Executive summary

Access to finance for new and innovative small firms involves both debt and equity finance. Even before the recent financial crisis, banks were reluctant to lend to small, young firms due to their perceived riskiness and lack of collateral. The financial crisis widened the existing gap at the seed and early stage with bank lending to falling start-ups and venture capital firms moving to later investment stages where risks are lower.

Angel investors, who are often experienced entrepreneurs or business people, have become increasingly recognised as an important source of equity capital at the seed and early stage of company formation. With fewer and fewer venture capitalists investing at the early stage, the equity funding gap between individual angel investment and venture capital has grown dramatically. Angel investors have sought to fill this gap by investing with other angel investors through groups and syndicates, increasing the total deal size for companies seeking early-stage financing.

Why angel investment is important

While angel investment has existed in practice for centuries, the concept of angel investors as a powerful source of financing for high-growth companies has emerged over the past couple of decades in the United States and Europe and is rapidly growing in other regions around the world. The angel investment sector is not only growing, but it is becoming more formalised and organised through the creation of angel groups and networks. In addition to the money provided, angel investors play a key role in providing strategic and operational expertise for new ventures as well as social capital (*i.e.* their personal networks).

The angel investment market is much larger than most people realise. Estimates from both the United States and the United Kingdom from over the past ten years indicate that angel investment has been consistently larger than seed and early-stage venture capital (VC) investment despite some fall off following the dot com era in the late 1990s as well as some drop during the recent financial crisis. While methods of estimating the full angel market size vary, it has been documented through many studies over the past decade that total angel investment is much greater than overall VC investment in the United States and as well as in some countries in Europe.

While venture capital tends to attract the bulk of the attention from policy makers, the primary source of external seed and early-stage equity financing in many countries is angel financing not venture capital. In addition, angel investors tend to be less sensitive to market cycles than venture capitalists, although a “wealth effect” could impact how much they are willing to invest when markets fluctuate. However, in the current market environment, the lack of exits (whether through an IPO or M&A) has put a strain on both angel and venture investment.

At the same time, the internet has created opportunities for the creation of firms with smaller amounts of initial capital than more traditional technology and science sectors. These firms have been termed “lean start-ups” as they allow greater capital efficiency and more rapid testing and adjustment of products and/or business models. Angel investors have been able to invest in this space and support companies through an “early exit” (usually M&A) without needing VCs to come in for later rounds.

Angel investors support a much wider range of innovation than VC firms as they traditionally invest locally and in a wider range of sectors than venture capitalists. This means there is broader investment coverage both in terms of industry sectors and geography (angels live everywhere, not only in areas where VCs have offices, which tend to be concentrated in a few technology or science hubs). However, it also means that angel investors can also be involved in companies that are not necessarily technology intensive or high growth as well as companies in later stages of development. Like VCs, angel investors tend to invest in a portfolio of companies, not just in one or two.

Universities are often highlighted as an important potential source of start-ups, however, often these companies are more research rather than commercially focused and therefore do not succeed as often in securing angel or venture capital as often as assumed. This example points to a potential disconnect between innovation policies, which tend to focus on R&D rather than commercialisation, and entrepreneurship policies which focus on the translation of innovation into firms.

Is there a role for policy?

Angel investors are playing an increasingly important role in the economy in countries around the world. As a result, they have attracted the attention of policy makers. Yet little is known about angel investors. This report seeks to shed light on what the angel market is and how it works, how it has evolved and what types of policies have been utilised with the goal of facilitating the development of the market.

Given the local nature of angel investing, there is no homogeneous national angel market. The level, sophistication and dynamics of angel investment can vary greatly across regions within countries and therefore policy makers must take this into account. In fact, in a number of countries such as Canada and the United States, angel policies are implemented at the regional rather than the national level. In addition, angel investment can vary greatly across countries, both in terms of volume and approach. Policies that have worked in one country may not necessarily work the same way, or be as successful, in another country. Also, while policies targeting angel investment are being put in place in a growing number of countries, there have been few formal evaluations of these programmes to date.

There are several reasons for the lack of knowledge about angel investment. Traditionally individual angel investors have preferred to keep information about their investments private. Even as the industry has professionalised with the formation of groups and networks, accurate data collection has remained a major challenge.

Another key issue is the one of definitions. Often the words business angels or angel investors, informal investor and informal venture capital are used interchangeably. However, most definitions clearly differentiate investment from founders, family and friends from angel investors, who do not have a personal connection to the entrepreneur prior to making an investment. Some studies use total informal investment (founders, family and friends plus angel investment) and others use only angel investment. This complicates data analysis as angel investment measures used in one study might not be comparable to those in another.

For policy makers to intervene in a market, there often needs to be evidence of a "market failure". In the seed and early-stage financing market there is a clear financing gap. While a financing gap is not necessarily a "market failure", the funding gap has been persistent and has grown over time triggering greater attention from policy makers. In addition, there is a well-documented information asymmetry in the market (*i.e.* it is not easy for entrepreneurs and investors to find each other). Angel groups and networks can help to address this problem.

A second potential argument for policy action relates to the potential positive spillover effects of angel investment. Estimates indicate that companies backed by angel investments have been important contributors to economic and job growth. Representatives of a number of the countries interviewed during the project research highlighted these potential economic benefits as the main justification for implementing programmes focused on seed and early-stage investment. Some countries also spoke about how these programmes form an important part of a broader economic development strategy focused on high-growth and technology-backed firms.

The angel investment market has developed significantly in a number of countries throughout the world, particularly over the past 5-10 years. In some countries, policies to encourage a greater number of angel investors seem to have played a role. These include supply-side measures such as tax incentives and the creation of co-investment funds.

Tax incentive programmes have aimed to increase the number of angel investors as well as to address tax asymmetries in profit and losses. Countries such as the United Kingdom, with long standing angel tax incentive programmes cite the impact the programmes have had on increasing angel investment activity which in turn creates jobs and economic growth (and therefore greater tax returns). However, tax incentives can be difficult to structure and target appropriately so monitoring and evaluation is important. In addition, tax incentives are a hot political topic, particularly in today's economic environment.

Co-investment funds leverage public money with private money and also support the professionalisation of the industry. Co-investment funds have been implemented in Scotland, New Zealand, the Netherlands and other countries. These models have been examined and adapted by some countries around the world and interest is growing in this approach. Both tax incentive and co-investment programmes can have the side-benefit of collecting additional data on angel investment in a country.

Other areas in which policy makers have acted to develop the angel financing market include providing support directly to national angel associations or federations as well as networks and groups to help defray operating expenses. National angel associations and networks help raise awareness about angel investment, which is a critical step in building the market. Public support can play an important role in launching associations and networks but it should be structured in a way that sets clear benchmarks or provides incentives for these organisations to move to a self-sustaining model over time. Unlike angel groups, which consist entirely of angel investors, business angel networks (BANs) include service providers and other non-investors. If public support is given to BANs, it is important to make sure the angel networks are generating an appropriate level of angel investment activity.

Training of angel investors is seen to be important for professionalising the industry as well as for attracting new angel investors. However, it is an area that can often be overlooked by policy makers. Because angel investors are typically experienced entrepreneurs and business people, it is assumed that they also know how to invest. However, investing in start-ups differs greatly from being a financial investor or building a company in a particular sector. It requires a combination of both skill sets as well as specific technical skills in terms of conducting due diligence and determining company valuations. Therefore training and mentoring, in which new angel investors can learn from experienced angel investors is a very important part of the process.

While most policies have focused on the supply side, other policy actions have focused on demand-side actions which may help to increase the quality and sourcing of deals. Developing human capability, whether on the investor or the entrepreneur side, is critical. Investment readiness of entrepreneurs is an area on which a number of countries have focused. In addition, public and private incubator and accelerators are increasingly emerging to focus on commercialisation of R&D as well as serve as a catalyst or hub in the entrepreneurial ecosystem. The facilitation of networks, across sectors and geographies (local, national and international) are also important.

The lack of an entrepreneurial culture in many countries is seen as a critical barrier to entrepreneurship. Without entrepreneurs, there will not be any start-ups. Changing culture is difficult and requires a long-term effort. Initiatives to raise awareness about entrepreneurship, such as Global Entrepreneurship Week, the growing number of "Startup (country)" and other initiatives are playing a key role. In addition, entrepreneurship is increasingly being introduced into curricula in some or all education levels in a growing number of countries around the world.

A healthy entrepreneurial ecosystem is critical for successful angel investing. Entrepreneurship does not operation in a vacuum. It can only flourish in a healthy entrepreneurial ecosystem in which a range of stakeholders play a role, including entrepreneurs, investors, large companies, universities, governments, services providers, etc. Governments can help by making sure the appropriate legal and financial framework conditions are in place and by addressing market failures. However, the main actors in building the angel market must be angel investors themselves.