NETWORK EVOLUTION AND THE CHANGING NATURE OF BUSINESS ANGEL INVESTING IN THE UK: EVIDENCE FROM SCOTLAND

Principal Topic

The financing of growing businesses has typically been conceptualised as a funding escalator, with each stage in company growth associated with a particular source of finance, a pattern typical of the predictions of the pecking order hypothesis: entrepreneurs will be driven by information asymmetries and transaction costs to use internally generated capital before turning to more expensive sources of financing. Once these internal sources are used, firms will turn to debt finance (where the information asymmetry problem is less severe) and then to external equity. In other words, businesses initially get started on the basis of the funding of the founder/founding team and their family and friends (the "3Fs") and then access business angels, venture capital and public markets in order to finance their growth.

However, this funding escalator does not function equally effectively over all geographies, and there has been a marked geographical centralisation in the location of both the supply of and the investment of institutional venture capital and private equity. In this paper we argue that a key section of the market – business angel finance – is changing, from a market characterised by individual investors and largely informal and invisible investment groups to one increasingly defined by formalised groups, syndicates and networks which channel and consolidate investment finance from individual investors to entrepreneurial ventures. This evolution is patchy geographically: at the macro scale it is much more evident in the USA than in Europe; at the regional scale, within Europe the process has proceeded furthest in Scotland, which, if it was a US state, would be the 11th largest in terms of angel group investment activity.

Method/Approach

We review the reasons for the emergence of angel groups, in terms of the information economics of increasing potential investment deal flow, the credibility signalling benefits of increased visibility of a group vis a vis individual investors, and the opportunity for investors to reduce investment risk and adverse selection issues through knowledge sharing and co-investing. Scotland provides a valuable case study to examine this evolution in the market: first, the number of identifiable networks and syndicates has grown from 2 to over 20 between 2001 and 2012, the most radical shift in market organisation of any region in Europe; second, the original business angel network, LINC Scotland, has evolved from a traditional information sharing introduction service to a network catalyst and development role (partly in response to a progressive reduction in public funding for its original role), supporting the emergence of most of the new networks to be formed over the decade; and third, Scotland has been the locus of a number of policy evolutions designed to stimulate the evolution of the risk capital market, notably a business-angel oriented co-investment fund that would not have been possible without this network evolution.

We present detailed data on the impact of these investor groups on the supply of risk capital at two levels. First, using data from LINC Scotland and the annual surveys of business angel investing in the UK commissioned by the Department of Business Innovation and Skills we will profile the key features of the market in terms of the volume of investment (number and size of deals, including relevant VC comparisons), deal size and co-investment patterns (with other angel investors and with VC investors), the profile of investee companies (stage of development, size, sector, sub-regional distribution in Scotland, where there are longstanding concerns that there is a distinct west-east imbalance in the flows of risk capital that mirrors the wider north-south split in the UK as a whole). Second, we provide data from a 2 year study of the investment practices and outcomes of one specific business angel syndicate, which has over 100 investor members, over 30 active investments and a 10 year plus record of investment, to illuminate the ay in which the angel market has changed and become more formalised in Scotland.

Results/Implications

We conclude the paper by arguing that in terms of the escalator model, angel funding was traditionally the second step after friends and family and before VC. Largely because of changes in the VC market the angel role has enlarged, covering more steps on the escalator. They have only been able to do this by coming together as angel groups, providing deeper pockets, facilitating bigger deals and more funding rounds, and increasingly taking firms to exit themselves. The Scottish case demonstrates that angel groups are a vital partner of government which favours co-investment as the most appropriate means of intervention, From a supply side, angels play a critical role. Without them many companies would not have got started, or run out of money and failed, or simply not grown. However, the Scottish evidence also suggests that they still have a limited economic impact: there have been few exits, either by M&A or IPO. This may be because of a lack of sufficiently good investments, which are too small and needed more capital, or it might reflect poor investor deal selection. In short, despite the significant evolution of the angel market in Scotland in terms of scale, formalization and visibility, the experience of Scotland suggests the limitations of (enforced) reliance on angel investors in stimulating entrepreneur-led economic development. The paper will conclude by drawing out some of the implications for a regional entrepreneurial risk capital investment policy.