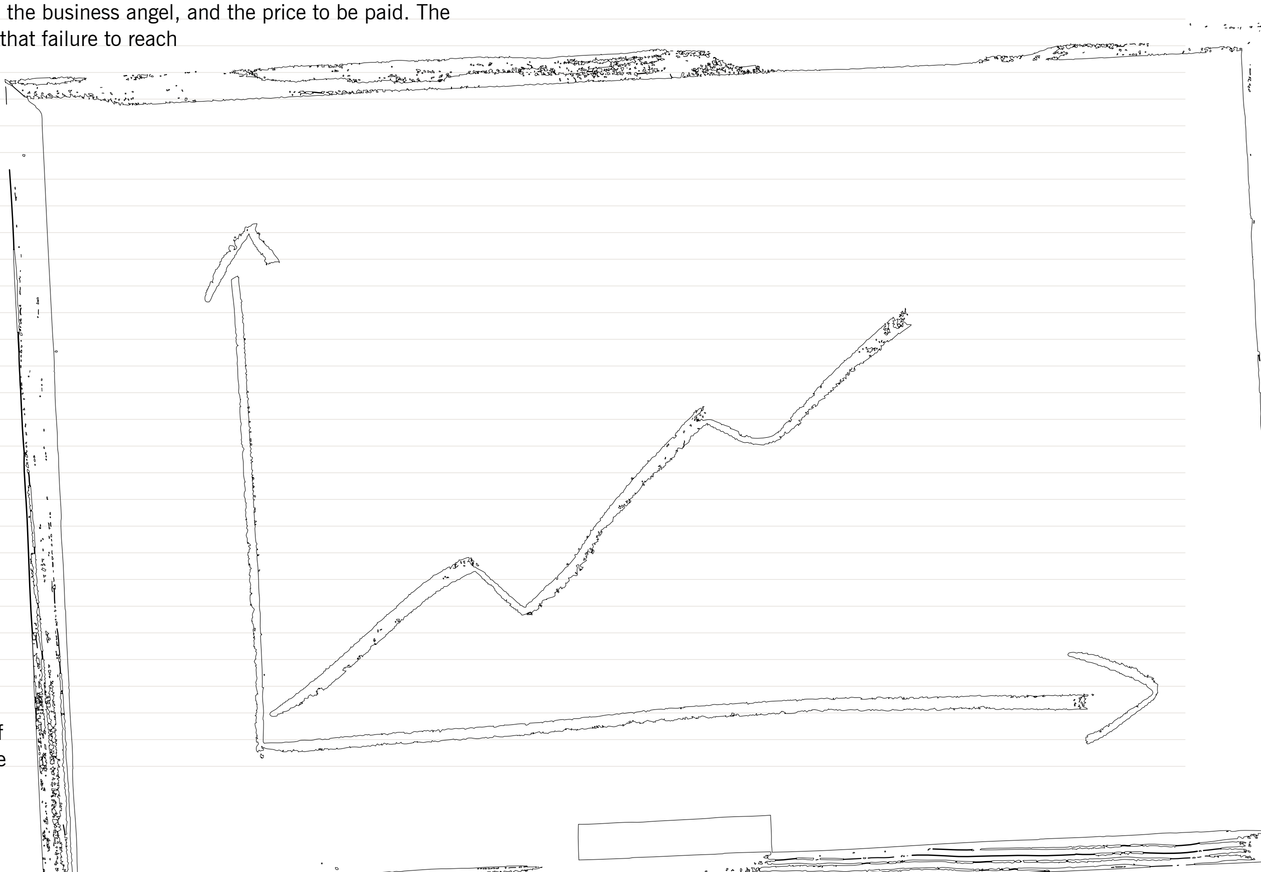


TABLE 1: RATE OF RETURN FOR BUSINESS ANGEL INVESTMENTS

Internal rate of return	Percentage of investments
More than 100%	10%
50% to 99%	13%
25% to 49%	13%
0% to 24%	24%
Negative	40%

We can see in **Table 1** that while some investments make very high returns, by far the largest proportion produces a negative IRR.

A large study of 539 business angels in the US found that the average IRR from investments was 27%. However, there was a wide range of performance, with 52% of all investments returning less than the initial capital invested. The study found that three factors had a positive effect on investment returns. These were:

- the time spent on due diligence
- the business angel's expertise in the business sector
- the participation of the business angel in the investee business.

The study also found that where a business angel made follow-on investments, there was a greater likelihood of lower returns. This is consistent with additional investments being made to help a struggling business survive (see reference 8).

These results raise some important points. First, business angels tend to make relatively few investments and so they are unlikely to hold the well-diversified portfolio of investments required to reduce risk. Such high failure rates can therefore be a real problem for the business angel and can hinder future investment flows. Some business angels, however, seek to reduce their exposure to risk by becoming a member of a syndicate.

Second, it is not clear whether the high failure rates mentioned in the studies are due to the high-risk nature of the investments or to the poor investment skills of business angels. The fact that business angels have enjoyed successful business careers does not necessarily mean that they have the skills required to become successful investors. Many might benefit by being mentored by more experienced business angels, or by attending formal training programmes. However, there are few such opportunities available.

FINDING AN EXIT ROUTE

Before making the initial investment, a business angel should consider possible exit routes. Unless there is a clear way out at the end of the investment period, usually three to five years, the proposal may be rejected even though it is expected to be profitable. Table 2 shows the results of research carried out by Mason and Harrison (see reference 9) into the ways in which business angels exit from their investments.

TABLE 2: BUSINESS ANGEL EXIT ROUTES

Exit route	Percentage of exits
Write investment off as a loss	40%
Trade sale to another business	26%
Sell to other shareholders, including management buyouts	16%
Sell to a third party	10%
Float on the stock markets (AIM, OFEX, LSE/Official list)	8%

Leaving aside the large percentage of investments that simply have to be written off, we can see that a trade sale to another business is easily the most popular exit route.

ANGEL SYNDICATES

As mentioned earlier, business angels may decide to become part of a syndicate in order to diversify risk. Other advantages, however, can spring from the pooling of expertise and capital. These include:

- access to a larger number of investment opportunities and/or larger-scale investment opportunities
- an increased capacity to provide follow-up funding where necessary
- an ability to add greater value to an investee business
- better scrutiny and monitoring of investments
- shared search and transaction costs
- access to knowledge and expertise of others within the syndicate.

Various studies have shown that business angels are generally enthusiastic about syndication. There are, however, potential disadvantages, such as the greater complexity of deal structures, the potential for disputes within the syndicate, and the need to comply with group decisions.

BUSINESS ANGEL NETWORKS

Finding suitable investment opportunities can be a problem. Research evidence suggests that a lack of investment opportunities is often an important constraint on a business angel's ability to invest (see reference 10). It has been pointed out that business angels are not always very visible, and owners of small businesses may find them hard to find. There are, however, an increasing number of networks available to help match business angels with small businesses seeking finance. These networks offer various services, including:

- publishing investor bulletins and organising meetings to promote the investment opportunities available
- registering the investment interests of business angels and matching them with emerging opportunities
- screening investment proposals and advising owners of small businesses on how to present their proposals to interested angels.

The British Business Angels Association (BBAA) is the trade association for UK business angel networks. In addition to being a major source of information about the business angel industry, it can help direct small businesses to their local network.

The development of business angel networks has led to a more efficient market for business angel finance. Greater visibility and greater information flow has made the search for investment opportunities easier. Various studies, however, have shown that these networks are not highly regarded by business angels as a source of investment opportunities. They have been criticised for the quality of the deals offered, the quality of staff employed, and for poor matching of business angels' interests to investment opportunities. It is interesting to note that the Welsh study mentioned earlier found that business associates and friends were business angels' main sources of suitable investment opportunities (see reference 4).

CONCLUSION

Business angels play an important role in filling the 'equity gap' that many small businesses experience. Although a business angel's primary motivation is to make a financial return, the evidence shows that their investment performance is far from encouraging. While a few investments may make exciting financial returns, most seem destined to fail. Such a high failure rate can create difficulties for business angels as they are unlikely to be well-diversified against risk. However, participating in a syndicate can help.

The development of business angel networks has helped to improve the efficiency of the market for this type of finance, but improvements in the services offered are needed before business angels regard these networks as a primary source of investment opportunities. It seems that business angels regard business associates and friends as the best sources of investment opportunities.

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