REGIONS, NETWORKS AND FINANCE IN AUSTERITY: BUSINESS ANGEL INVESTING IN SCOTLAND

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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

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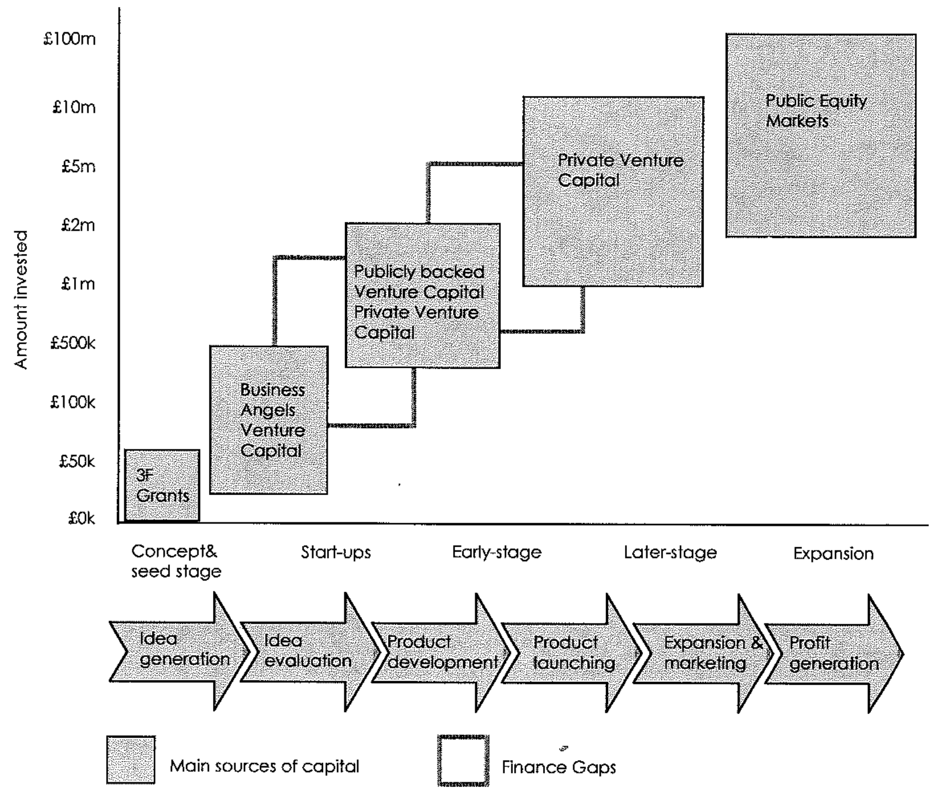
The Funding Escalator Model

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)

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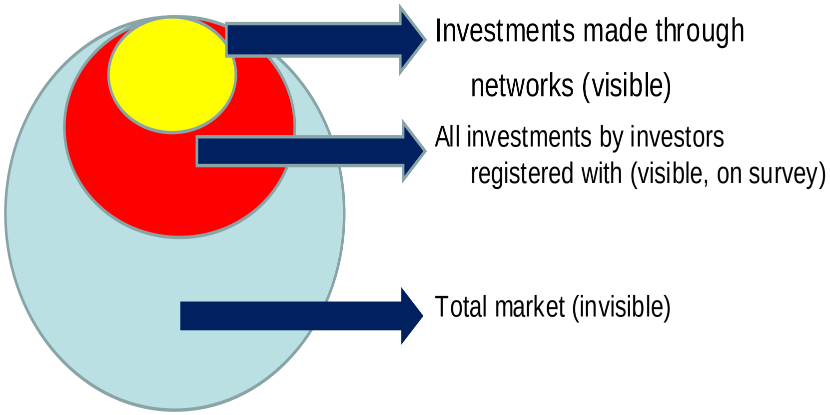
- – Very difficult to gather data – invisible activity, no single entry point to gather information
- – Emergence of ‘visible’ part of the market (networks, groups) which can be measured



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- 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

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- 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

	2012 Q1-Q3	2011 Q1-Q3	2011	2010
Inv by LINC members	£10.1m	£7.4m	£12.2m	£12.6m
Other private investors	£5.5m	£4.9m	£14.2m	£11,40
Public sector	£6.2m	£6.1m	£8.3m	£8.9m
Total investment	£21.8m	£18.5m	£34.7m	£32.8m
No. of investments	59	54	78	105
Amount invested per deal	0,368m	0,343m	0,445m	0,312m
No. of companies	49	43	56	65
Amount invested per company	0,448m	0,430m	0,620m	0,505m

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

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- 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

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- 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)

	2012	2011	2010
Inv by LINC members	£13.4m	£12.2m	£12.6m
Other private investors	£7.3m	£14.2m	£11,40
Public sector	£8.3m	£8.3m	£8.9m
Total investment	£29.1m	£34.7m	£32.8m
No. of investments	79	78	105
Amount invested per deal	0,368m	0,445m	0,312m
No. of companies	65	56	65
Amount invested per company	0,448m	0,620m	0,505m

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