

Business angels

Giving ideas wings

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Entrepreneurs can struggle to raise the first million or so, even with a good idea. But a business angel might smile on them



IN AUGUST 2003 Skype released the first version of its software, which allows people to make free voice and video calls over the internet. The company had raised its seed capital only a year before from a group of private investors, who had later been joined by venture-capital funds. It was a remarkable investment. In September 2005 Skype was bought by eBay for €2.1 billion (\$2.6 billion). The deal made its Scandinavian founders, Niklas Zennstrom and Janus Friis, millionaires many times over. For their part, the earliest investors saw a huge return, 350 times or so, on their estimated €2m investment.

Few start-ups can hope to become so big so fast. Most new companies wither and die in their first few years, leaving their investors out of pocket. That risk and would-be investors' unavoidable lack of knowledge when faced with unproven business plans explain why entrepreneurs struggle to finance their dreams. Not only must entrepreneurs find the money to get a business off the ground, but they will also need further finance if it is to flourish.

The search was never easy. But it has become harder in recent years with the opening of what has been called the "equity gap"—a scarcity of ready sources of outside financing for the smallest companies. This matters in an age that has recognised the part new businesses play in invigorating economies. Governments everywhere are desperate to help entrepreneurs start the companies that will create new jobs and new wealth.

Which is where the ragtag army of "business angels" comes in. Professional venture capitalists get all the kudos—and most of the money—but the informal choir of business angels plays a large role in starting the innovation machine rolling. Between

them, the angels form an unofficial and little-known capital market on which the future is built.

The equity gap exists because two well-trawled sources of finance no longer overlap. In their earliest stages, start-up companies typically rely on precarious financing, such as their owners' credit cards, second mortgages or cash from close contacts. There is a limit to these sources, which professional venture capitalists disparagingly called the "three Fs"—family, friends and fools. They might provide the first \$250,000 or so. But that is too meagre to bring to market the sort of groundbreaking ideas, like Skype, that can eventually turn into a billion-dollar business. So another source of funds is needed.

Once, businesses would have turned to venture capitalists, who put up money in return for a stake in the enterprise. A decade or more ago \$1m could have been raised this way. But as venture-capital funds have developed and expanded, so their ambitions have grown with them. Many are no longer interested in deals unless they are worth much more.

Most venture-capital firms in America will now consider only deals in which they can invest at least \$7m, says Jeffrey Sohl, director of the Centre for Venture Research at the University of New Hampshire. Europe is not much different. British entrepreneurs struggle to find well organised investors if they are looking for less than £2m-3m (\$3.7m-5.6m), estimates Colin Mason, academic director of the Hunter Centre for Entrepreneurship at the University of Strathclyde in Glasgow.

A wing and a prayer

Where can business people go to bridge this equity gap? British entrepreneurs could try a television programme such as the BBC's "Dragons' Den". Contestants pitch their business plans to a group of potential investors to win the prize of some backing. But television is about entertainment. So, one of the show's advisers recently confided, "I find them a few mad people and plonkers."

To avoid humiliation, it might be better to seek help privately, from some business angels. Angels are rich. They usually have business experience and are often prepared to invest in a risky venture. But they do not operate by the standard rules typical of stock exchanges or formal investment firms.

For all its obscurity, the market they operate in is huge. Mr Sohl estimates there are up to 350,000 business angels in America who invest around \$30 billion a year in some 50,000 ventures, an average of \$600,000 per investment. In contrast, venture-capital funds in America invest on average \$6m in each venture, according to PricewaterhouseCoopers.

Business angels have a long history. America's National Venture Capital Association believes that over the past 30 years they have put more than twice as much money into new ventures as have venture-capital funds. In Europe business angels may be investing between €10 billion and €20 billion each year, thinks Mr Mason. He estimates there are as many as 40,000 business angels in Britain alone.

The angels' distant origins are on display in Mel Brooks's comedy "The Producers". In the 1920s Broadway executives sought people like the little old ladies in the film to back their shaky new stage productions. In return, these backers—and here imagine a greenroom thick with endearments like "darling" and "angel"—could expect to rub

shoulders with the stars at post-production parties. Rarely would they get their money back.

Where VCs fear to tread

Just as theatrical angels are now less star-struck, so business angels tend to be highly professional. Many are successful entrepreneurs in their own right. Others are well-paid managers or professionals who have specialist knowledge of an industry. Like most rich people, they prize anonymity and do not broadcast their activities, which can make them as hard to dig out as the details of their successes.

And they do expect success. Typically, a business angel is willing to invest between \$25,000 and \$250,000 in each of between five and ten new ventures. They expect to make money from the spread of investments, but Mr Sohl believes they also seek "psychic income". Angels want the satisfaction of putting their commercial acumen, contacts and practical knowledge to work on behalf of talented people whom they like.

Such sentiment may explain why professional venture capitalists can often be critical of business angels. "Angels usually overvalue businesses. This makes it difficult for us to come in later on," says one. Another adds: "Angels interfere in businesses, particularly in Britain where they have less experience."

Mr Sohl agrees that there can be problems, cautioning would-be entrepreneurs to make careful inquiries into any prospective investors. "Finding out about your investors before you sign them up is critical," he says. "And you have to understand what everybody wants from the business. It's a marriage without the possibility of divorce. If you can't make it work, bankruptcy is the only alternative."

Sentiment also helps explain the differences between angels and venture-capital firms. The managers of venture-capital funds take an almost-universal fee of "two and 20"; a 2% annual management fee and up to 20% of any profits made by their funds. Angel investors set their own terms.

Despite the potential for acrimony, business angels and venture capitalists have to work together. Angels are an important source of deals for the bigger funds. In America, according to one estimate, angels introduce about two-fifths of the new investment opportunities seen by venture-capital firms.

Raising money will never be easy for the kind of new business that exists only on paper. Skype was no exception. Some 20 venture-capital firms are said to have refused to finance it in its early days. Many of these were sceptical about its business plan. Not only was the company setting out to take on the trillion-dollar telecoms industry, but its founders also bore the taint of litigation. In 2001 Skype's founders had set up Kazaa, an online file-sharing service that enabled people to download music from each other's computers—to the great irritation of copyright holders.

Litigation is just one of the things the big venture-capital funds now have to worry about. In the 1980s most funds were only worth \$10m-20m. Today, most funds are worth more than \$100m. The firms have to do a lot of work before investing. Because they owe fiduciary duties to their own investors, they must delve deeply into whether a new idea can work, the people behind it and whether there is a market for it. They must draw up contracts to allocate any profits and what will happen if anything goes wrong. These complex arrangements contain a baffling

array of “liquidation preferences”, “redemption rights”, “anti-dilution protection” and other jargon. Few smaller investments justify all this paper work.

Another reason to avoid the smallest deals is that they promise lower overall profits than more mature ones do. According to the European Private Equity and Venture Capital Association, investments in “early stage” European ventures have in total made no money for their investors over the past 20 years, whereas later-stage ventures have provided 6% annual returns. Those totals, of course, contain a great many failures and a few big successes. Nevertheless, the record gives yet more reason for bigger funds to seek to avoid fledgling companies—especially those that have not yet put together a complete team of managers and so require extra attention.

Some entrepreneurs whose investment needs fall somewhere between venture-capital and angels can play one off against the other. But the market can be confusing. Venture-capital firms are often demanding, setting ambitious commercial objectives—milestones, as they are known—and complex provisions to protect the value of their shares. If things do not go according to plan, company founders can quickly end up losing their voting rights and even their jobs.

Besides offering entrepreneurs easier terms, angel investors have their own strengths and weaknesses. Sometimes, in fields where they have experience, they can advise managers on the nitty-gritty just as well as a venture-capital firm would. They may even have more time and patience to offer.

Their informality has its benefits, too. “The entrepreneur's life is a lonely one,” Mr Mason observes. “His wife will leave, his employees will look for other jobs and his bank manager will repossess his house.” Besides giving practical help, an experienced angel might also provide much-needed encouragement in the inevitable hard times. Angels can help young companies meet important new customers and recruit essential employees. And, says one business founder, business angels can help negotiate better terms with the venture capitalists when the day comes to scale up even further.

How should entrepreneurs find an angel? What was once a hit-and-miss affair is becoming increasingly systematic. Interest in investing in small businesses is growing among the wealthy, not least because of tax breaks that some countries offer. Business angels have started to organise themselves into groups that can go out and develop contacts who will steer promising opportunities in their direction.

These new networks gather angels into quasi-professional investment syndicates, allowing investors to spread their risk and take part in bigger and sometimes more attractive opportunities without betting the bank. Europe has perhaps as many as 200 networks already. Some contain a handful of investors; others have several hundred.

This more “professional” angel market is expected to bring with it specialisation and even brand recognition, thinks Mark Pluszcz, who is both an angel and a professional investor, as the managing partner of Mangrove Capital Partners, a Luxembourg-based venture-capital firm. Mr Pluszcz believes that a small number of angels will eventually form a “first tier” in each industry, investing in a few specialist businesses. The most promising entrepreneurs will probably seek out these investors first. Any scheme they back will gain credibility at critical moments, such as when they are signing up the first big new customers or trying to lure a manager with valuable experience.

This rapidly evolving capital market even has its own award. The first winner of a European angel prize sponsored by three European business schools and a number of financial institutions was the German-born Klaus Hommels. A former manager at AOL, the "Entrepreneurial Private Investor" for 2006 has focused on how the internet can foster new markets, linking millions of consumers. Luckily for Mr Hommels, investing came early. He picked his first shares at 14, when his grandmother gave him \$20,000 to invest. His portfolio has included several successes, notably Skype, and now he has interests in a handful of internet start-ups in China.

In addition to expecting his entrepreneurs to apply sensible commercial disciplines, such as knowing their market, Mr Hommels looks for obsession in the people he backs. "If you talk to them about vacations, they must always find a way to bring the conversation back to the business," he says. One common European pitfall is that entrepreneurs too often think locally or nationally, but fail to grasp that there are much bigger opportunities afforded elsewhere.

Even a better-organised angel market—with or without awards—will still have its flaws. Mr Sohl, of the University of New Hampshire, believes that some weaknesses have already started to surface in America. He identifies a new, emerging "secondary equity gap". Loose networks of angel investors are beginning to codify the terms on which they can work together, such as by agreeing investment strategies and standardising investment terms. That is sensible, because it makes it easier to do deals. The trouble is that such angel syndicates may start to behave more like venture-capital firms.

This risks having two unwelcome effects. One is that the syndicates will spurn smaller deals because of the cost of the paperwork. This would be at the expense of the market for seed capital, which means more businesses could struggle to get off the ground. Second, a more organised market could become more prone to the herd mentality that infected the venture-capital industry in the dotcom craze.

Wary since last year of a fresh outburst of exuberance, Mr Sohl now monitors the share of business plans in America that succeed in getting finance. In the long run, he estimates that only 10% of new ideas get enough money to set up. However, in 2000 the proportion shot up to 25%, before falling back to the teens during the bear market. He frets that since 2004 the approval rate has steadily risen from 18% to 23%. It is still rising. This rise may reflect the increasing supply of capital as existing angels lend more and new angels join the throng. Either way, some undeserving businesses are probably raising capital.

The value of nothing

It is all very well to talk in general terms about an overheating market. But in any single deal how do the entrepreneur and the angel work out whether the price is right? As any corporate financier will privately admit, assessing the value of even an established business is more art than science. When that business has rarely made a sale, let alone a profit, valuation becomes inspired guesswork.

David Beer runs a network that matches British entrepreneurs with prospective investors. In 20 years of observing start-ups, he has developed a simple rule of thumb. "If it's just an idea, it's worth £10,000; if it has a credible management team in place, it might be worth £100,000. On the other hand, if it has sold something for real money to real customers, it could be worth £500,000."

Another investor says that early stage capital is flowing too freely now. He remarks that managers now "think 30 pages of business plan are worth \$5m without a management team or even having made a penny in sales." He believes that entrepreneurs have less humility than they once did. "You have to make these guys understand that they are better off with a smaller slice of a really big pie than owning most of a tiny business."



Although luck is a big part of finding the right opportunities, Anthony Clarke, president of the European Business Angel Network, offers further advice to budding angels. He advises avoiding lone wolves and backing fully formed founding management teams instead. The founders should show an innate ability to sell. And they must have a one-track mind and the obsession to work 60 or 70 hours week in, week out.

Perhaps of greater importance in raising finance is what angel networks now call "investor readiness". Few entrepreneurs realise that most angels will decide whether or not to look at a business in depth after skimming a business plan for only a couple of minutes. In spite of this, one commentator suggests that fully four-fifths of business plans put potential investors off, by being badly written or making implausible claims such as "we have no competition".

Ultimately, the success of any new venture will depend on the desire of people with ideas to risk their careers and livelihoods on the promise of wealth and success. According to the Global Entrepreneurship Monitor, an annual report of enterprise, the proof of such animal spirits depends on the fear of failure and the example of successful entrepreneurs. A survey on attitudes to entrepreneurship, sponsored by the European Commission, estimated that 26% of Americans would refrain from starting a business because of the risk to income and career. This share grows to 34% in Britain and to 46% in the European Union as a whole.

The European Business Angel Network says there is a social dimension to this disparate result. Americans are surrounded by entrepreneurs who have "cashed out" and have lived through a full cycle of founding, cultivating and then selling their businesses only to start all over again. Angels are more likely to put up their money if the person knocking on the gate has already worked out a heavenly exit route.