Chapter 6. Business Angels and Venture Capital

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Abstract

Among the many formulas that exist for financing a business project, two of the most widely used by entrepreneurs today are business angels (BA) and venture capital (VC). This chapter sheds light on the interaction between these sources of funding. Both financing options played an essential role for the growth of start-ups even before the financial crisis. In particular, the main goal of this chapter is to provide the reader with an accurate understanding of both sources of financing before making an investment decision. The chapter shows the concept, operations and growth expectations of BA and VC, and a subsequent comparison between the two methods. Overall, this chapter provides a more fine-grained understanding of the role that BA and VC investors can play in the process of creating new ventures. As the main takeaways of this chapter, it is expected that entrepreneurs will learn to successfully find the financing formula that best suits the characteristics and urgencies of their project and that, in this way, their company will develop or continue to grow.

Keywords: business angels, venture capital, entrepreneurship

1. Introduction

Access to finance is one of the main concerns of entrepreneurs since many innovative and growth-oriented companies are unable to access financing and their own resources are not enough to develop the business ideas (Sendra-Pons et al., 2022). Fortunately, access to finance has evolved considerably since the financial crisis of 2008, private equity (PE) being one of the most important pillars of entrepreneurial finance, becoming an important source of funding in recent years (Block, Fisch, Vismara and Andres, 2019). In contrast to stock markets or debtholders, PE investors are active investors who provide their portfolio companies with bundles of value-added activities. The benefits can be direct, such as through coaching activities or network access, and indirect through certification effects to third parties (e.g., customers, skilled workers, alliance partners, and financial intermediaries).

Within PE financing, two of the possible options are those from business angels (BA) and venture capital (VC). BA are wealthy individuals that invest their own money while VC investors invest in entrepreneurial finance. Both options played an essential role for the growth of start-ups even before the financial crisis (Kelly, 2007; Mason, 2006). This chapter is oriented towards better understanding sources of PE financing and to comprehensively understand their differences from the perspective of entrepreneurs.

Defining the concept of BA should take into account the development of this source of financing since its inception. The European Commission (2016) defines a BA as a private individual who directly invests part of their assets in new and growing private businesses, in which there is no family link and who, after making the investment, generally takes an active participation in business, for example, as a member of the board of directors. This informal investor is often characterized by high net worth and usually a considerable business experience. They can invest individually or as part of a syndicate in which an angel usually takes the leading role. BA usually possess deep knowledge of the sector in which they invest to provide the maximum possible added value to favour the growth of the company. BA not only contribute with capital but also with know-how and personal contacts (smart capital). Yet the volume of investment is notably lower in relation to that from VC. BA are usually focused on companies in which a rapid growth is expected and a quick and high return rate which, is the ultimate objective of these investors. It is convenient to differentiate BA from those investors with a strong personal relationship with the entrepreneur (so-called FFF (family, friends or fools), since their expectations of obtaining profits are lower due to their unconditional support of the entrepreneur.

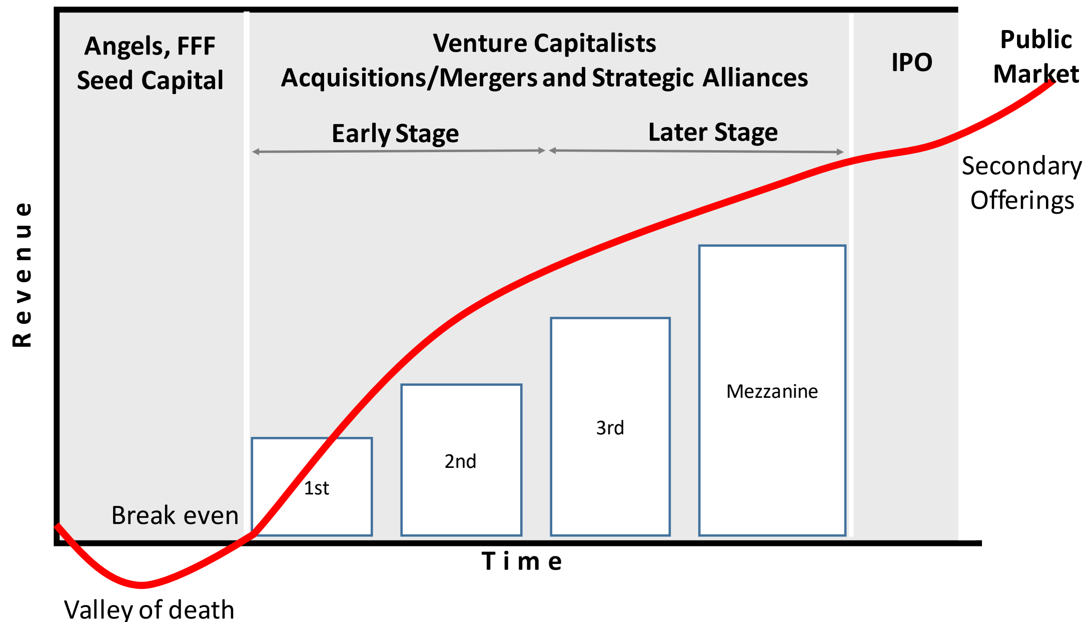
With regard to individual characteristics, BA are usually older than investment professionals and more often have entrepreneurial experience (Collewaert and Manigart, 2016). Often, previous entrepreneurial activities are one of the sources of BA funds. Some BA are well-known business personalities, such as Jeff Bezos (Domo and Everfi), Paul Graham (Watsi and ClassDojo), and David Lee (DoorDash and Judicata). Yet, most BA used to be anonymous angel investors who usually act in certain specific entrepreneurship ecosystems.

Related to VC, the Regulation on European Venture (EUVeCa) (European Commission, 2013) defines VC as a method of financing private capital and providing advice to small companies. The monetary contribution of VC investors comes from funds known as OPM (Other People's Money), that is, from people who entrust their resources to these companies. As previously stated, VC investment is not merely a monetary injection of capital, since VC funds provide companies with valuable experience and knowledge, business contacts, brand value and strategic advice. If the successful growth of the start-up occurs, the VC entity usually divests with the aim of obtaining a capital gain as a result.

From the offer-side perspective, some of the largest VC companies are Tiger Global Management, New Enterprise Associates and Sequoia Capital. From the demand-side view, the list of companies with considerable success is long and includes Alphabet Inc. (Google), Amazon, Facebook and Twitter already consolidated or others of more recent creation such as Bolt. All of them are clear examples of business ideas that were possible after years of VC funding fuelling user and revenue growth.

One of the most crucial issues in PE is the lifecycle of the entrepreneur. Although there is no universal model that determines the different stages of PE, there is some consensus about the different steps. The process of developing new ventures is included in the model proposed by Ruhnka and Young (1987) where five sequential stages or phases are identified. As shown in Figure 1, these are: 0) Valley of Death; 1) Seed; 2) Start-up; 3) Second stage; 4) Third stage; and 5) Exit stage.

Figure 1. Venture capital's process



Source: Own elaboration based on BGF Insights (2020)

As shown in **Figure 1**, when entrepreneurs start to develop their business idea or a company is at a very early stage, only some financial alternatives are possible: FFF, Seed capital and BA. Specifically, BA help small companies not only through financial support but also by managing and leading the project.

Investing, in the very early stages, involves a comparatively high degree of uncertainty. One way to reduce this uncertainty and to mitigate investment risk is to engage in syndication with multiple other investors. Yet investing in the very early stages can lead to potentially large payoffs since, as reported by Block et al. (2019) in their empirical study, BA achieved a significantly higher share of investments with cash-on-cash multiples larger than factor 10.

Despite the importance of the investment selection, only a few studies have yet assessed how BA investors actually select their investments and conduct investment decisions (Block et al., 2019). Overall, the BA investment criteria are international scalability, the innovative business model and the experience and background of the entrepreneurial team.

Phase 0: **Seed Stage**

The funding needed to validate the business idea occurs at the seed stage. At this stage, it is likely that the project still does not have any commercially available product. The entrepreneur must show that her/his project will be viable and successful in the market in order to achieve the objective of this stage, to convince potential investors why her/his business idea deserves the support of VC. Before making any decision, potential investors will investigate the economic viability of the project. Once the financing is approved, the funds are usually used for product development and market research. Regarding the financing of this stage, it is usually modest compared to the financing of later stages.

Phase 1: **Start-up Stage**

In the start-up stage, projects seek to begin marketing and advertising campaigns to start acquiring customers once the initial market analysis has been completed and business plans established. At this stage, start-ups are expected to already have a sample product available (Minimum Viable Product (MVP), and once tested, there is a need of funding for further product development.

VC funding at this stage could also include investing funds towards acquiring additional management staff, refining the product/service, or conducting additional research, such as having investors come up with a realistic forecast of the investment needed to propel the company into the next stage.

Phase 2: **Second Stage**

The second stage, also called the early stage, is characterized by the fact that the start-up has already developed and sells its product/service in the market, hoping to reach a wider audience in order to achieve positive profitability. Investors at this stage can really check the viability of the business project based on financial information. PE funds received at this stage are typically used for additional expansion projects. The volume invested by PE at this stage can be significantly higher than in previous stages.

Phase 3: **Third Stage**

In the third stage, also known as the expansion stage, the start-up must obtain significant volume of income. VC investors will expect entrepreneurs to reduce costs in this phase and analyse how the start-up stands against competitors. The funding is used to scale the

business and expand market share by expanding into additional markets and diversifying and differentiating product lines.

***Phase 4:* Output Stage**

The exit stage, also called the Mezzanine stage or pre-IPO (Initial Public Offering), is the last stage of the VC financing process. At this stage, the company is ready to go for an IPO. In this way, investors hope to sell their shares and end their commitment to the start-up, having achieved a significant capital gain. Funds received at this stage are used for various projects, such as merging or acquiring other companies, implementing strategies (for example, lowering prices) to eliminate competitors, or financing the process towards an IPO.

As is shown in the next sections, Stage 0 is related to BA and the others stages to VC. In the following sections, the differences between BA and VC are pointed out and, finally, a series of conclusions are established.

2. Business Angels

2.1. Introduction to Business Angels: Concept and Process

There is no consensus to determine the process followed by Business Angels (BA) investments. Many authors have designed different approaches to the stages of the BA investment process, however the most widespread and accepted is the one proposed by Paul et al. (2007). This framework consists of five stages: familiarization, screening, bargaining, managing and harvesting.

The first stage, familiarization, tries to introduce the BA to the entrepreneurs and their business idea. In the next stage, screening, the pre-investment activities take place where the investors exhaustively analyse the business plan where both hard and soft data about the entrepreneurs' project are considered. The most analysed sections are marketing and financing aspects. This stage starts with an initial selection during different meetings with the entrepreneur as informal investors attempt to confirm their first impressions and delve deeper into the business opportunity. Once the decision to invest is made, the bargaining stage arrives, where the value of the financial investment is decided and it is determined what the investor will receive according to the different levels of investment made. The form and time in which the investment funds will be made available are also determined at this stage. The result of this process is a formal contract between the entrepreneurs and the BA that establishes the details of the agreement reached. After the investment, the next stage begins, managing, where investors begin to play an active practical role in the businesses in which they invest. This means that the angels must restrict the number of businesses in which they invest, since not only the general level of funds but also the time available are limiting factors. Finally, the harvesting stage is reached when the investors decide to divest themselves of their participation in the company with a commercial sale or with an IPO or a buyback by the management. As for the exit terms, these different options may vary, although in general BA want to hold on to their investment at least as long as necessary to maximize the tax advantages.

2.2. Evolution and Expectations of Business Angels

Determining the evolution and future trend of BA is complicated due to the difficulty in obtaining data on their activity due to the discretion and anonymity that characterizes this type of investor. Even so, in several countries there are BA associations that, in addition to monitoring and advising on this type of investment, provide information on the most significant data. We should bear in mind that BA play an important role in the economy, as in many countries they are the second largest source of external funding for start-ups, after FFF. They are increasingly important as providers of PE and contributors to economic growth and technological advances. In this way, given its importance, there is also a network at a European level, the European Business Angels Network (EBAN), the annual report of which, ENAB Statistics Compendium 2021 European Early Stage Market Statistics, is an important source of information.

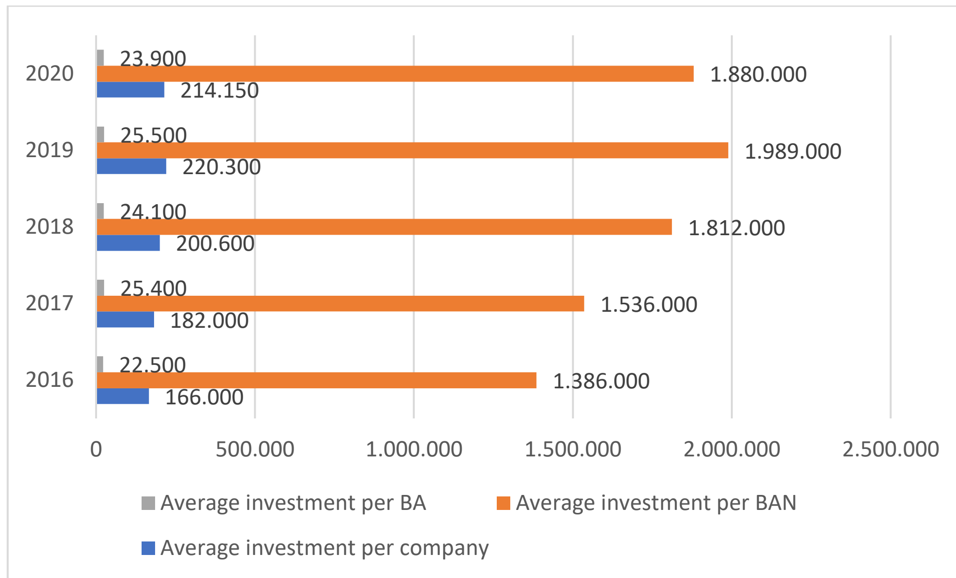
Total early-stage investment in the European market is valued at €13.21 billion. The BA represent the largest part (58%) of the total private investment in the initial stage, reaching an estimated annual investment of 7,670 million euros. They are followed in the initial stage, with 4.6 billion euros of financing provided by the VC (35%), while the equity crowdfunding market barely reaches 7% of the total market (940 million euros).

In European countries, there has been a decrease of -4.5% of the investments made in the BA market. It has decreased from €804 million in 2019 to €767 million in 2020. Like the financing rounds in which the BA participated, they decreased by 0.5%, with around 3,500 financing rounds of initial investments and of follow-on investments made in European-based start-ups. On the other hand, the BA networks have risen (1%), reaching more than 400 different networks. It turns out that there are approximately 32,200 active BA investors on the European continent who invest mainly through a local investment network or club.

The level of economic investment made by BA is diverse. On average, close to 30% (compared to 27% in 2019) of all the investments made were in rounds equal to or less than 100,000 euros. Approximately 45.25% were in rounds between €0.1–0.5 million (compared to 50% in 2019). The rounds in which the BA invested between 0.5 and 1 million euros were 13.8% (compared to 13% in 2019) and 11% were already in rounds greater than 1 million euros (compared to 10% in 2019).

Since more investments under €100,000 were made across Europe in 2020 compared to 2019, both the average amount invested by BA per company decreased from 2019 to 2020 by -2.8% (€214,150) and the average amount invested by BA within each financing round decreased 'slightly by -0.64% from 2019 to 2020 (€23,900). The European Business Angel networks (BANs) also invested slightly lower amounts on average during 2020, a total of €1,880,000, where Denmark, with only one operating BA, continues to lead, followed by Finland and Belgium. Although there is no evidence, it is possible that the effects of COVID-19 could be a reason for this change of trend of BA and VC investment during 2020.

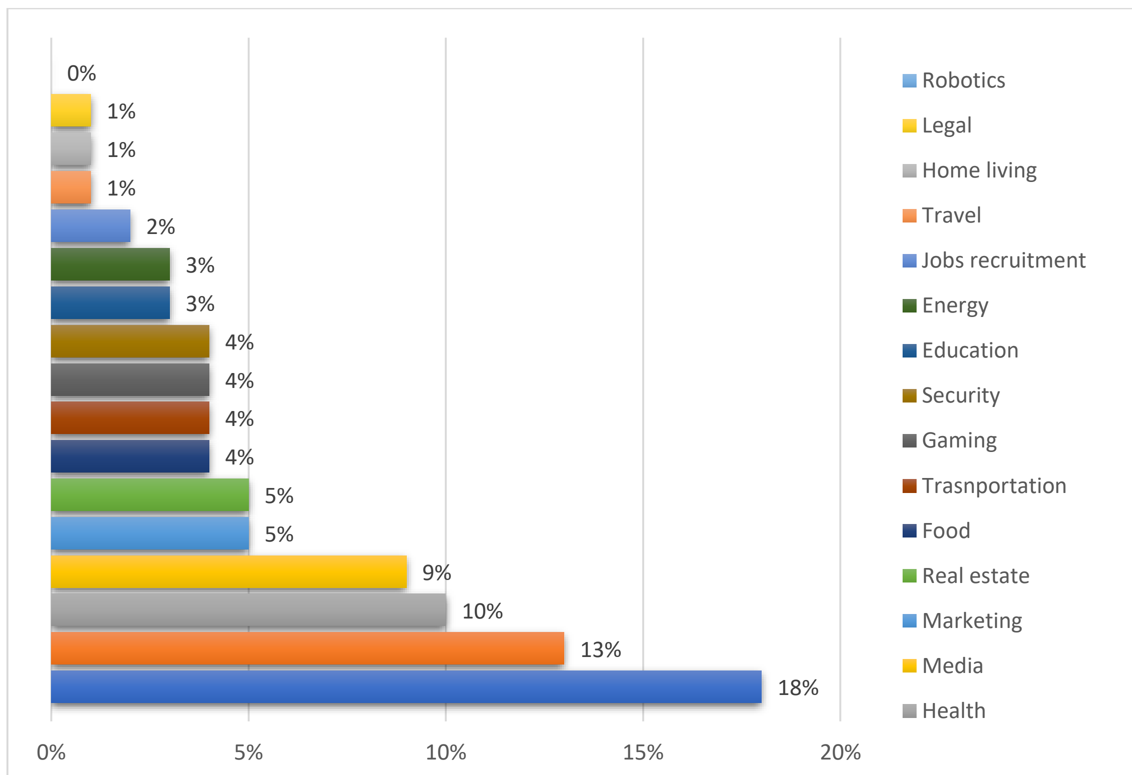
Figure 2. Average investments 2016–2020, in €; visible market statistics



Source: Own elaboration based on European Business Angels Network (2021)

Regarding the sectors that receive the largest amount of total euros in investment, they have varied. The Fintech sector (18%) is positioned as the sector that has received the most investment in 2020, surpassing the main sector of 2019, Enterprise Software (13%). In addition, the Fintech sector is also positioned as the leading sector in terms of total rounds of investments made. The health (10%), media (9%) and marketing (5%) sectors had strong growth in the total amount of investments made during 2020.

Figure 3. Sectors of early-stage investment in Europe, percentages of the total amount invested, 2020



Source: Own elaboration based on European Business Angels Network (2021)

Additionally, an archetype of the informal investor by Morales-Alonso et al. (2020) shows that BA tend to be men in their 40s, with university studies in business administration or economics, who are characterized by making only one investment, especially in the ICT sector, and who start this investment when they have already had their own business adventure and have professional experience for more than 15 years. Other data to highlight is that the participation of women seems to continue to be low and when the BA is a younger investor, they tend to select new ventures to join the financial market as financiers.

3. Venture Capital

3.1. Introduction to Venture Capital: Concept and Process

VC, as we consider it nowadays, is a relatively recent "phenomenon" which emerged in the U.S. following the end of the Second World War. After initial uncertainty, the VC industry rapidly evolved toward a consolidated organizational model (Grilli et al., 2018). VC investments are usually structured through funds with a finite life of around 8 to 10 years. In the first year, VC usually commit a certain amount of money to the fund that will be required at a later stage as investments are performed.

Despite globalization and diffusion of technologies that allow access to remote markets, VC can still very much be considered a local and geographically-bounded market (Bruton et al., 2005).

The VC industry has shrunk and moved toward later-stage investment, as VCs have lost a substantial portion of their business – particularly early-stage financing – to newly emerging financing platforms such as angel groups, business accelerators, micro VC funds, and online platforms (Shane and Nicolaou, 2017). According to Bonini and Capizzi (2019), Harrison and Mason (2019) and Shane and Nicolaou (2017), the reasons for this market institutional change are: (i) traditional VCs handle too much money in too few investments, as transaction costs are very high and the labor involved in deal finalization is intense; (ii) the newly emerging platforms and software-based companies are much better suited to making investments in many early-stage companies with smaller investments; (iii) BA investors are less concentrated geographically and BA investments are generally smaller; and (iv) there have been both advances in digital practices, such as cheaper software, and a significant growth in online networking platforms.

3.2. Evolution and Expectations of Venture Capital Investments

In the current context of global uncertainty, after it would seem that pre-COVID-19 pandemic normality was recovering, we find ourselves in a situation of instability caused by the Russian invasion of Ukraine and the increase of inflation rates across Europe.

Despite these events hitting Europe and sapping investor sentiment, VC investment in Europe has been incredibly strong in the first quarter of 2022, achieving the second-highest registered count of VC invested in a single quarter, in contrast with the evolution in the US and Asia where this source of financing has decreased. All these data and those that are presented below to glimpse the evolution and expectations of VC, are collected

in two reports: KPMG's Venture Pulse Q1 2022 Report and PitchBook's Q1 2022 European Venture Report.

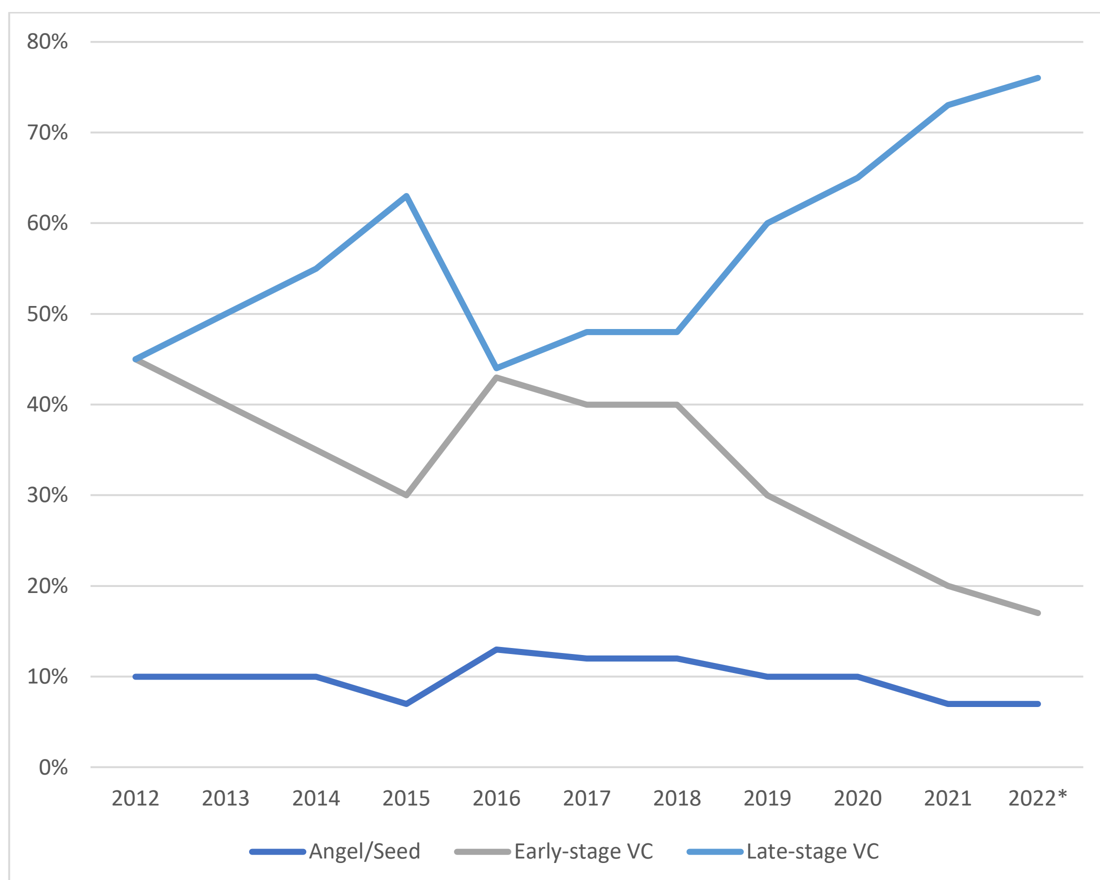
Currently, the VC investment trends that dominate in Europe and that will probably continue in the future are:

1- *European VC deals on a similar pace to 2021*: during 2021 there was a considerable increase reaching 105,800 million euros in 11,066 deals, the year 2021 being when more injection was produced through this source of financing. Similar figures are expected to be reached in 2022, although more capital is being raised through less VC funding.

2- *The main sector receiving VC funds is software*: Software companies receive large investments, since software is present throughout the information technology ecosystem, and therefore in our daily lives and businesses. The biotechnology sector is expected to reach significant investments in the near future.

3- *Late-stage capital dominates Europe VC*: Figure 3 shows the confidence that European investors have with the maturity processes, since 71% of the total amount invested is in the late-stage.

Figure 3. Share of VC deal value by stage

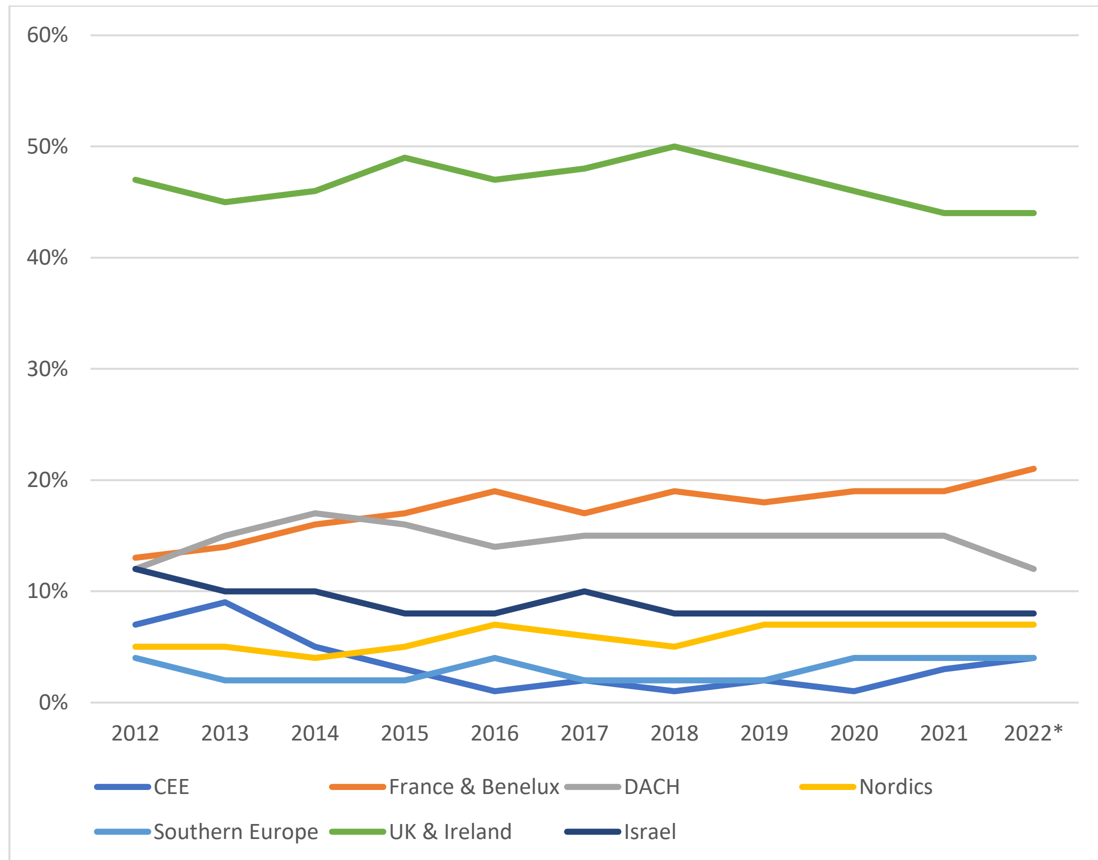


Source: Own elaboration based on PitchBook (2022)

4- *United Kingdom and Ireland are the leading countries*: The UK and Ireland represented 30.55% of the total CV invested in Europe. The UK hit a new VC investment high on Checkout.com's massive rounds ($1bn). Germany (DACH) continues with a

solid situation and France is positioned as the country with the largest rounds of financing, while the countries of southern Europe hardly exceed 5% of the total capital invested in the first quarter and those of Central and Eastern Europe (CEE) represented less than 5%. CEE countries are presented with a complicated scenario with the injection of VC due to the ongoing political turmoil with Russia.

Figure 4. The main countries in VC investment



Source: Own elaboration based on PitchBook (2022)

5- *Technology applied to the environment and finance are the hottest areas of VC investment*: ESG and climate tech are well positioned for growth in VC investment. Fintech and e-commerce dominate the top 10 funding rounds in Europe.

When investing, VC must take into account the profile of the entrepreneur to facilitate the choice of funds to which proposals are submitted by various entrepreneurs. To form the profile of entrepreneurs that VC can invest in, Santillán Salgado et al. (2015) indicate that honesty, knowledge of the sector, physical and mental health, and teamwork are significant characteristics worthy of attention when investing. Other characteristics such as the independence of the entrepreneur, her/his resume, and the compatibility with the fund are also very important, but with less specific weight compared to the first four characteristics.

4. Differences between Business Angels and Venture Capital: Who Is Who?

Once the concepts of VC and BA have been explained, it is necessary to compare the two types of financing to further know what type of financing the entrepreneur may be interested in based on these various characteristics. Both forms of financing present similar aspects although they have significant differences that separate them. In addition, advantages and disadvantages for entrepreneurs are also stated.

As previously stated, a BA is a person (or group of people) who contribute their own financial amount in new entrepreneurial projects and VC financing is managed by an organization that transacts the money of limited partners. The main function of this organization is to invest in various projects of existing entities that are at the expansion stage.

Normally, BA invest in projects in which they have experience. They seek to finance nearby companies and sectors with low volatility while VC tend to invest without giving so much importance to geographical location and choosing sectors with great growth potential, with large foreign markets and innovation, such as technology, communication, biotechnology sectors. Nonetheless, VC organizations tend to invest in conservative projects and remain attached to the chosen project for a long horizon of time; for instance, until the company achieves the desired sale or IPO (Dutta and Folta, 2016).

Before investing in a new project, the BA assesses the business plan and analyzes the rates of return on investment (ROI). The agreements are smaller and more informal than in VC since the BA are based on their intuition when choosing a project (Bessière et al., 2020). However, the requirements are strict and demanding in compliance with the plans presented. BA take an extremely high risk due to the insecurity and instability of the initial stage of the enterprise. In return, they expect to receive a high profit when the company starts billing (Capizzi et al., 2022).

In the relationship between entrepreneur and investor, the BA brings advice, business experience, knowledge in the sector, trust and a network of business and personal contacts. VC organizations offer advice as well as a network of business and personal contacts to entrepreneurs. They also stimulate the prestige and credibility of the new projects.

The BA and VC companies will be connected with the enterprise for a long period of time and sometimes demand control of the business by the founder. The process to obtain financing VC is complex because it requires more of a legal and accounting background and requires auditing of the company in which to make the investment. In addition, sometimes VC also requires membership of the Board of Directors, the right to vote and involvement in decision-making, to control the evolution of the company. The risk, return and profitability of the project should be high in exchange for VC participation.

Finally, BA may not have an exit strategy for withdrawal of investment since they are based on intuitions, enthusiasm for the project and previous experiences. Regarding the investment output of VC, it is important to have a clear exit strategy to be able to withdraw the money and report the profits to the VC shareholders.

In conclusion, BA is a financing option in the first round and VC in the second round, where the amount of resources to be raised is higher. Depending on the stage the business has reached, the entrepreneur must choose between these two options. Entrepreneurs willing to accept financing from BA will be open to attracting other types of external financing, such as VC (Elitzur and Gavious, 2003). However, Bonini and Capizzi (2019) pointed out that companies that receive capital from BA in the initial stage and surviving companies usually access financing from VC in the later stages. Hence, other studies have revealed a negative relationship between BA and VC; these types of financing can act as dynamic substitutes (Cumming and Zhang, 2019; Hellman, Schure and Vo, 2019). Consequently, the entrepreneur should address the requirements, demands and problems arising from the chosen external financing. Table 1 presents a summary of all the characteristics of BA and VC.

Table 1. Comparison between VC and BA financing

INVESTOR TYPE	BUSINESS ANGELS	VENTURE CAPITAL
FORM	A private investor or group of investors	An organization
INVESTMENT SOURCE	Own capital	Other People's Money (OPM)
WAY OF INVESTING	Equity in projects, in which they have experience	External means of financing in various projects
INVESTMENT STAGE	Early stage	Mostly later stage
INVESTMENT HORIZON	Long term	Long term
PROCESS/METHOD TO GET FUNDING	Minor	Higher. More complex
INVOLVEMENT OF INVESTORS	They may have another occupation (entrepreneur, businessman, etc.)	Main function
WHAT DOES IT OFFER?	Advice, business experience, knowledge in the sector, trust and a network of business and personal contacts	Advice, network of business and personal contacts, prestige and credibility
CONTROL OVER THE BUSINESS	Demand control of the business by the founder	Demand control of the business
MANAGEMENT TEAM	Complete with good learning of a sector	Not know the sector

AGREEMENTS	Less formalized than professional investors	Complex contracts
INVESTMENT RETURN	Lower required return than financing entities	High return on investment. High profit
INVESTMENT RISK	Extremely high due to initial stage uncertainty	High level of risk
APPROACH TO RISK	Acceptance of higher level of risk than venture funds	Conservative
REQUIREMENTS	Strict and demanding in compliance with the plans presented	It does not require endorsement from entrepreneurs
DERIVED PROBLEMS	Financing can be insufficient. Investor brings more problems than solutions to the company	Combination of entrepreneurs who inflate their income statements and investors who are looking for bargains
INVESTMENT SCOPE/LOCATION	Companies that are relatively close and usually invest in companies from their own country	They tend to invest without giving so much importance to geographical location and tend to invest globally
SECTORS OF THE COMPANY	All sectors. Especially the less volatile sectors of the economy	Sectors with great growth potential, with large foreign markets and technology
INVESTMENT OUTPUT/EXIT STRATEGY	Often in unplanned way. Less important	Planned. Very important

Source: Own elaboration based on previous articles, such as Avdeitchikova et al. (2008), Brzozowska (2008) and Clerq et al. (2008)

5. Conclusions

Entrepreneurs cannot focus only on developing a revolutionary idea that brings value and develops a realistic and quality business project. Attracting the capital needed for the start-up to work is a complicated task and requires a lot of effort. Before starting to search for financing, entrepreneurs must perform a preliminary analysis to determine the optimal amount of money and the type of financing according to their needs. It is also very important to know the types of financing and investors, since not all investors are equal and do not expect the same from entrepreneurs.

This chapter helps entrepreneurs to learn about two types of financing widely used by current entrepreneurs: VC and BA. However, it is important for the entrepreneur to be advised in advance of the most recognized BA or VC companies in her/his country, and specifically, who are the most influential investors in their sector of activity. The psychological profile of investors tends to lead them to invest in projects in the same sector of activity.

Another point to be taken into consideration by the entrepreneur is the need to reach out to VC and BA investors. To avoid unnecessary expenses, entrepreneurs must avoid intermediaries. It is best to contact the investor directly. Obtaining financing from BA and VC is not easy and there is no type of guarantee to access the capital of these investors. To this end, entrepreneurs will have to do a lot of networking at different events attended by these types of investors, such as: forums for the transfer of knowledge from the company to society, events on entrepreneurship, programs and calls related to start-ups and entrepreneurship, assistance to business incubators and coworking spaces or meetings with experts in the sector, among others, which will increase the chances of these investors to decide to bet on the project. Social networks and the digital and print press will also facilitate the connection between investor and entrepreneur, since the interest generated will put the two parties in contact with each other.

Therefore, entrepreneurs need to know the concept, characteristics and growth expectations of VC and BA investors to successfully find the financing necessary for their start-up to be developed or continue to grow.

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