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PUBLIC POLICY SUPPORT FOR THE INFORMAL VENTURE CAPITAL MARKET IN EUROPE: A CRITICAL REVIEW

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ABSTRACT. The ability of small firms to access finance is hindered by persistent market failure which creates funding gaps for new businesses, particularly in technology sectors, seeking small amounts of finance. This has prompted various forms of public sector intervention to increase the supply of both debt and risk finance. For the past decade (longer in the UK) both the EU and Member States have increasingly focused on the informal venture capital market as a means of increasing the supply of early stage venture capital .This paper describes the changing nature of the forms of intervention and provides a critical review of its effectiveness. The lack of data on angel investing means that there is very little evidence on the impact of these forms of intervention. The paper advocates that governments should invest in appropriate methodologies which can accurately measure investment trends in the early stage venture capital market, and specifically angel investment activity, so that the need for public sector intervention can be demonstrated and the impact of such interventions can be measured.

Key words: business angels, business angel networks, investment readiness, co-investment schemes

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1. INTRODUCTION

Addressing the difficulties that small firms encounter in accessing external finance has been a longstanding focus of policy in Europe. Intervention is based on the belief that small firms in general, and technology-based small firms in particular, are a key source of innovation, job creation and productivity growth. However, the ability of small firms to access finance is hindered by persistent market failures which create funding gaps. These funding gaps are greatest for new firms seeking external finance for the first time, for firms seeking small amounts of finance, for technology-based firms and for firms in peripheral regions.

The initial focus of intervention by both the European Union and Member States was on enhancing the availability of loan finance. The focus then broadened to include venture capital, and had widened further since the mid-1990s to encompass support for informal venture capital (i.e. business angels) which has only been recognised relatively recently in Europe as an important part of the entrepreneurial ecosystem and is underdeveloped compared with the USA. There is now a significant literature on policy interventions in the institutional venture capital market at both national and EU scales (e.g. Gompers and Lerner, 2001, ch. 8; Murray, 2007). However, there has been much less discussion of interventions designed to promote informal venture capital investment. The paper starts with a brief overview of the changing nature of government intervention in small firm finance markets. This provide a context for the main aims of the paper which are, first, to explain the rationale for supporting the informal venture capital market; and second, to describe and critically assess the forms of this intervention and how it has this evolved over time.

2. GOVERNMENT INTERVENTION IN THE MARKET FOR SMALL FIRM FINANCE: AN OVERVIEW

The financing constraints experienced by small firms arise from imperfections in capital markets which are conventionally attributed to the existence of information asymmetries. This has two dimensions. First, one party to a transaction is in possession of relevant information that is not known by the other party. Specifically, entrepreneurs possess more information about their own abilities and the prospects of their firm than the provider of finance and may misrepresent this information. This creates the risk of adverse selection by the funder which can only be mitigated by incurring the expense of a lengthy due diligence process to obtain relevant information about the entrepreneur and the business (which because of its private nature may not be available) and interpret it. This is particularly problematic in technology sectors where it is difficult to value the firm's scientific knowledge and intellectual property, the products are likely to be new and untested in the market, and the management may lack commercial skills. Second, one party to a transaction cannot observe relevant actions taken by the other party that might influence the outcome of the investment. Dealing with this problem – moral hazard – is also costly to the investor, requiring complicated contracts that are time consuming to design and negotiate and labour-intensive monitoring systems. Because the costs involved in investment appraisal and monitoring are fixed regardless of the size of investment, this makes small investments uneconomic for funders.

Funders have several potential responses to these problems. They may impose restrictive terms and conditions, require a high return to compensate for the greater costs and higher risks, or may simply be unwilling to make finance available under

any conditions. The outcome is a restriction in the range and availability of finance for particular types of firm, notably new firms, firms seeking small amounts of finance and technology-based firms (Carpentier and Suret, 2006).

Governments initially responded by seeking to address deficiencies in the availability of loan finance through the introduction of loan guarantee schemes (LGS). These schemes are aimed at small firms with viable business propositions but lack the collateral with which to secure a loan. Indeed, the most recent review of the UK LGS concluded that "the principal gap in the UK debt market remains the need for collateral" (Graham, 2004).

One of the limitations of a focus on loan finance is that it does little to address the financing needs of technology-based firms which often require to make significant investment in R&D and product development prior to generating sales. Their need is for access to risk capital. Thus, the focus for government intervention shifted during the 1990s to the provision of venture capital. This intervention is premised on two beliefs. First, venture capital is essential for the emergence and growth of innovative companies, and thereby enhances economic development, wealth creation and job creation (Lerner and Watson, 2008). Second, the early stage venture capital market is characterised by serious and persistent market failures which have limited the supply of finance from the private sector.

Indeed, it has been suggested that specialist early stage venture capital investment may be an activity that cannot be effectively mediated through market mechanisms (Murray, 2007). First, the costs of investment appraisal and monitoring are high and

fixed regardless of the size of investment, hence small investments absorb a level of investor time that is out of proportion with their significance or potential return. These costs are likely to be highest in the case of investments in technology based small firms because of the requirement for more detailed information to understand the technology and markets (Mason and Harrison, 2004a; Murray, 1999). Increasing regulation – which is another fixed cost – has also discouraged small investments. Second, the way in which fund managers are compensated has meant that the growth in the size of venture capital funds occurs without a commensurate increase in the number of investment executives. This has had the inevitable outcome of driving up deal sizes. Third, returns from early stage venture capital investing have been poor in Europe (Murray, 1999; 2007). Private equity, in contrast, has been very profitable and has therefore been the favoured asset class for institutional investors. Finally, career progress in private equity is linked to doing later stage deals which involves a very different skill set to that of making early stage investments, creating a shortage of early stage investment professionals

Government interventions to increase the supply of early stage venture capital have evolved over time (Aernoudt, 1999; Murray, 2007). Initially, governments established their own venture capital funds. However, this approach was quickly seen as being inappropriate. Investment decisions were potentially subject to political influence. Government bureaucrats lacked investment skills. The market was distorted because of lower return expectations. And there was the risk of crowding out private sector investors. As a result governments now typically adopt a capital participation approach. This can take two forms: providing some or all of the investment funds and appointing private venture capital fund managers to make the investments or investing

in existing privately managed venture capital funds (a fund-of-funds approach). However, a capital participation approach does not address the fundamental risk, cost and return factors which have discouraged private sector venture capital funds from making small, early stage investments. Governments have therefore had to enhance the risk-reward ratio in order to attract private investors as co-investors in their funds. Governments can provide private investors with downside protection, for example, by assuming a disproportionate share of failures. Or they can provide upside leverage to provide the private investors with the possibility of achieving enhanced returns. Or they can provide support for the operating costs of the funds (Murray, 1999). However, the problem of the lack of experienced early stage investment professionals remains.

The impact of this intervention is questionable. Murray (1998; 1999) is critical of the funds that have been created as a result of public sector intervention for being too small and hence ultimately non-viable on account of the high proportion of their funding that is absorbed by running costs and their limited ability to provide follow-on funding. These factors combine to depress investment returns, which severely hampers the fund's ability to attract follow-on funds from private sector investors. Public sector funds are often further constrained by having an upper limit on how much they can invest in any business. This prevents such funds from making follow-on funding which, in turn, leads to a dilution of the fund's investments, which further depresses returns.

A further shift in the nature of government intervention, observable in the UK from the early 1990s and from the late 1990s elsewhere in Western Europe, has been to

complement its venture capital intervention with support for the informal venture capital market. This market comprises high net worth individuals – termed *business angels* – who invest their own money, along with their time and expertise, directly in unquoted companies in which they have no family connection, in the hope of financial gain (Mason, 2006a). The rationale for supporting the informal venture capital market emerged following publication of early empirical studies in Europe (e.g. Harrison and Mason, 1992a; Landström, 1993; Mason and Harrison, 1994; Coveney and Moore, 1997; van Osnabrugge and Robinson, 2000). These studies supported earlier US studies (e.g. Wetzel, 1983; 1987; Gaston, 1989; Freear et al, 1995) by highlighting the scale of the market, its potential for expansion and the types of investments made by business angels. These investments were a precise match of those which were least attractive for venture capital to make. More importantly, these studies drew attention to the market's untapped potential. Not only were active investors unable to find enough investment opportunities, and so had substantial capital available for investment, but there also appeared to be significant scope for expanding the numbers of active investors (Mason and Harrison, 1993; 1994).

The rationale for supporting the informal venture capital market is fourfold. First, business angels have different cost structures to those of venture capital funds, and are often motivated in part by non-financial considerations, enabling them to make small investments, well below the minimum deal sizes considered by venture capital firms, and in seed and start-up businesses. Second, because business angels are widely distributed (Gaston, 1989) and make the majority of their investments 'locally' (within 50-100 miles of where they live) (Harrison et al, 2003) they are able to address regional gaps in the availability of finance. Third, informal venture capital is

‘smart money’. Business angels are typically ‘hands on’ investors who seek to contribute their experience, knowledge and contacts to the benefit of their investee businesses (Harrison and Mason, 1992b; Politis, 2008). The opportunity to become involved is a major reason for becoming a business angel. Since most business angels have an entrepreneurial background and often invest in sectors where they have had experience this involvement can also be expected to benefit the businesses in which angels invest. Finally, although statistics on angel investing are very limited (Mason and Harrison, 2008), it is widely believed amongst policy-makers that the population of angels in Europe and their scale of investment activity is much lower than in the USA. Hence there is thought to be considerable scope to expand the supply of angel finance. One of the few challenges to this consensus view comes from Gompers and Lerner (2003) who question whether government should be encouraging people to become business angels.

3. GOVERNMENT INTERVENTION TO SUPPORT THE INFORMAL VENTURE CAPITAL MARKET

Government intervention to stimulate and support the development of the informal venture capital market is relatively recent, commencing in the early 1990s in the UK and the late 1990s in other parts of Western Europe, while in eastern Europe such intervention is in its infancy. Forms of intervention have evolved over time, with new approaches supplementing, rather than replacing earlier approaches. Six forms of intervention can be identified (Table 1): fiscal incentives for investors; business angel networks (BANs) to enable investors and entrepreneurs to find one another more early; changes to Securities Legislation to remove constrains on the advertising of investment opportunities; capacity building initiatives to raise the competence of investors to make investments and to improve the investment readiness of businesses

seeking finance; and co-investment schemes which leverage public money with angel money. It is significant that the majority of these interventions have been on the supply side: investment readiness schemes are the only demand-side intervention.

TABLE 1 ABOUT HERE

1. Fiscal Incentives

The longest established approach to stimulate the informal venture capital market has been tax incentives. Typically, under such schemes private individuals get tax relief for specific types of investments in specified types of businesses. These can be structured in several ways: tax relief on the amount invested, exemption of capital gains from tax, tax deduction for losses, and writing-off or rolling-over capital losses. The aim of such schemes is to improve the risk-reward ratio and thereby increase both the supply of both investors and capital. The major use of tax incentives have been the UK, with its Enterprise Investment Scheme (EIS) and France, with its Société Unipersonnelle d'Investissements à Risque (SUIR). Ireland, Flanders and The Netherlands have also offered tax incentives to business angels in the past.

Business angels claim not to take the availability of tax incentives into account when evaluating *specific* investments. Rather, the effect of tax incentives influences the proportion of their overall investment portfolio that they allocate to investments in unquoted companies. Providing tax incentives is consistent with UK evidence which suggests that business angels are acutely sensitive to levels of tax. Indeed, this is the only macro-economic factor that has a significant effect on encouraging or discouraging their investment activity (Mason and Harrison, 1999; 2000a). German

investors, on the other hand, place less emphasis on tax breaks (Stedler and Peters, 2003).

An evaluation of the EIS has suggested that additionality is over 50% (i.e. at least half of the monies would not have been invested by these investors in the absence of the scheme) and that companies also benefited in terms of attracting investors who also provided business advice and expertise (Boyns et al, 2003). The most recent evaluation also concluded that it has had a positive impact on the investee businesses (Cowling et al, 2008). Survey evidence by Mason and Harrison (1999) suggests that the EIS was used by a high proportion of investors and achieved high additionality but did not alter investment preferences. Reinvestment Relief (at the time of the study a separate incentive but subsequently incorporated into EIS) was more effective, at least in part on account of its time limited nature (investors had to re-invest their gains within three years) and fewer restrictions on qualifying investments. However, business angels are not attracted to professionally managed collective investment vehicles (Venture Capital Trusts) because they want to be able to make the investment decisions and engage with the businesses in which they invest.

Tax incentive schemes also have disadvantages. First, they may attract ‘dumb money’ – passive investors who do not want to provide hands-on support to their investee companies or lack the competence to do so. In the case of the EIS, only 27% of investors reported having a ‘hands on’ role in their investee companies (Boyns et al, 2003). Second, as the experience of the UK’s Business Expansion Scheme (the predecessor to the EIS) showed, there is a danger that financial intermediaries will try to distort the scheme in an effort to reduce investment risks (Mason et al, 1988).

Third, tax incentives are administratively complex, expensive to monitor and create uncertainty for investors. Fourth, the effectiveness of tax incentives is influenced by the state of the economy. For example, the ability to defer capital gains tax lost its effectiveness in the investment downturn which followed the post-2000 dot-com crash when investors did not have capital gains to shelter, reducing EIS investments by between half and two-thirds between 2000-01 and 2003-4. Finally, increasing the supply of finance does nothing to address the problem that investors have in finding suitable investment opportunities.

Business angels in the UK argue that the potential effectiveness of the EIS has been reduced by artificial barriers. The bureaucracy is clumsy and creates uncertainty. For example, relief will be clawed back if the eligibility of the investment is subsequently struck down. The rules exclude certain types of investment. For example, the 'closely connected' rule excluded certain types of investors, the overseas subsidiaries rule created difficulties for technology-based firms and the upper limit (30%) on the size of the shareholding has been problematic in cases where multiple funding rounds are required, and the requirement that investments have to be in ordinary shares, prevents the use of convertible instruments which are helpful in overcoming some of the difficulties in valuing new businesses. Some of these rules have subsequently been relaxed. Such schemes may also come into conflict with the EU's 'state aid rules'. This has restricted the use of EIS to companies with less than 50 employees and have raised less than £2m in previous years. This seems to be particularly inappropriate when angels are having to take companies through more funding rounds than previously because of the lack of early stage institutional venture capital.

Equity guarantee schemes have been an alternative fiscal approach to encourage angel investment. In Finland and Austria existing schemes for the institutional venture capital industry have been extended to include business angels, while The Netherlands and Wallonia (in Belgium) created specific schemes for angels. Aernoudt et al (2007: 78) suggest that "these schemes rarely represent good value for public money as the negative selection argument is often preponderant in the decision of a business angel to guarantee the deal". Indeed, the schemes in The Netherlands and Wallonia were subsequently closed.

2. Business Angel Networks

One of the most consistent findings in research on business angels is that they are opportunity constrained, with the majority unable to find sufficient investment opportunities (Wetzel, 1987; Mason and Harrison, 1994; 1999; 2002; Reitan and Sørheim, 2000; Paul et al, 2003). This reflects the fragmented nature of the market and the invisibility of business angels (arising from their strong desire for anonymity), which has resulted in high search costs for both entrepreneurs and angels as they tried, often unsuccessfully to find one another. One consequence is that it reduces the effectiveness of supply-side initiatives such as tax incentives.

A second form of intervention, and the most common, strongly advocated by Mason and Harrison (1992; 1993; 1995), has therefore been the establishment of what has come to be known as *business angel networks* (BANs). The main function of these organisations – which can be thought of as being similar to 'dating agencies' – is to improve the efficiency of information flow in the market by providing a channel of communication which enables entrepreneurs seeking finance to come to the attention

of business angels and at the same time enables business angels to receive information on investment opportunities without compromising their privacy (Mason and Harrison, 1996a). However, the network plays no role in the actual investment process: the business angels make their own investment decisions, undertake their own due diligence and negotiate their own term sheet directly the with entrepreneur. BANs have also played a critical role in several countries in raising awareness of the business angel market and building capacity through training entrepreneurs and investors.

Most BANs operate on a local or regional scale (EBAN, 2008), reflecting the preferences of the majority of investors to invest locally.[1] They use a variety of matching mechanisms, sometimes in parallel, notably databases, investment forums and fairs, workshops and newsletters (EBAN, 2008). The "touch and feel" nature of investing means that the Internet has not replaced the need for investors and entrepreneurs to interact in person, hence the dominance of investment meetings as the most common matching process (used by 81% of networks: EBAN, 2008) at which entrepreneurs make a 'pitch' to an audience of potential investors. The majority of BANs (64%) are not-for-profit entities (EBAN, 2008), supported by organisations with a remit for economic development (e.g. local authorities, government agencies, universities, science parks, business incubators). They typically rely on a range of income sources, notably fees from investors and entrepreneurs, sponsorship and success fees from investments which occur (EBAN, 2008). However, this is generally insufficient to cover their operating costs, hence most are not financially self-supporting and depend on the public sector for their ongoing existence (EBAN, 2008).

[1] However, there are also a small number of cross-border BANs (see EBAN, 2008) and a new EU scheme (EASY) which is seeking to promote cross-border investing by angels.

There has been an increase in for-profit networks in recent years (EBAN, 2008), partly as BANs have lost their public funding and partly on account of the emergence of commercially-oriented BANs operating with different business models (Mason, 2006b).

TABLE 2 ABOUT HERE

The earliest BANs were established in the UK in the early 1990s, followed by The Netherlands (NEBIB) in 1995, Finland (the SITRA Matching Service) in 1996 and Belgium (the Vlerick Business Angels Network) in 1999. At the formation of the European Business Angel Network (EBAN)[2] in 1999 there were 66 BANs in Europe, the majority of which were in the UK. The European Union Business Angel Network Pilot Action, funded under the 3rd Multi-annual Programme for SMEs (1997-2000) was a key driver in the initial establishment of networks elsewhere in Europe, funding dissemination actions to heighten awareness and spread good practice, feasibility studies to test the validity of the BAN concept in particular areas, and setting up and supporting the creation of new BANs (European Commission, 2003). By mid-2008 the number of networks had risen to 298, with almost half established since 2005 (Table 2).

TABLE 3 ABOUT HERE

[2] EBAN is an association of BANs and national federations of BANs. Its aims are to encourage the exchange of experiences between national associations and individual BANs and promote good practice, promote the concept of BANs and assist in the creation and development of a favourable environment for business angel activities.

The geographical distribution of BANs across Europe is highly uneven. The countries with the most BANs are France (66), Germany (38), Spain (37) and the UK (35) (Table 3). The overall number of BANs has stabilised and has even declined in some countries with more mature angel markets, such as UK, Sweden, Germany and Belgium. For example, in the Flanders region of Belgium the four government-supported networks that operated between 1999 and 2004 were merged into one regional network (Collewaert et al, 2007). Meanwhile, the number of BANs has risen significantly in France, Spain and Portugal. BANs are now being established in Eastern Europe (Table 3). For example, five networks have been established in Poland since 2004.

BANs have received a mixed assessment. Harrison and Mason (1996) were positive about the early impact of the pilot BANs in the UK that were launched in 1992, arguing that they had mobilised capital that would otherwise have remained invisible and promoted a relatively significant number of investments which, in turn, sometimes unlocked further bank lending. Some entrepreneurs benefited from advice and signposting to more appropriate sources of assistance and feedback from investors to whom they were introduced but did not invest, and there have been wider benefits in terms of the education of entrepreneurs, investors and intermediaries and a general raising of awareness about equity. The cost-per-job was also very low when compared with alternative economic development initiatives. Moreover, in view of the likelihood that businesses which attracted business angel funding would have to be offering something distinctive in the market place displacement levels are likely to be low. Collewaert et al (2007) were also positive about several aspects of BANs in Flanders, noting that the investments made were likely to have a high level of

additionality, they enabled the businesses to leverage other sources of finance and that the cost-per-job was low.

However, other evidence suggests that their impact has been fairly limited. Relatively few investments have been made through BANs (Mason and Harrison, 1996c). They have been a marginal source of investments for most angels (Mason and Harrison, 1996c; 1999; 2002). A majority of investors do not think that BANs have generated a superior quality of deals (Mason and Harrison, 1999). The main reason is that BANs have lacked the critical mass of investors and investment opportunities for investments to occur. This, in turn, can be linked to their lack of resourcing, preventing marketing and client management, and the small size of operating territories, which was a particular problem with the first wave of UK BANs that were established in the early to mid 1990s.

The emergence of private sector commercially-oriented networks that operate on the basis of charging significant up-front fees and success related fees would appear to challenge the need for public sector funding to underwrite the running costs of BANs. More than one-third of BANs currently operating in the UK are now commercially-oriented.[3] However, these networks have only been able to flourish by replacing the simple introduction model with a private placement model (Mason, 2006b). In this model the BAN not only generates the deal flow for its investors but also takes the lead in completing the due diligence and negotiating the term sheet with the company, for which the BAN earns management fees and carried interest. After that point the investors will be invited to invest. However, Mason and Harrison (1997) argue that

[3] Calculated from the current (2008) British Business Angels Association Directory

this development is driving up deal sizes because of the higher transaction costs involved.

3. Securities Legislation

Financial securities legislation is a further potential barrier to the dissemination of information on investment opportunities. Each country has its own legislation (which must conform to the European Prospectus Directive) but the general effect is to impose restrictions on the ability of ‘unauthorised persons’ to promote particular investments or to encourage individuals to engage in investment activity unless it has been approved by an authorised person such as an accountant or stockbroker. The very laudable objective is to protect ‘widows and orphans’ from unscrupulous promoters. However, by providing protection in the form of a ‘one size fits all’ format it has prevented small businesses seeking to raise finance from circulating information to business angels because the costs of associated with obtaining approval would normally to be too high in relation to the amount of finance that is typically being sought. This has exacerbated the information barriers in the informal venture capital market, reducing investment opportunities and, in turn, prevents angels from investing as frequently as they wish. Admittedly, the actual effect of this restriction has never been empirically established. In practice it also possible that many ‘introductions’ have been made informally either in defiance or in ignorance of the law (Mason and Harrison, 2000). However, it is widely thought to have discouraged intermediaries such as accountants and lawyers from introducing their personal high net worth clients to business clients who were seeking to raise finance on account of the legal risks.

Most Member States have concluded that BANs do not make investment recommendations and so are exempt from Securities Legislation because they are not providing investment advisory services. However, following lobbying, UK policy-makers took the view that legislation had to create specific exemptions for business angels. Consequently, BANs were given a specific exemption under the Financial Services Act (1986) from promoting investment opportunities to their registered investors as long as their principal objective or one of their principal objectives is the promotion of 'economic development' and they did not have any pecuniary interest in the outcome of the introduction other than to enable the recovery of the costs of providing the service (Clarke, 1996). This enabled not-for-profit BANs to circulate information on investment opportunities to its registered investors but only if it included a prominent 'wealth warning' about the potential risks of investing in unquoted companies. However, they were not permitted to give any investment advice or recommend particular investments.

Following extensive lobbying from the business angel community, the Financial Services and Markets Act 2000 (which replaced the Financial Services Act 1986) created an important exemption to enable unquoted firms to raise equity capital without the substantial costs of getting their financial promotion approved if the promotions are made to potential investors who are certified as high net worth individuals or sophisticated investors. In order to gain a high net worth exemption, investors had to obtain a certificate from either their employer or accountant stating that they either earn in excess of £100,000 or have net assets worth at least £250,000 (excluding their principal residence and pension benefits). The sophisticated investor exemption required an authorised person to certify that the investor is sufficiently

knowledgeable to understand the risks associated with the investment. However, the business angel community saw this being time-consuming, costly and intrusive while it appears that authorised persons (such as accountants) have been reluctant to certify investors as sophisticated because of the subjective nature of the test, leading to concerns that they might be liable if investors lost money on their investments. The cost of obtaining an exemption because of the due diligence that an authorised person must undertake to avoid making an incorrect certification has been a further deterrent (HM Treasury, 2004a).

In order to address these problems the UK Government has introduced a *self*-certification scheme whereby potential investors would be allowed to self-certify themselves as either high net worth individuals or sophisticated investors, without having to go through an authorised intermediary. The high net worth criteria are as before. There are also a range of conditions under which individuals can self-certify as sophisticated investors. Accordingly, firms can now promote to individuals that they 'reasonably believe' are self-certified as high net worth or sophisticated investors, confident that they are operating within the law (HM Treasury, 2004b). By making it easier for small firms to approach and attract investors and, at the same time, improve the deal flow for business angels this change represented a significant improvement in the informal venture capital environment.

The Markets in Financial Instruments Directive (MiFID), part of the European Union's Financial Services Action Plan, which took effect on 1 November 2007, makes significant changes to the regulatory framework of financial services and markets in Member States. The Commission's view is that BANs will be unaffected

as long as they limit their role to matching and refrain from any activities that come under the heading of 'investment services'[4]. Clearly, private sector BANs do perform specific investment activities but they will already be authorised under the FSA and so should not be affected. However, Blackett-Ord (2007) takes a less sanguine view of MiFID's potential impact on BANs.

4. Investment Readiness

One of the key conclusions from evaluations of BANs is that they have not significantly improved the ability of angels to invest because they have failed to provide business angels with superior investment opportunities (Mason and Harrison, 1996a; 1996c; 1999, 2002). This has highlighted the problem that many of the businesses seeking finance are not 'investment ready' (Mason and Harrison, 2001). This concept encompasses all aspects of the business that relate to an investor's perception of its 'investability', including management team skills, the clarity with which the opportunity is defined, the business model, route to market, governance arrangements and presentation (Shepherd and Douglas, 1999). Thus, a fourth form of intervention has been *investment readiness schemes* that aim to improve the number of investable opportunities that business angels receive.

Some BANs have recognised the need to complement their matching services with complementary initiatives that address the demand-side. These are often termed 2nd generation BANs to differentiate them from those that only offer matching services. A mapping exercise of training provision for investors and entrepreneurs identified 18 investment ready programmes spread across six European countries (Ready for

[4] See http://ec.europa.eu/internal_market/securities/isd/questions/index_en.htm?

Equity, 2008). The UK government had also funded various investment readiness demonstration projects (HM Treasury/Small Business Service, 2001; 2003; SQW, 2004).

Many of the investment ready schemes that have emerged can be criticised for restricting their focus to raising awareness and understanding of the various financing options available and on presentational issues but have not effectively engaged in the critical, and more costly, diagnostic and business support components (Mason and Harrison, 2001). Hayton et al (2008) note that public sector investment readiness schemes in Scotland have been criticised for being synonymous with preparing a business plan. What is being delivered through such programmes is therefore *necessary* but is not *sufficient* to get businesses investment ready. This is because investment readiness is fundamentally about business development issues, which is often time-consuming and, therefore, expensive to deliver (and, of course, well beyond the means of most start-up and early stage companies to purchase themselves).

One interesting approach is to use business angels themselves to help businesses to become investment ready. A proportion of businesses that investors reject because they are not investment ready have the potential to become investable. However, in such cases investors will be deterred by the costs (typically the time involved) of undertaking the necessary investigations in order to assess whether the business has the potential to become an attractive investment opportunity. Having identified the problems that prevent such businesses from being investment ready, there are likely to be further costs – both time inputs to provide the necessary level of support and fees

to employ specialists - to fix them. The rational response of investors would be to reject these opportunities and seek out others that involve lower investigative and support costs (Douglas and Shepherd, 2002). To address this problem LINC Scotland has developed an Investment Facilitation Grant scheme using the ERDF programme to enable investors to cost-effectively pursue opportunities that they might otherwise have rejected. Potential investee companies apply in response to the feedback they received from potential investors on what issues need to be resolved to make it investable (e.g. costs relating to market analysis and access, technology validation, legal due diligence). The grant, which is limited to a maximum of £15,000 of eligible costs, becomes convertible into LINC Scotland equity if the investment goes ahead (Mason and Harrison, 2004b).

5. Investor Education

There has been rather less emphasis on education and training to raise the competence of investors. It may be that this reflects the common stereotype of business angels as successful entrepreneurs and as such do not require to learn how to become a business angel. However, not all business angels are of this type (Sørheim and Landström, 2003; Avdeitchokova, 2008). Those who are not 'classic angels' (and even some who are) may lack the necessary skills, competence and understanding of the investment process. This might be a further factor which contributes to the underdevelopment of the market. It will prevent some potential angels from making their first investment, while those who do make investments despite their lack of competence are unlikely to be successful, prompting their early withdrawal from the market. Both virgin and active angels recognise the need to improve their investment skills (San Jose et al, 2005). This has promoted a fifth form of intervention – providing investor education

to provide investors with the specialist knowledge and skills that they require to invest successfully.

The Ready for Equity (2008) mapping exercise identified 20 programmes across Europe specifically for training investors. There are mostly offered by BANs and have largely been established since 2000. The aims are to attract investors to the network, to train virgin angels and train experienced angels in new areas to enhance their competence. There are several 'business angel academies' which offer a business school-based education based on regular sessions over a semester,, to provide angels with a thorough understanding of the investment process so that they can take advantage of investment opportunities that arise (San Jose et al, 2005). However, most programmes are of short duration (day and half-day events). There has also been some recent examples of training courses aimed at potential women business angels who are significantly under-represented amongst active angels (Harrison and Mason, 2007). Less emphasis has been give to the training of intermediaries, such as accountants, lawyers, bankers, consultants, business incubator managers, etc. who can be a significant source of advice for entrepreneurs, including on financial issues. Future capacity building efforts must also include these players.

6. Co-investment schemes

The newest form of public sector intervention is *co-investment schemes* which have emerged in recognition of a new equity gap in the £0.5m to £2m range (i.e. post seed but pre-institutional capital) (Almeida Capital, 2005; Hayton et al, 2008). Co-investment funds provide public money to match investments made by private early stage investors. However, they differ in terms of how they operate. At one extreme

are passive funds, such as the Scottish Co-Investment Fund. It follows the lead of its private sector partners who have been approved to invest under the scheme. It does not undertake its own due diligence and plays no part in the investment. Any investment that the investor makes and which meets the scheme's criteria will automatically qualify for co-investment. The co-investment fund invests on identical term and conditions to those of the private investors. This feature removes any uncertainty for the investor, and reduces the operating costs of the scheme to a minimum (Hayton et al, 2008). Because of the maximum investment size under the scheme (£500,000) the partners are almost exclusively angel groups – that is, organised and managed groups of angels who invest together rather than as individuals (Mason, 2006b). Other co-investment funds are more actively managed, inviting investors to bring deals to them (or may approve deals from particular sources, such as business angel networks) but make their own investment decision and may invest on different terms and conditions to those of the angel group. For example, London Seed Capital co-invests with the London Business Angels Network and the Great Eastern Investment Forum (GEIF) has a co-investment fund that only invests in companies which receive investments from GEIF angels.

Co-investment schemes appear to have been very successful in significantly increasing the volume of investment activity in the early stage venture capital market. However, the only scheme to have been the subject of evaluation is the Scottish Co-Investment Scheme (Hayton et al, 2008). This highlights angel groups as being the main beneficiary, accounting for 82% of the co-investments. By providing matched funding it has enabled these groups not only to make more investments but also to

make investments that in the absence of the co-investment fund they would not have made, notably larger investments that will require significant follow-on funding.

Co-investment schemes have two limitations. First, they are constrained by the lack of investable businesses. The partners in the Scottish Co-investment scheme identified investment readiness as an issue, particularly in certain areas (notably the West of Scotland). Second, it is most appropriate in mature markets where there are angel groups with whom the fund can co-invest. The emergence of angel groups - angels who invest together rather than as individuals or small ad hoc groups (Mason, 2006b: 284-288) - has been one of the most significant structural changes in the informal venture capital market. They have emerged, largely since 2000, partly for positive reasons and partly out of necessity. The positive reason is that individual angels have found advantages of working together, notably in terms of better deal flow, superior evaluation and due diligence of investment opportunities, and diversification, as well as social attractions. The necessity for angel groups has arisen from the withdrawal of venture capital funds from the early stage market, requiring angel investors to make larger investments and follow-on investments in a context where the time to exit has stretched from three or four years during the dot.com era to seven years or more. Indeed, some of the larger angel groups are now making multiple rounds of funding and even taking businesses to an IPO or a sale without the need for investment from venture capital funds. However, with the exception of the UK (in particular, Scotland), angel syndicates are much less numerous in Europe than in the USA. Recognition of the importance of angel groups is encouraging an emerging form of

intervention that provides financial support to such groups to offset their running costs.[5]

It can be questioned whether this emerging model of investment intermediation involving organised angel groups and syndicates, often attracting passive investors (‘dumb money’), frequently supported by the public sector and co-investing with public sector funds, is entirely positive. No doubt it is more effective in increasing the supply of early stage finance and channelling it into entrepreneurial businesses than when the market was invisible and fragmented. However, the concern is that the ‘smart’ aspect of business angel investment may become diluted or lost, especially as solo angels migrate to angel groups to diversify their investments and thereby reduce their risks but at the expense of reducing their hands-on involvement.[6] It also risks re-opening a finance gap for small (sub-£250,000) investments.

4. CONCLUSION

The informal venture capital market has been a focus of public sector intervention to improve access to finance for small firms for less than 20 years in Europe, and in most countries for less than 10 years. This paper has charted the forms that this intervention has taken and identified how it has changed in several significant respects.

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[5] LINC Scotland does this on an ad hoc basis. However, the best example of this form of intervention is the Ontario Angel Network Programme, launched in September 2007, which will provide financial support for both new angel groups and to foster the growth of existing angel groups to cover the costs of start-up, organisation, development and management. Examples of what this funding could support include developing training materials for entrepreneurs and investors, running best practice workshops, developing due diligence processes and developing online review systems (National Angel Organisation, 2007).

[6] For example, in 2000 LINC Scotland serviced 400 individual investors and one angel syndicate. By 2005 it had just 200 individual investors but 14 syndicates (with a total of 300 members) (David Grahame, Chief Executive of LINC Scotland, personal communication).

First, the form of intervention has evolved from a supply-side approach using tax incentives targeted at high net worth individuals, through an intermediation approach aimed at improving information availability, through capacity raising and, most recently of all, back to a supply-side approach based on using public money to leverage private investment. Second, the target for intervention has shifted from the individual investor to the creation of, and support for, intermediary organisations (BANs). These intermediary organisations have, in turn, evolved in several respects. Initially most were publicly supported organisations whose role was simply to enhance the flow of information between investors and entrepreneurs. Then they added capacity building functions designed to raise the investment readiness of businesses seeking finance and the investment skills of business angels. In more mature markets governments have withdrawn from funding BANs. As a consequence, an increasing number of networks are now commercial organisations that take a much more active part in the investment process, identifying investment opportunities and facilitating their investors to invest, for example by negotiating on their behalf and structuring the investment. Third, faced with a widening equity gap as venture capital funds have withdrawn from the early stage market governments are now establishing co-investment funds that invest alongside angel groups to enable them to make larger and follow-on investments.

However, there is very little evidence on the impact of these various forms of intervention. Because of the informal and private nature of angel investing it has been extremely problematic to measure the size of the market, the number of business angel investors or the level of investment activity or to track trends over time (Mason and Harrison, 2008). Supporting the informal venture capital market has therefore

been largely an act of faith by governments. Thus, a key priority for governments must be to invest in appropriate methodologies which can accurately measure investment trends in the early stage venture capital market over time, and specifically angel investment activity, so that the need for public sector intervention can be demonstrated and the impact of such interventions can be measured.

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Table 1. Types of government intervention in the informal venture capital market

Nature of intervention	Objective
Fiscal incentives	To increase the number of business angels and the amounts invested by existing angels by improving the risk-reward ratio: e.g. front-end reliefs, capital gains tax reliefs; roll-over reliefs; equity guarantee.
First generation business angel networks (BANs)	To reduce informational inefficiencies in the market so that investors seeking to invest and entrepreneurs seeking finance can more easily locate one another, thereby reducing the incentive for both parties to withdraw from the market.
Securities Legislation	Changes to Securities legislation which prevented entrepreneurs from circulating 'invitations to invest' (e.g. business plans) unless they had been approved by an authorised body, a requirement that was costly to fulfil.
Capacity building - entrepreneurs	Training for entrepreneurs to improve their investment readiness – usually provided by '2nd generation' BANs
Capacity building - investors	Training for investors to raise their competence in making investments – also usually provided by '2nd generation' BANs
Co-investment vehicles	Government-financed venture capital funds which leverage investments made by business angels to increase deals sizes and to enable angel groups to make more investments and follow-on investments

Table 2. Trends in the Number of Business Angel Networks in Europe

year	number
1999	66
2000	132
2001	155
2002	177
2003	197
mid-2004	231
mid-2005	228
mid-2006	211
mid-2007	234
mid-2008	298

Source: EBAN (2008)

Table 3. Distribution of Business Angel Networks in Europe (mid-2008)

number	countries
1	Croatia, Finland, Greece, Latvia, Luxembourg, Malta, Slovenia, Ukraine
2-5	Austria (3), Belgium (4), Bulgaria (2), Czech Republic (2), Denmark (3), Hungary (3), Ireland (4), Poland (5), Russia (4), Turkey (2)
6-10	Italy (11), Netherlands (9), Norway (7), Portugal (10), Switzerland (8)
11-20	-
21-30	Sweden (22)
31-40	Germany (38), Spain (37), UK (35)
Over 40	France (66)

Plus 4 transnational networks

Source: EBAN (2008)