EUROPEAN
INVESTMENT
FUND

Business Angels in Germany

EIF's initiative to support the non-institutional financing market

Helmut Kraemer-Eis
Markus Schillo

Working Paper 2011/11
EIF Research & Market Analysis

Author

Helmut Kraemer-Eis heads EIF's Research & Market Analysis.

Contact: h.kraemer-eis@eif.org
Tel.: +352 42 66 88 394

Markus Schillo heads the ERP-EIF Dachfonds and EIF's Business Angel Co-Investment activity.

Contact: m.schillo@eif.org
Tel.: +352 42 66 88 284

Editor

Helmut Kraemer-Eis, Head of EIF's Research & Market Analysis

Contact:
European Investment Fund
96, Blvd Konrad Adenauer, L-2968 Luxembourg
Tel.: +352 42 66 88 1
Fax: +352 42 66 88 280
www.eif.org

Luxembourg, November 2011

Disclaimer:

Abstract

Business Angels (BAs) are an important financing source for SMEs, and seed and start-up companies in particular. BAs are even more important in countries and regions lacking an institutionalised VC infrastructure, often being the only major source of equity finance for young innovative SMEs. An important additional element of their activity is often the provision of non-financial benefits like mentoring/advice, contacts etc.

However, especially in comparison with the US, the European BAs segment is still in its emerging phase both in terms of the number of active BAs and the amounts invested by BAs. Strained exit markets as well as an overall deterioration of the private wealth situation of many business angels as result of the financial crisis additionally limit the investment activity of BAs with investment activity at low levels.

This paper gives insights into the BA segment with a special focus on Germany. First we introduce the concept of BA financing. In a second step we analyse the BA market in Germany. We conclude that there is a significant excess demand for early stage financing. In the third part of this paper we explain, how the EIF aims to address this by providing a flexible and timely support to the BAs market through establishing an intermediation infrastructure to efficiently leverage this investor base. This infrastructure is going to be piloted in collaboration with the German Business Angel Network (BAND) in Germany soon (launch planned in the context of the Deutscher Business Angels Tag in March 2012), with the intention to conduct a roll-out in other geographies following the successful implementation of the pilot.

JEL Classification Numbers: G20, G24, G32, O16

Table of contents

1. Introduction

1.1 What are Business Angels?

We start with the definition by Mason and Harrison (2008):

> *"Individuals, acting alone or in a formal or informal syndicate, who invests their own money directly in an unquoted business in which there is no family connection, and who, after making the investment, takes an active involvement in the business, for example as an advisor or a member of the board of directors"*

One could characterise the stereotypical Business Angel (BA) as a rich, middle-aged man with business experience, typically an ex-CEO, MD or entrepreneur, probably with his own experience in founding one or more companies[1]. However, such a stereotype would give a misleadingly general picture about Business Angels, the activities of which in reality cover a broad spectrum. Mason and Harrison (2008) refer to a six-fold categorisation of Business Angels, which gives an idea of the heterogeneity of the group:

- Virgin angels – individuals with funds available looking to make their first investment but yet to find a suitable proposal;
- Latent angels – rich individuals who have made angel investments but not in the past three years, principally because of a lack of suitable proposals;
- Wealth-maximising angels – rich individuals who invest in several businesses for financial gain;
- Entrepreneurial angels – individuals who back a number of businesses for the fun of it and as a better option than the stock market;
- Income-seeking angels – very rich, very entrepreneurial individuals who back a number of businesses to generate an income or even an activity for themselves;
- Corporate angels – companies which make regular and large angel-type investments, often for majority stakes.[2]

The European Business Angel Network, EBAN, defines BAs as follows:[3]

"A business angel is an individual investor (qualified as defined by some national regulations) that invests directly (or through their personal holding) their own money predominantly in seed or start-up companies with no family relationships. Business angels make their own (final) investment decisions and are financially independent, i.e. a possible total loss of their business angel investments will not significantly change the economic situation of their assets. BAs invest with a medium to long term set time-frame and are ready to provide, on top of their individual investment, follow-up strategic support to entrepreneurs from investment to exit. They respect a code of ethics including rules for confidentiality and fairness of treatment (vis-à-vis entrepreneurs and other BAs), and compliance to anti-money-laundering".

[1] For example, 97% of the BAs in Germany are male, with an average age of around 50 years (Harrer, 2010b). Typically their private wealth is higher than EUR 5m (Fryges et al, 2007).

[2] However, we do not consider this latter category of Mason/Harrison as BAs as their characteristics are more like institutional VCs.

[3] http://www.eban.org/resource-center/glossary

One key distinction is that business angels invest their own funds, unlike VC funds, who primarily invest funds committed by others (e.g. institutional investors). For this reason they typically invest in companies with which they can maintain close contacts (OECD, 2006).

Furthermore, typically companies that receive BA financing are smaller (i.e. in terms of turnover – see also table 1 later in this text) than VC backed companies. Most of the companies that receive BA financing, do not receive VC financing at the same time. A study by Mason and Harrison (2002) found that the median holding period for an investment was four years for a profitable exit, two years for a failure, and six years for a 'living dead' investment. It is notable that these periods are significantly shorter than the corresponding holding periods experienced in an average Venture Capital Fund.

Typical exit channels are repurchase by the business owner as well as stock exchanges, or trade sales. As is the case with most risk capital investments, a significant percentage of the investments fail or return an amount equal or lower than the capital invested. However, returns can be high, and the likelihood of success appears to be directly related to the actions of the angel, as demonstrated by the results of a recent study on Business Angels in the UK (see box 1).

Box 1: Siding with the angels: business angel investing, promising outcomes and effective strategies, by Robert E. Wiltbank

The following findings are based on a survey of 158 UK-based angel investors in late 2008:

1. 56% of exits failed to return capital, but 9% generate more than 10 times the capital invested.
2. Despite the fact that only 44% of investments generate positive exits, the overall return to business angel investing in the UK is 2.2 times invested capital.
3. Given a holding period of just under 4 years, this translates into an IRR of approximately 22%.
4. More than half of the investments went into pre-revenue ventures
5. Those investments conducted by BAs with entrepreneurial expertise and/or specific industry expertise were more successful.
6. Performing at least 20 hours due diligence had a significant positive impact on the likelihood of success.

It is widely accepted that, together with seed funds, Business Angels are the main providers of venture capital for high growth companies at their early stages, particularly in the current economic climate which has seen VC funds migrate to less risky investments in later stages. Mason and Harrison (2008) identify three reasons why Business Angels are critical in the creation of an entrepreneurial environment.

1. They fill a gap: as BAs do not face the transaction costs faced by venture capitalists, they are able to conduct smaller investments. Studies show that, while Business Angels invest across the full range of company stages, they are the main source of funding when the deal size is under USD 1m, and they participate in a higher number of rounds of seed and start up capital than venture capital funds. Mason and Harrison note that the informal venture capital market is the largest external source of early stage risk capital, dwarfing the institutional venture capital market (but also noting that capital supplied by family members/friends substantially exceed the amounts raised by Business Angels).
2. Business Angels are more geographically dispersed than venture capital firms, which tend to be concentrated in metropolitan regions. Furthermore BAs tend to invest locally. However, it should be noted that Business Angels are more common in regions with a thriving entrepreneurial climate – most likely because they tend to be current or former entrepreneurs.
3. The capital contributed by BAs is usually perceived by the companies as 'smart money' as Business Angels tend to be hands-on investors: this aspect is a major reason for becoming a Business Angel.

Business Angels increasingly co-invest with other angels and with early stage funds to fill the early-stage equity gap. Business Angel networks (BANs) facilitate the matching of investment demand and supply; they aim to organize and link angels, as well as to attract prospective investment targets (investees) to angels and match both parties for business contacts. Such networks come in a number of forms; some are more like investment clubs, while others are set up on a regional or national basis. Some networks concentrate on a certain industry or sector. One should nevertheless take into account that the closeness to and investment activity with networks usually decreases with the experience and force of a Business Angel. Notwithstanding this, some of the very experienced BAs sometimes organize themselves loosely in (usually closed) groups, which can rather be seen as opportunistic "investment clubs" than a typical (formally organized) BA network.

That only certain angels and entrepreneurs operate through networks has been confirmed in an older survey of the European Commission (2002), which revealed that only around 19% of contacted angels were registered with networks, and about 2% of new entrepreneurs contacted a network. Nevertheless, an update of this survey would most likely result in a higher degree of organization today.

An important element of Business Angels' activities is often, in addition to financial support, the provision of non-financial benefits, e.g. in the form of contacts, reputation (signaling), mentoring and strategic advice, sometimes even operational collaboration (see Politis and Gabrielsson, 2006 a and b, and KfW, 2011).

Table 1 below shows the main differences between Business Angels and VCs.

Table 1: Main differences between Business Angels and VCs

	Business Angels	Venture Capitalists
Background	Former entrepreneurs	Finance, consulting, from industry
Investment approach	Investing own money; face smaller transactions costs; conduct smaller investments	Invest funds granted to them by others (e.g. institutional investors)
Investment stage	Full range of company stages but with focus on seed and early stage	Range from early to (increasingly) later stage; exceptionally seed stage
Investment instruments	Common shares	Preferred shares
Deal flow	Through social networks and/or angel groups/networks	Standard deal flow based on unsolicited submission of proposals based on the VC's visibility. Additional deal flow through social networks as well as proactive approaches
Due diligence	Conducted by angel investors based on their own experience	Conducted by staff of VC firm, sometimes with assistance of outside firms (law firms, etc)
Geographic proximity of investments	Geographically dispersed; most investments are local (within a few hours drive)	Invest nationally and increasingly internationally with local partners
Post investment role	Active/close contacts, hands-on approach	Board seat, strategic
Return on investment	Important (but sometimes not the only reason for angel investing)	Critical. The fund must provide decent returns to existing investors to enable them to raise a new fund (and therefore stay in business)
Syndication	Focus on alignment of business approach and mindsets	Focus on alignment of financial parameters and objectives

Source: Adapted from OECD (ongoing research project on the role of angel investment (2011)).[4]

1.2 Measurement issues

The inclusion of Business Angels in the range of 'informal' (as opposed to 'institutional') investors provides us an indication that there are potential difficulties in measuring the size of the Business Angel community. Mason and Harrison identify two main problems, identification and definition. Regarding the former, in his seminal work on Business Angels, William Wetzel (1983) notes that the total population of Business Angels is unknown and probably unknowable on account of their invisibility, desire for anonymity, and the undocumented nature of their investing. Most studies are based on samples of convenience, such as angels who are members of Business Angel networks, or arising from snowball sampling methods (whereby a small number of angels are identified and asked to identify other angels, etc.). However many angels prefer to act alone, or are one-time or infrequent opportunistic investors.

[4] Adapted with permission from OECD. The OECD research will be published in November 2011.

Regarding identification, we need to differentiate between Business Angels and the wider informal investment market. Informal investment describes non-institutional risk capital investments in unquoted businesses, including Business Angel investments, investments by family offices, and also the category of investments made by family and friends. The latter two categories are often not commercially oriented. However, matters are complicated by the definition of 'friends' – social, as well as business networks are sources used to identify potential investment opportunities.

Identification is further complicated by the fact that some individuals who identify themselves as 'virgin' angels, i.e. looking to make their first investment, may never do so. Furthermore, some individuals may have acted as angels but are no longer actively looking to invest; counting either of these categories as active angels risks exaggerating the true number.

Angel investors are not homogenous; they operate on a spectrum, with at one end a solo investor, and at the other investors who are part of syndicates who play no direct hands-on role in the investee company, and may not even make the decision about which investment to make.

1.3 Importance of Business Angels in Europe and the US

The data included below must be interpreted with caution, indeed those providing the data themselves advise caution in using it. The European data comes from the European Business Angel Network (EBAN), and the US data comes from the Angel Capital Association or the Centre for Venture Research, University of New Hampshire. EBAN note that their numbers only include activity that takes place within Business Angel networks, and as such by no means represent the full extent of Business Angel activity existing in Europe. Furthermore, it is important to note that their statistics are based on information provided by surveyed Business Angel networks; the data is self-reported by the networks and not verified. Similar caveats apply for the US data.

The (estimated) number of angel investors active both within networks and on an independent basis (individual activity or in syndicates) is estimated to be around 75k in Europe (EBAN, 2010c); the corresponding figure for the US is 259k. Often Business Angels in the US are "Serial Angels" - this means they invest regularly.

In terms of overall investment, the amount invested by angels annually is EUR 3 to 5bn in the EU (invested into approx. 2800 companies (2009 data)), compared to USD 20.1bn (approx. EUR 14.9bn) in the US (invested into 61,900 companies (Sohl, 2011)). Of course, these figures have been impacted to a degree by the global financial crisis, in particular the amount invested, which was reportedly USD 26bn (EUR 19.3bn) in the US in 2007.

According to EBAN (EBAN, 2010c), there are almost 400 Business Angel networks in Europe, with around 14.8k investors operating in groups; the corresponding figure for the US is 340, with around 6.5k investors (operating in groups). The median number of investors in a typical European business angel network is 79 (EBAN, 2010c).[5] The number of networks in Europe has increased rapidly over the past decade, from around less than 100; at the same time the number of venture capital funds has fallen from around 1,600 to 700; this could be taken as a support for the hypothesis that Business Angels are fulfilling some of the role of what was once the exclusive arena of venture capital funds.

[5] Please note that this type of statistics can only be indicative as double counting cannot be excluded. A BA can be in more than one network.

Regarding size of investment, Business Angels, working together in syndicates, invest on average EUR 200k per deal (per round) in Europe. In the US the average deal size is with around USD 218k (EUR 160k) slightly smaller. Among angel networks in Europe, most (61%) investment is in early stage companies, with 21% going to seed and 13% going to expansion capital investments (EBAN, 2010c).

With regard to the destination of the invested funds in terms of sector allocation, we are restricted to use data obtained about business angel networks (see EBAN, 2010c). While it is generally difficult to apply insights gained from networks to the overall BA market, it might be fair to assume such sector data to be representative for the market in general. In Europe the ICT sector was the most significant identified sector, accounting for 20% (31%) by value (number) of investments, followed by creative industries (19% by value; 12% by number), biotech (15% by value, 13% by number) and energy (10% by value, 7% by number). The picture in the US (see Sohl, 2011) shows a strong focus on healthcare services/medical devices and equipment; this sector accounted for the largest share of investments (30%), followed by software (16%), biotech (15%), industrial/energy (8%), retail (5% and IT services (5%). As for exits: in the US, mergers and acquisitions accounted for 66% of angel exits.

2 Business Angels in Germany

2.1 Importance of Informal Investment in Germany

The term Business Angel has only been used in Germany since the early 1990s. According to the German Business Angel network BAND, German Business Angel associations/federations have approximately 1,400 registered members. Most of the actors are "silent angels", this means they do not look for publicity and most of them are not organised in networks. The "Promotion Angels" are a minority - they are looking for publicity and are participating in public discussions (Harrer, 2010b). Hence, the real number of Business Angels is higher: Fryges et al (2007) estimate between 2,700 and 3,400 active Business Angels for Germany; alternative estimates (based on Business Angels financed exits with a lower assumption for the number of participations per Business Angel) mention 5,200 to 5,400 Business Angels.[6]

The total annual amount invested by Business Angels in Germany is estimated to be between EUR 100m and up to EUR 300m.[7] The amounts invested per individual investee company vary significantly. Often, amounts between EUR 50k and EUR 100k are mentioned as average, however, during the financial crisis these amounts went down significantly (see also text box 2 on the Business Angel Panel below).

On average German Business Angels hold 5 to 7 participations; the average holding period is estimated to be around 4 to 7 years (Fryges et al, 2007). Wallisch (2009) mentions 3 to 10 years

[6] For details see Fryges et al, 2007, p. 57; Wallisch, 2009, p. 38f; or KfW, 2008, p. 6f.

[7] E.g. Wallisch, 2009: EUR 100m to 150m; Fryges et al, 2007: EUR 190m. The latter study is based on a survey; the estimation refers only to first round investments and the high-tech sector. Based on this study, market participants extrapolate an overall amount, annually invested by BAs, of up to EUR 300m. To analyse the potential BA financing one would need to analyse the potential for innovative company creations that could be considered for BA financing, but only the real start-ups are observable.

with an average of below 5 years. Business Angels in Germany often invest in the high-tech sector or in tech-oriented services.

97% of the Business Angels in Germany are male, their average age is around 50 years and typically they are ex CEOs, MDs, or entrepreneurs, and often with own experience in founding companies (Harrer, 2010b). Typically their private wealth is higher than EUR 5m (Fryges et al, 2007).

A study for the German Ministry of Economics and Technology (Fryges et al, 2007) analysed high-tech start-ups and Business Angels. The results, presented here, are based on analysed companies that have been founded between 2001 and 2005 (formation cohort/group 2001-2005).

According to the study, the most important source of financing for the young companies of this formation cohort is cash-flow and owner's equity. Among newly created high-tech companies of the cohort 2001-2005 in Germany approx. 5% received Business Angel financing (approx 3,700 companies). Companies with Business Angel support received (on average) financing from about 2 BAs.

Typically, Business Angels take minority stakes; according to the study, only 5% of the BA financed companies have majority participations of Business Angels. Slightly more than 50% received financing at or before creation. Almost one third received support 3 years after creation - this means that Business Angels do not only finance companies in the seed and start-up, but also in the expansion phase.

Table 2 below shows the attributes of companies with Business Angel or/and VC support. The authors surveyed 3,000 companies of the formation cohort 2001-2005 in the fields of high-tech/high-quality tech and tech-oriented services. The comparison between VC and Business Angel financing is for companies that received risk capital since their creation.

Table 2: Attributes of companies with Business Angel or/and VC support[8]

	Attributes of companies with risk capital	
	from VCs	from BAs
Turnover in year 1 (first year in business)	EUR 250k	EUR 130k
Turnover growth p.a.(on average)	63%	59%
Employment growth p.a. (on average)	35%	27%
Companies undertaking R&D	79%	65%
Companies undertaking R&D continuously	73%	43%
R&D intensity (on average)[9]	40%	20%
Companies, using own patents	61%	18%
Companies, owning patents before creation	33%	12%
Sum of provided risk capital (mean)	EUR 2,148,000	EUR 103,324

Source: Fryges et. al, 2007 and KfW, 2008.

[8] Reading example: Young companies, having received BA financing, have a turnover of EUR 250k in their first year of business, the turnover-growth is 63% p.a. and the employment growth 35% p.a. 79% of the companies undertake R&D (73% continuously).

[9] R&D expenditure divided by turnover.

It can be seen that there is a significant difference with regard to the invested amounts between VC and BA activity in Germany. BAs provided around EUR 0.1m per company (median: EUR 30k[10]). Compared to the median the mean is high, because there are a few high tech companies that received comparably high amounts from the BAs, some of them more than EUR 1m. VCs provided around EUR 2.1m per company, 20-times the value of an average BA participation.

It appears that, compared to VCs, BAs in Germany have lower growth and innovation requirements for companies and invest (small amounts) in early stages of the lifecycle. Hence, not only cutting edge high-technology is being financed, but also other high quality technology and technology oriented services. Against this background, the German sector composition can provide many targets for BA financing. Moreover, as KfW concludes, increased BA support could result in more dynamic start-up activities (see KfW, 2008).

The above mentioned study (Fryges et al, 2007) surveyed companies, the investees. Studies, based on BA surveys (the investors), show a similar - but not the same – picture compared to the results presented above. According to the BAs they provide around EUR 0.2m (Bomholt, 2006). Stedler and Peters (2002) analysed that 76% of BAs invested less than EUR 0.5m.

Business Angels increasingly work via syndication within their networks (OECD, 2006), also in Germany. Typically the contacts between BA and companies are originally established on an informal basis (according to Fryges et al, 2007: 93%). Only around 1/3 of the contacts are successful (in other words, only around one third of meetings between Business Angels and entrepreneurs result in financing). The study mentions many different reasons for failure (a contact not resulting in a business relationship), i.e. diverging views on investment level and conditions (investment amount, valuation, etc.) and reasons related to the business model (concept, insufficient growth potential).

With regard to spatial patterns of angel investing there are so far only a few analyses available. Often, the one-hour-distance-rule is mentioned and, as already mentioned before, the network is typically local (not only the BANs (see next paragraph), but also lawyers, accountants etc.). A small survey, done by Wallisch (2009) confirmed this rule of thumb. He analysed the distance between the location of the BA and their investee companies: almost 40% of the companies were reachable within one hour, more than 60% of the companies were reachable within three hours.[11]

[10] Median means: 50% of the companies received more and 50% received less capital from the BA.
[11] For a general analysis of BAs' decision making see Smith, Mason and Harrison (2010).

Box 2: The Business Angel Panel

The Business Angel Panel surveys since 2002 quarterly the business climate for BAs in Germany (status quo & future perspective/expectation) and ranks on a scale from 1 (very bad) to 7 (very good); there are around 30 participants (experienced BAs); see: www.ba-panel.de

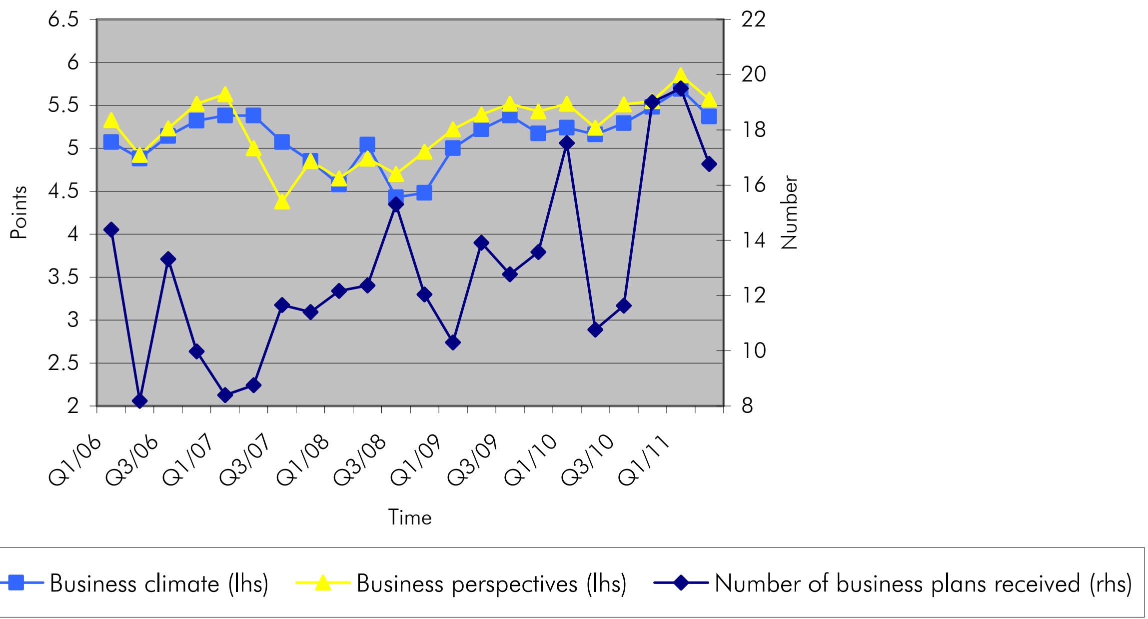
Current ratings: The current rating (showing Q2/2011) for the status quo is 5.37, for the business perspectives it is 5.57, both values are below the previous quarter – but the values for Q1/2011 were all time highs (status quo: 5.69/expectation: 5.85). However, only 19% of the surveyed BAs finally invested in Q2/2011 (mainly follow-on investments). The BAs mention attractive (but increasing) valuations, combined with a positive business environment in Germany, as reason for their opinion. The graph below shows that the assessment of the BA business climate/perspectives only slightly worsened during the peak of the financial crisis.[12]

Number of business plans: On average, every surveyed BA received almost 17 business plans as investment proposals, slightly less than in the previous quarter (all time high, 20), but well above the long term average (13.9). These proposals resulted (on average) in 2.8 meetings.

Dry powder: the remaining amount foreseen for investments is high (almost 50% of the total amount).

Investment amounts: On average the BAs invested EUR 27k; these amounts are well behind the peak values, e.g. in 2004 the BAs invested EUR 150k per quarter.

Sectors: The ranking of preferred sectors has changed over the past quarters. Now, proposals related to energy are on the pole position, followed by web services/e-business, cleantech and medtech.



Source: Based on BAND, RWTH, VDI Nachrichten, and WHU Vallendar (2011)

[12] The future effects of the current financial turmoil, economic headwinds, and related uncertainties remain to be seen in future Business Angel Panels. The ZEW Indicator of Economic Sentiment for Germany has dropped in September 2011 to a level that was seen last in December 2008. See e.g. http://www.zew.de/en/presse/1807

2.2 Organisations: Business Angel Networks

There are around 40 BA networks (BANs) in Germany. Most of the networks have been founded in the late 1990s. The BANs can be categorized in different groups (see e.g. BAND, 2010 or Wallisch, 2009)[13]:

a) BANs as public project

According to Kirchhof and Günther (2005) almost half of networks are in this category

- Motivation: structural policy
- Agency: Landesbanken, Chambers of Commerce, Business Development Agencies
- Form: Initiative/project, sometimes only listing of BAs
- Geographical focus: in line with geographical focus of the sponsor/responsible body
- Financing: public support, sometimes additional sponsors have been taken on board.

b) BANs as „Verein" (incorporated society)

According to Kirchhof and Günther (2005) around 30% of networks are in this category

- Motivation: Private or structural policy
- Form: Society (members are BAs and sometimes also intermediaries, VCs, banks)
- Focus: regional or countrywide
- Financing: membership fees, sponsors, sometimes public support, sometimes fees for services

c) BANs as clubs

- Motivation: private
- Form: Low level of institutionalisation, sometimes circle of friends („Freundeskreis"), sometimes "BGB-Gesellschaft"
- Focus: regional or countrywide, sometimes focussed on certain sectors
- Financing: private, sponsoring, low costs (often only honorary posts)

d) Some networks are organised as a (profit driven) company, e.g. in the form of a limited liability company (GmbH).

2.3 Significant excess demand

The availability of information about informal Business Angel financing is obviously more limited than for the formal Private Equity/Venture Capital. However, the above analysis shows that BAs play an increasingly important role for the financing of SMEs, and seed/early stage companies in the high-tech oriented sectors in particular. This is also to be seen against the background of the difficult situation for Venture Capital financing in Europe in general. Worries about Europe's sluggish and uneven economic recovery are impacting investors - some left the VC market, others

[13] A detailed list of BANs can be found here: http://www.business-angels.de/default.aspx/G/111327/L/1031/R/-1/T/130360/A/1/ID/132162

tend to focus on a smaller number of transactions and on the later stage area. Such shift in the stage focus of VCs results not only in a reduction in capital available for early stage financing, but at the same time might impact the early stage financing conducted by BAs because they sometimes need co-investments by VC funds, as already mentioned earlier.

The German Business Angel Panel Survey, discussed in box 2 above, notes that the business angels surveyed received on average 13.9 business plans as investment proposals (during the respective quarter). Of course, we cannot consider all these to be "investable" (eligible demand). These proposals resulted in 2.8 meetings with BAs. This means that only 20% of the proposals have been deemed to be 'potentially investable' by the participating BAs. This ratio seems to be rather constant as it varied (since 2006) mainly between 15% and 25% (with most observations around 20%).[14] It is unknown, how many of these meetings were successful. The study by Fryges et al (2007) notes e.g. that around one third of these contacts between BAs and potential investees resulted in financing.

Although rejected proposals might receive finance from other angels or in a following quarter, the data is an indication of significant excess demand for this type of financing - which however does not necessarily mean that the gap should be fully closed as typically not all proposals deserve financing from an economical point of view.

Also an analysis by KfW concludes that in Germany the VCs are not able to meet the excess demand of young, innovative companies and that this gap could be mitigated by a stimulation of BA activity (KfW, 2011). How a part of this gap can be closed will be explained in the next chapter.

3 EIF's planned support of the BA market

3.1 Approach

As discussed above, Business Angels are broadly recognised to be an important financing source for SMEs and seed and early-stage companies in particular. BAs are even more important in countries and regions lacking an institutionalised VC infrastructure, often being the only major source of equity finance for young innovative SMEs. However, especially in comparison with the US, the European BAs segment is still in its emerging phase, in terms of the number of active BAs, number of deals, and the amounts invested by BAs. Currently strained exit markets additionally limit the investment capacity of BAs as part of their resources is "locked" in existing companies which might additionally need follow-on financing.

The EIF aims to address this by providing a flexible and timely support to the BAs market through establishing an intermediation infrastructure to efficiently leverage this investor base. It is planned to establish a Co-investment Facility (the "Facility") that is going to be piloted in Germany - a market with a strong potential for business angel activity and where EIF has built up a broad know-how and solid experience in the past decade - with a possible roll-out in other geographies. Such co-investment product will be set-up in collaboration with the respective Business Angel Networks (i.e in Germany in collaboration with BAND) to achieve the full support of all market participants and will be complementary to other major (co-) financing instruments, available for BAs in this market, e.g. it will not exclude co-investments by the ERP Startfonds, the

[14] Data source: http://www.vdi-nachrichten.com/vdi-nachrichten/studien/wirtschaft/ba_panel/index.asp.

HighTechGründerfonds or comparable initiatives.

This enlargement of EIF's reach towards parts of the SME finance chain currently not accessible through EIF's existing instruments constitutes one of the priority axes for the development of EIF's Venture Capital activity in view of building a sustainable European VC ecosystem supporting innovation and entrepreneurship. The Co-investment Facility Pilot is an important concrete implementation step in this context. The Facility aims to co-invest with Business Angels (and other non-institutional investors, e.g. family offices) in SMEs (incl. start-ups/early stage).

Additional pilots could be considered in other geographies in view of a broader rollout of the Facility as a Co-Investment Platform in the Europe 2020[15] context. Such pan-European coverage will provide the full benefit to investors and the BAs market through:

- promoting best market practices in the non-institutional investors segment expected to support further professionalization and the establishment of market standards to the benefit of the financed SMEs especially given the fact the investments size and level of expertise of BAs differ considerably within the various European countries,
- ensuring the coordination of alignment of objectives of policy investors in view of creating a truly European BAs market which will support cross border investment activity and optimise overall value added and impact,
- a lean cost structure and well diversified underlying portfolio of BA investments of critical mass to reach an interesting risk-return profile providing for downside capital protection and a risk-commensurate return potential.

3.2 Investment model

Generally, the investment model of EIF's co-investment activity will be structured in a way that it largely harmonises with the usual investment process of BAs, i.e. it does – once a BA has agreed a framework contract with EIF - not require additional steps to be taken by the BA to receive a co-investment for an individual investment.

In line with EIF's existing VC business model of supporting and working with private sector intermediaries, EIF will focus on the selection of BAs (who will select and manage the investments) instead of taking individual investment and management decisions. EIF will hence build on its key expertise and experience in evaluating investors, build and manage relationships and monitor them.

Selection of BAs will primarily be depending on their experience and past activity ("proven"), their willingness and ability to conduct a certain number of investments during the investment period ("relevant") and their resources and ability to conduct the necessary co-investments ("significant").

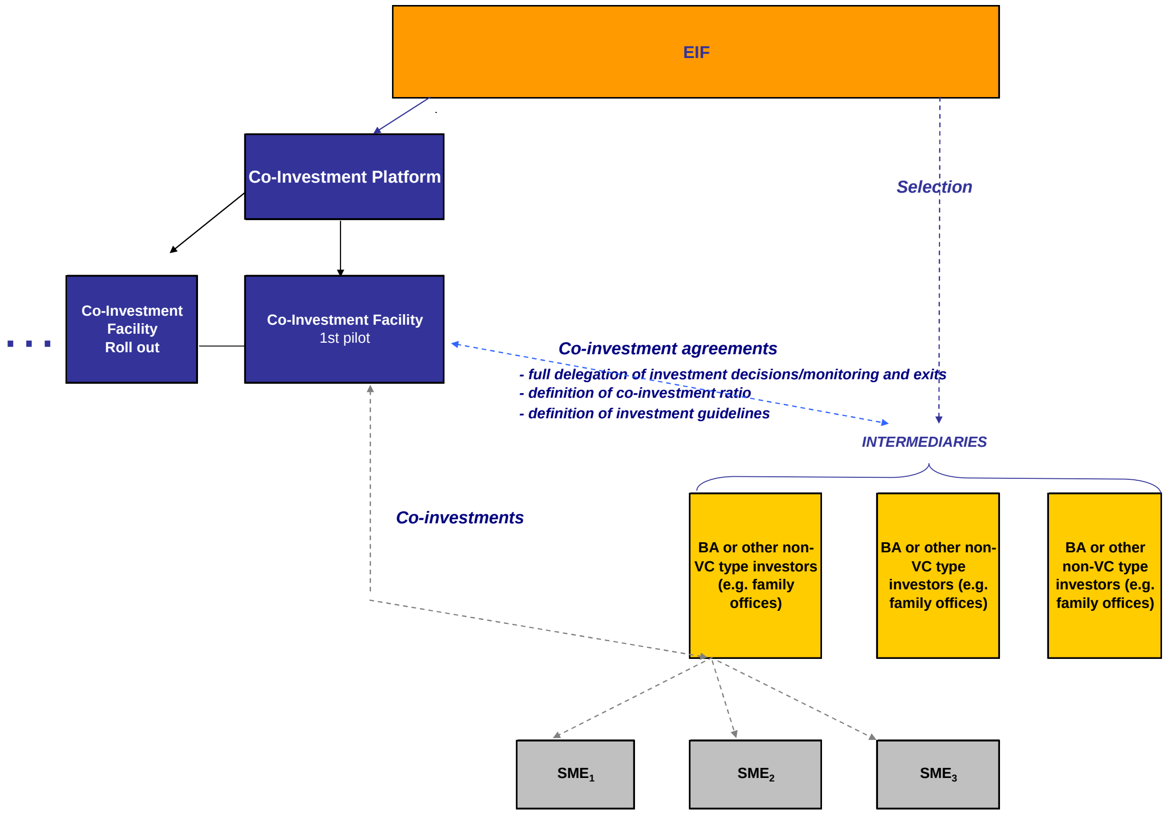
Once a BA has been selected, investment decisions for all co-investments with such BA would then be delegated to the respective BA. Co-investments will be used for all investments the BA is

[15] Europe 2020 is the EU's growth strategy for the coming decade. More information can be found here: http://ec.europa.eu/europe2020/index_en.htm

conducting in a predefined area (e.g. market sector, stage, business model etc.), including potential follow-on investments.

An overview of the facility is displayed in the following figure:

Figure 1: EIF's co-investment scheme for Business Angels



Source: EIF

The German pilot of the Facility is planned to be launched in the context of the German Business Angel day (Deutscher Business Angels Tag 2012, March 11th and 12th 2012 in Frankfurt) organized by BAND, where further details of the facility will be presented.

4 Concluding remarks

There are significant challenges for the financing of small business in general, and for seed and early stage financing in particular. Overall, and in addition to traditional structural issues, small business finance is suffering from the repercussions of the financial crisis.[16]

In this context, public support is very important but it is also important to realise that public support cannot be the only solution – it needs to play a catalytic role to attract private finance, to

[16] For a general overview please see e.g. European Small Business Finance Outlook (Kelly and Kraemer-Eis, 2011).

crowd-in private investors. It is a key priority for the EIF to help establish a well functioning, liquid Venture Capital market that attracts a wide range of private sector investors, and develop new and pioneering financing instruments in order to reach to parts of the market currently not accessible through EIF's existing instruments (i.e. Business Angels, but also e.g. Corporate VC). The objective is to leverage EIF's activity and seize market opportunities in all areas of the VC eco-system which are relevant for the sustainable development of the industry.

We analysed the German Business Angels market, where there is excess demand for early stage financing, but the general results are valid for other European geographies as well. An (ongoing) OECD research project on the role of angel investors confirms that policies and government support can be a catalyst for developing the business angel activity. Public support for this market segment is only available to a very limited extend. However, in several countries, policy actions have already been taken to support angel investing, i.e. tax incentives (e.g. France, UK), the support of creation of associations/networks, or investment structures.

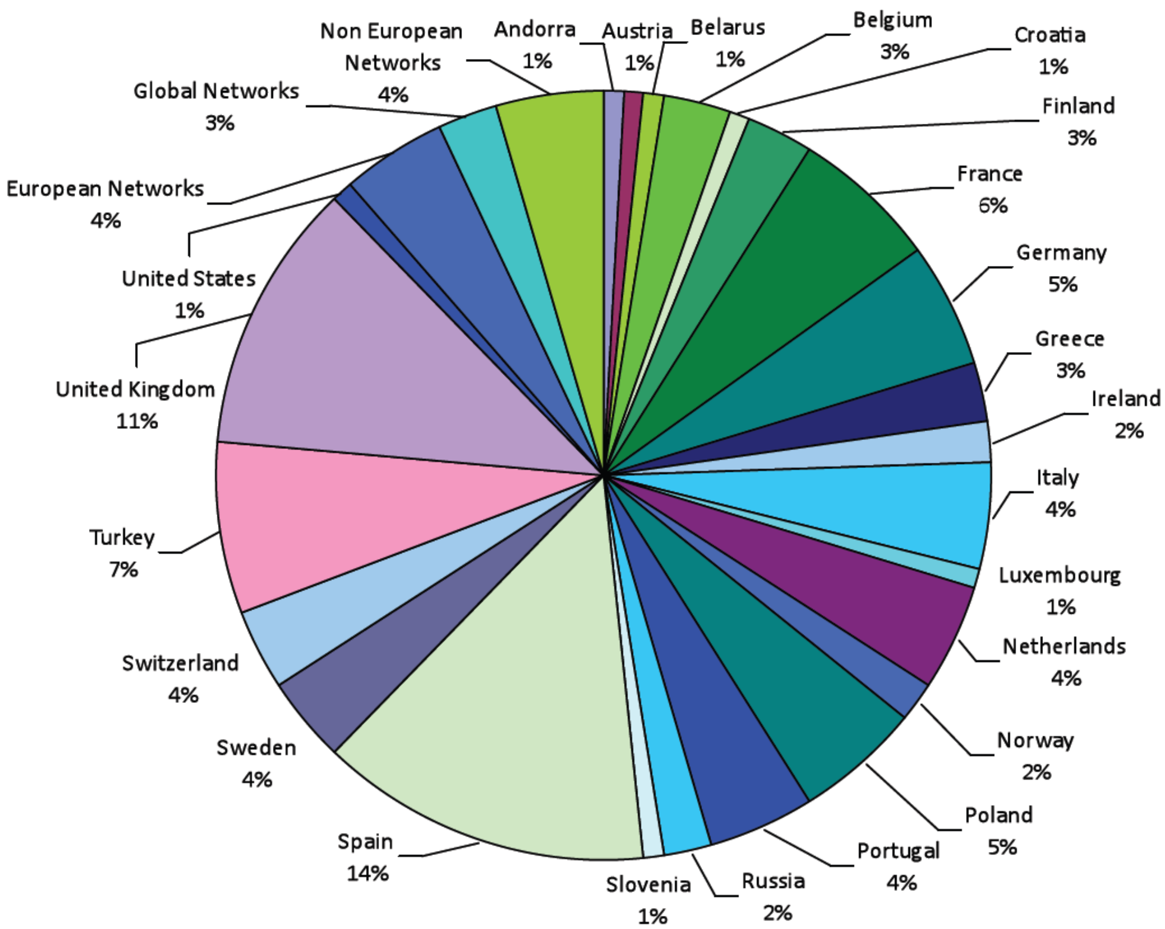
The approach, briefly presented above, to start with a national pilot project with the potential to have a pan-European rollout later-on, provides an innovative tool to facilitate the development of this important market segment and to reduce the market gap by stimulating Business Angel activities.

ANNEX

Annex 1: European Business Angel Network (EBAN)[17]

As of April 15, 2011, EBAN had 114 members from 27 countries, out of which 60 are BA networks and early stage funds, 16 federations of BA networks, 29 (including 9 reciprocal memberships) associated organisations and 9 affiliated members (individual angels). EBAN has members in 18 countries out of the 27 EU member states. The other countries represented in EBAN are part of geographic Europe but not the EU and/or countries outside Europe.

The country breakdown for EBAN's European based members is as follows:



[17] Source: EBAN (2011).

Annex 2: List of acronyms

- BA: Business Angel
- BAN: Business Angel Network
- BAND: Business Angels Netzwerk Deutschland
- BGB: Bundesgesetzbuch
- CEE: Central and Eastern Europe
- CEO: Chief Executive Officer
- EBAN: European Business Angel Network
- EC: European Commission
- ECB: European Central Bank
- ECF: European Co-investment Facility
- EIB: European Investment Bank
- EIF: European Investment Fund
- EU: European Union
- EVCA: European Private Equity & Venture Capital Association
- GDP: Gross Domestic Product
- IFI: International Financial Institution
- IMF: International Monetary Fund
- IPO: Initial public offering
- IRR: Internal Rate of Return
- LP: Limited Partner
- M&A: Mergers and acquisitions
- MD: Managing Director
- OECD: Organisation for Economic Co-Operation and Development
- PE: Private Equity
- SMEs: Small and medium sized enterprises
- VC: Venture Capital
- VCs: Venture Capitalists

References

- BAND (2010). Typology. http://www.business-angels.de/default.aspx/G/111327/L/1031/R/-1/T/130358/A/1/ID/130360.
- BAND, RWTH, VDI nachrichten, and WHU Vallendar (2011). Business Angels Panel 2/2011. See: http://www.vdi-nachrichten.com/aktuell/technikundfinanzen/redaktion_00000159/ ba-panel/cache.aspx.
- Bomholt, J. (2006). Business Angel Investment Portfolios. Eine empirische Studie des Erfolges von Business Angel Investments aus Sicht aktiver Privatinvestoren im deutschsprachigen Raum. Difo-Druck, Bamberg. 2006.
- Bosma, N. and Levie, J. (2010). Global Entrepreneurship Monitor 2009. (See i.e. chapter5.1 on Informal Investment).
- BVK (2010). BVK Statistik. Der deutsche Beteiligungsmarkt im 3. Quartal 2010, 11.11.2010.
- EBAN (2006). Business Angels. Summary brief on private informal venture capital players. 2006.
- EBAN (2010a). Activity report 2009.
- EBAN (2010b). Early stage investing: An asset class in support of the EU strategy for growth and jobs. White Paper. October 2010.
- EBAN (2010c). Statistics compendium 2010. Brussels. December 2010.
- EBAN (2011a). Activity report 2010.
- EBAN (2011b). European early stage impact investing. EBAN White Paper. June 2011.
- European Commission (2002). Benchmarking Business Angels.
- Fryges, H., Gottschalk, S., Licht, G. and Müller, K. (2007). Hightech-Gründungen und Business Angels. Final Report for the German Ministry of Economics and Technology. October 2007.
- Harrer, S. (2010a). Gegen die USA sind wir ein Entwicklungsland. Interview mit Business Angel Peter Jungen. In: *Venture Capital Magazin*. Special. July 2010.
- Harrer, S. (2010b). Wer sind die Engel mit dem Kapital? Merkmale und Klassifizierung von Business Angels. In: *Venture Capital Magazin*. Special. July 2010.
- Kelly, R. and Kraemer-Eis, H. (2011). European Small Business Finance Outlook. *EIF Working Paper 2011/10*. June 2011.
- KfW (2008). Der informelle Beteiligungsmarkt in Deutschland. *WirtschaftsObserver online Nr. 41*. Nov-2008.
- KfW (2010). Beteiligungsmarkt nach der Krise: Optimistischer Ausblick aber Angebotslücke beim Wachstumkapital wird grösser.
- KfW (2011). Business Angels aus der Sicht von Venture Capital-Gesellschaften. *KfW Research. Akzente Nr. 49*. August 2011.
- Kirchhof, R. and Günther, U. (2005). Business Angels-Netzwerke: Bunt und vielfältig. In: *Venture Capital Magazin* 4/2005.
- Mason, C. (2008). The real Venture Capitalists: a review of research on Business Angels. September 2008.

- Mason, C. and Harrison, R. (2002). Is it worth it? The rates of return from informal venture capital investments. *Journal of Business Venturing, 17*.
- Mason, C. and Harrison, R. (2008). Developing time series data on the size and scope of the UK Business Angel market. Report for BERR.
- OECD (2006). The SME Financing Gap (Vol. 1): Theory and evidence. 2006.
- Politis, D. and Gabrielsson, J. (2006a). Informal investors and value added: The contribution of investors' experientially acquired resources in the entrepreneurial process. *Circle Paper no. 2006/12*.
- Politis, D. and Gabrielsson, J. (2006b). Informal investors and value added: what do we know and where do we go? *Circle Paper no. 2006/13*.
- Smith, D. J., Mason, C.M. and Harrison, R.T. (2010). Angel investment decision making as a learning process. Working Paper 10-05. Hunter Center for Entrepreneurship. University of Strathclyde. November 2010.
- Sohl, J. (2011). The angel investor market in 2010: a market on the rebound. Center for Venture Research. University of New Hampshire. April 2011.
- Stedler, H. and Peters, H. (2002). Forschungsprojekt Business Angels im Auftrag der tbg Technologie-Beteiligungs-Gesellschaft mbH der Deutschen Ausgleichsbank. Fachhochschule Hannover.
- Wallisch, M. (2009). Der informelle Beteiligungsmarkt in Deutschland. Rahmenbedingungen, Netzwerke und räumliche Investitionsmuster. München, 2009.
- Wetzel, W. E. (1983) Angels and Informal Risk Capital, Sloan Management Review 24(4).
- Wiltbank, R. E. (2009) Siding with the Angels. NESTA Research Report.

About …

… the European Investment Fund

The European Investment Fund (EIF) is the European body specialised in small and medium sized enterprise (SME) risk financing. The EIF is part of the European Investment Bank group and has a unique combination of public and private shareholders. It is owned by the EIB (61.2%), the European Union - through the European Commission (30%) and a number (28 from 16 countries) of public and private financial institutions (8.8%).

The EIF supports high growth innovative SMEs by means of equity (venture capital and private equity) and guarantees instruments through a diverse array of financial institutions using either its own funds, or those available through mandates given by EIB (the Risk Capital Mandate or RCM), the EU (the Competitiveness and Innovation Framework Programme or CIP), Member States or other third parties.

Complementing the EIB product offering, the EIF has a crucial role to play throughout the value chain of enterprise creation, from the early stages of intellectual property development and licensing to mid and later stage SMEs.

End 2010, EIF had invested in some 350 venture capital and growth funds with net commitments of over EUR 5.4bn. At end 2010, the EIF net guarantee portfolio amounted to over EUR 14.7bn in some 190 operations.

The EIF fosters EU objectives in support of innovation, research and regional development, entrepreneurship, growth, and job creation.

… EIF's Research & Market Analysis

Research & Market Analysis (RMA) supports EIF's strategic decision-making, product development and mandate management processes through applied research and market analyses. RMA works as internal advisor, participates in international fora and maintains liaison with many organisations and institutions.

… this Working Paper series

The EIF Working Papers are designed to make available to a wider readership selected topics and studies in relation to EIF´s business. The Working Papers are edited by EIF´s Research & Market Analysis and are typically authored or co-authored by EIF staff. The Working Papers are usually available only in English and distributed only in electronic form (pdf).

EIF Working Papers

2009/001 *Microfinance in Europe – A market overview*.
November 2009.

2009/002 *Financing Technology Transfer*.
December 2009.

2010/003 *Private Equity Market in Europe – Rise of a new cycle or tail of the recession?*
February 2010.

2010/004 *Private Equity and Venture Capital Indicators – A research of EU-27 Private Equity and Venture Capital Markets*. April 2010.

2010/005 *Private Equity Market Outlook.*
May 2010.

2010/006 *Drivers of Private Equity Investment activity. Are Buyout and Venture investors really so different?* August 2010

2010/007 *SME Loan Securitisation – an important tool to support European SME lending.*
October 2010.

2010/008 *Impact of Legislation on Credit Risk – How different are the U.K. and Germany?*
November 2010.

2011/009 *The performance and prospects of European Venture Capital.*
May 2011.

2011/010 *European Small Business Finance Outlook. 1/2011.*
June 2011.

2011/011 *Business Angels in Germany. EIF's initiative to support the non-institutional financing market.* November 2011.