1. Introduction

Impact of the financial crisis on SME financing:

- Decline in bank lending
- Decline in venture capital investing – small-scale, early stage equity investments
- House prices and housing finance – business owners no longer able to release capital from their homes to invest in their businesses (Reusche – workshop 11)

• What has happened to angel investment activity?
  - High net worth individuals (usually self-made) who invest directly in unquoted companies in the expectation of financial return and who take an hands-on role in their investee businesses
  - Angels play a key role in the funding escalator
The Funding Escalator Model

Chart 3.1: The SME Equity Funding Escalator

Source: Amended Figure 1 of ‘Reshaping the UK economy: The role of public investment in financing growth’ (NESTA, June 2009)
continued

– Very difficult to gather data – invisible activity, no single entry point to gather information

– Emergence of ‘visible’ part of the market (networks, groups) which can be measured
• BIS funded two angel investment activity reports covering 2008-9 and 2009-10 (Mason and Harrison, 2010, 2011) to report on investment activity in the visible market:
  – Investments made through angel networks (from BBAA – largely England, Wales and NI)
  – Investments made by Scottish angel groups
  – Evidence from survey of individual angels
• Results reveal that there has been no decline in angel investing since the onset of the financial crisis and even some evidence of an increase – in marked contrast to trends in bank lending and venture capital investing
Research Question

- The health of the angel market is therefore critical for the level of entrepreneurial activity
- So, what is the current health of the angel market?
- Very difficult to research the angel market
  - Invisible activity, angels seek anonymity
  - Records of their investments cannot be accessed systematically
  - No way to know if samples are ‘representative’
- Angel market is in the process of change – emergence of organised, visible segment(s), notably managed angel groups
Methodology

- Angel groups are visible
  - Can be interviewed, may be willing to share data

- Angel Groups
  - “a collection of angel investors who group together to invest in order to increase deal flow, syndication amongst members of the group and potential syndication between groups”
  - Vary in degree of formal organisational structure
  - Usually have an executive director (‘gatekeeper’) who is compensated
  - Streamlined submittal process for entrepreneurs
  - Executive director does initial screening
  - Regional investment focus
continued

- Reasons for emergence of angel groups
  - Vulnerability if investing on their own – need for ‘deep pockets’
  - Better deal flow
  - Access to shared expertise
  - Opportunity for individual angels to diversify
  - Easier to make changes
Context - Scotland

- Scotland’s angel market is dominated by angel groups – in contrast to the rest of the UK and continental Europe
  - Currently 19 angel groups in the LINC network with around 700 members

- Reasons
  - Role of LINC Scotland as a ‘trade association’ to promote the supply side
  - Scottish Co-Investment Fund – most angel groups are approved partners and so can access matched funding for their investments

- Data
  - Investment statistics from LINC
  - Interviews with 18 gatekeepers of angel groups
## Aggregate investment statistics

<table>
<thead>
<tr>
<th></th>
<th>2012 Q1-Q3</th>
<th>2011 Q1-Q3</th>
<th>2011</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inv by LINC members</td>
<td>£10.1m</td>
<td>£7.4m</td>
<td>£12.2m</td>
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<tr>
<td>Other private investors</td>
<td>£5.5m</td>
<td>£4.9m</td>
<td>£14.2m</td>
<td>£11,40</td>
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<tr>
<td>Public sector</td>
<td>£6.2m</td>
<td>£6.1m</td>
<td>£8.3m</td>
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</tr>
<tr>
<td>Total investment</td>
<td>£21.8m</td>
<td>£18.5m</td>
<td>£34.7m</td>
<td>£32.8m</td>
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<tr>
<td>No. of investments</td>
<td>59</td>
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</tr>
<tr>
<td>Amount invested per deal</td>
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<tr>
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<td>43</td>
<td>56</td>
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Key trends – from the aggregate data

• Investment is holding up
• ‘Lumpiness’ of investments can distort short term trends
• Investments getting bigger
• Close to 70% of investments are follow-on investments
Interview evidence

• Exits – fewer, taking longer to achieve, lower value
  – Companies taking longer to grow – economic conditions
  – Fewer VC funds to do follow-on rounds
  – Fewer M&A buyers

• Implications
  – Having to make more funding rounds
  – Ties up capital and attention that could otherwise be recycled in investments in new companies
  – Reduces morale of investors
  – Harder to attract new angels
  – Reduces IRR
continued

• Companies requiring more money than anticipated
  – Initial under-funding
    • Over-optimism of entrepreneurs
    • Entrepreneurs tailoring their funding needs to what they think is available
  – Longer timescale needed to grow companies
  – Fewer VC funds

• Consequences
  – Companies required more rounds of funding from angel groups
  – Entrepreneurs get diluted
continued

• Which, in turn, has the following consequences:
  – Ties up capital and attention that could otherwise be recycled in investments in new companies
  – Reduces morale of investors
  – Harder to attract new angels
  – Reduces IRR
  – Fewer investments in new companies
    • Implications for emergence of New Technology-Based Firms
## Aggregate investment statistics (Prediction)

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Conclusion and Implications

• Aggregate statistics on angel group investment activity presents an unduly optimistic picture of the state of the angel market
  – Follow-on investing dominates
  – Investments per company getting larger
  – Few new investments
  – Few seed investments
  – Lack of exits – to recycle capital and human resources
• Angel groups appear to be following the path of the venture capital/private equity sector
  – Abandoning small scale seed investments
  – Making bigger investment
• Funding escalator model is busted
  – Angels having to invest more finance per business and collaborate in co-investments to overcome the lack of VC
  – Gaps at under £50k and over £2mk
• What (more) can the public sector do?
  – Emphasis up to now has been on supply side initiatives
  – Present crisis requires different solutions