THE ELUSIVE ANGEL

An Honors Thesis (ID 499)
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Muncie, Indiana
May 4, 1989

Graduation: May 6, 1989
Finding Venture Capital in an Imperfect Market

A common folklore in the world of investments is that there exists a so-called "gap" in the availability of funds to finance certain types of business ventures. These gaps include financing for inventors, start-up firms, and high-growth firms whose current financial position cannot maintain the growth they are experiencing.

The initial equity required for a new firm, normally no more than $50,000, can usually be supplied by the founders and those close to them (Wetzel: a 24). However, when these sources are exhausted there are generally two visible markets which firms can look to in order to gain the additional financial backing they require. These markets are the public equity market and the professional venture market. According to William E. Wetzel, Jr., who has done considerable research in the area of capital investments, "... if an entrepreneur is trying to raise from $2 million to $5 million (or more) for a venture with sex appeal, the speculative new issues market represents a potential source of funds. The professional venture capitalist is generally interested in ventures that require $500,000 (or more) of postrevenue financing, that yield projected revenues of more than $20 million within five to ten years, and can go public or sell out by that time" (Wetzel: a 24).
In addition, a 1981 study by Jeffry Timmons and David Gumpert showed that the range of investment of the fifty-one largest and most active venture capital firms was from $300,000 to $4 million, with a typical investment of over $800,000. Unfortunately, this does appear to leave a gap in the capital investment market for smaller firms requiring financial backing of more than $50,000 but less than $500,000, especially those that are technology-based (Wetzel:b 92). This is of major concern, as it is these small technology-based firms (STBFs) that provide a considerable portion of our country's jobs and technological innovation. In addition, these firms contribute to other economic benefits such as favorable trade balances, price stability, and productivity gains (Wetzel:a 23).

The United States government, in an effort to close this apparent gap, has made considerable effort to aid small business in its plight to survive and grow. For instance, as early as 1958 Congress created the Small Business Investment Company (SBIC) program, which was designed to fill the gap. More recently the Small Business Incentive Act of 1980 and the SEC's regulation D, by streamlining security laws for small business, have attempted to entice investors who are considering financing smaller firms. In addition, the Small Business Innovation Act of 1982 provides for $1 billion in research, to be conducted over the next five years.
by STBFs (Wetzel: a 23). Unfortunately, despite all of this intervention provided to aid small business, the gap is still evident, that is, if we hold firm to the efficient market hypothesis.

Our modern financial theory rests on the assumption that we operate in a world of efficient markets. In such a scenario, all market participants, investors and investees, are aware of all pertinent market information (Wetzel: a 23). In addition, there exists a perfectly efficient network of communication which joins potential investors to appropriate investment opportunities. More realistically, we know this is not the case. In fact, a very significant member of the capital market is somewhat invisible, with his own less-than-efficient referral network. The member to which I refer is the informal investor, also known as the "business Angel."

Robert J. Gaston, in his book Finding Private Venture Capital for Your Firm: A Complete Guide, loosely defines this group of informal investors as "private individuals who supply risk capital dollars directly (without paid middlemen) to new or growing small businesses" (Gaston 1).

According to several sources, business Angels supply a considerable amount of capital to small businesses through product development, start-up, and growth financing. In fact, Wetzel holds that "There is evidence to suggest that informal investors represent
the largest pool of risk capital in the country" (Wetzel: b 91). Mr. Gaston asserts that although the typical Angel does not invest a colossal amount in any single opportunity, "... there are so many Angels that their commitments add up to over $32 billion in equity financing each year. This makes Angels the single largest supplier of external equity capital to new and growing small businesses in the United States." The two highly visible markets mentioned previously, the professional venture capitalists supplying only $3 to $8 billion a year, and the public equity market which supplies substantially less, fail to compare to the contribution made by the informal investor group (Gaston 5). In addition to the $32 billion in equity financing, informal investors also supply $24 billion in loans to small businesses. These figures combine to express a total capital contribution of $56 billion annually. This is approximately ten times greater than the contribution made by professional venture capital firms. Another important fact is that, of the 435 subjects in Mr. Gaston’s study, many were willing to invest more, but were unable to find promising investment opportunities. The significance of this is that American business Angels were willing to invest $20 billion more if given appropriate investment opportunities (Gaston 6).

In addition to supplying more capital to small
businesses, informal investors also make a contribution to a greater number of firms. United States business Angels, from the years 1982 to 1987, made 490,000 average annual investments in 87,000 entrepreneurs (Gaston 6).

The Business Angel

But who is the elusive Angel? Substantial research has been done in an attempt to answer this question. In addition to being a relatively broad group of people, informal investors are also a rather private group--probably in an effort to protect themselves from being bombarded by all of the "great deals" that are out there. However, through the effort of countless studies and surveys, the United States Composite Angel can be roughly identified.

When searching for a business Angel, occupation is a good place to start. Although another common finance folklore claims that doctors and lawyers are the most willing private investors, Gaston's study of 435 business Angels identifies the vast majority (44%) of informal investors as business owners. Another 25% are business managers and administrators. Physicians, lawyers, CPAs, and other professionals make up only 8% of the informal investing population, while science and engineering professionals total 5%. The remaining 18%
is made up of such a wide variety of investors, that there are too many to list (Gaston 17).

Another important factor to consider is the average age of the informal investor. Although the most active informal investors’ ages range from 35 to 50 years, some (11%) Angels are under the age of 35, and a few (6%) are over 65. However, the average business Angel is 47 years old. One out of every three Angels is between the age of 35 and 44, making up the largest group of informal investors. Another 31% of all Angels is 45 to 54 years of age. The remaining 19% of the Angel population is made up of investors between the ages of 55 and 65 (Gaston 18).

Gender and ethnic group is another point of consideration when trying to identify an Angel. The vast majority of business Angels are white males. They account for 84% of the population. Minority males combine to form 11%, while minority females make up only 0.3%. White females contribute 5% of the Angel population (Gaston 18).

Next we move to the education level of the typical Angel. Mr. Gaston’s study reveals that the most Angels have completed college. In fact, only 28% have achieved less than a Bachelor’s degree, and of those, 16% have at least attended college. Forty-four percent of all Angels hold a Bachelor’s degree, while 28% have gone on to earn a Master’s degree. However, a study compiled
from information given by 320 east coast Angels reports that an astounding 56.2% of the Angels surveyed hold a graduate degree (Haar 17). The 133 Angels in Mr. Wetzel’s study, which focused on informal investors in New England, also reported a significantly higher level of education (Wetzel:a 25). Once again the conclusion was that forty-four percent of the Angels hold a Bachelor’s degree. However, 51% of the New England Angels have gone on to earn a Master’s degree (Wetzel:a 27). Although the proportions in the three surveys vary, each study concludes that the majority of informal investors hold at least a Bachelor’s degree.

Not surprisingly, most Angels have earned their degree in business (44%). The next most popular field of study for Angels is engineering. In fact, 19% of all college educated Angels earned their degree in engineering. Another 10% of the Angels have law or medical degrees, while 20% hold degrees in various other fields (Gaston 18).

A third common myth pertaining to the business Angel is that he must be a millionaire. However, the family income level of the average Angel does not exceed $100,000, and is in fact, closer to $90,000. Only 13% of all Angels enjoy an annual income of or in excess of $200,000. On the other hand, only 10% receive an annual income under $40,000. Over half of all informal investors (54%) earn between $40,000 and $99,999, and 23% earn
from $100,000 to $199,999. In addition to annual earnings, net worth must be included in the Angel profile. Gaston’s study shows that the "Angel median wealth is $750,000, and two out of three Angels have a net worth of less than a million dollars. . . ." On the other hand, the typical business Angel is definitely not poor. Thirty-nine percent of informal investors have a net worth of under $500,000. Twenty-four percent are worth between $500,000 and $999,999. The remaining 37% of the Angel population is worth $1,000,000 or more (Gaston 19).

In summary, the typical business Angel is a forty-seven year old, white, male. He generally owns his own business, and holds a Bachelor’s degree in business. He enjoys an annual family income of $90,000 and has a net worth of $750,000. Although this is the breakdown of the typical informal investor, the statistics previously outlined express the great diversity of the 720,000 people who combine to form the U.S. business Angel population (Gaston 6). Therefore, no one within reason should be ignored when seeking a business Angel.

What a Business Angel Looks for in a Venture

Informal investors, although varying as much in market activity as in profile, are nonetheless a very popular group. The Angels in Mr. Gaston’s survey
reported that, in the past three years alone, they had been bombarded by nearly 4000 investment proposals. Of these, only 896 actually ended in an investment, but approximately 1300 of the proposals were given serious consideration by the Angels. This breaks down to nine investment proposals per Angel (three per year), with serious consideration given to three of them, and with only two of them actually receiving Angel backing. Although this 22% proposal/investment ratio seems low, we are better able to understand its significance when we compare it to the 1% acceptance rate offered by professional venture capitalists (Gaston 20).

Once again it is important to note the investment frequency diversity of this group. Most of the Angels surveyed (42%) had actually invested in only one project in the past three years. Thirty-four percent reported having made two investments in the same thirty-six month period, while 15% made three investments. The percentage of Angels who made four or five investments in the past three years was only 9%. However, because the average Angel's investment turns over about every five years, they normally hold three and a half investments at a time (Gaston 21).

Mr. Gaston next asked his business Angels to list the most common reasons that they reject a proposal. Not surprisingly, the majority of Angels listed "Inadequate growth potential" as the number one cause of
disqualification. Three other answers made the list of common reasons for proposal rejection. In their order of frequency, they are "2. Inadequate personal knowledge of the firm, its principals, and key personnel, 3. Management’s lack of experience or talent, and 4. Unrealistic proposed value of firm’s equity" (Gaston 20). The informal investors Mr. Wetzel surveyed added "lack of confidence in management; unsatisfactory risk/reward ratios; absence of a well-defined business plan; the investor’s unfamiliarity with products, processes, or markets; or the venture was a business the investor did not want to be in" to the list of typical rejection reasons (Wetzel:28).

Because inadequate potential growth is the primary reason for an investment rejection, it seems only logical that we next address the minimum return on investment (ROI) required by Angels. Surprisingly, the median answer was only 22%. This emphasizes that, although it is obviously important, the main objective of most business Angels is not purely financial reward. William Wetzel asserts that it is the nonfinancial rewards that are actually the key motivation behind a great number of informal investments. In his study of 133 New England Angels, Wetzel found that 45% of the investors reported that nonfinancial considerations greatly influence their investment decisions. In fact, about 40% of the Angels claimed that they would accept a
lower return or higher degree of risk on a venture that would create employment or develop technology that would benefit society. The most commonly mentioned non-financial rewards include "ventures creating jobs in areas of high unemployment, ventures developing socially useful technology (e.g., medical or energy-saving technology), ventures contributing to urban revitalization, ventures created by minority or female entrepreneurs, and the personal satisfaction derived from assisting entrepreneurs to build successful ventures in a free enterprise economy" (Wetzel: a 31). However, some Angels find the greatest reward in the pure excitement experienced by investors in the informal market. Bob McCray, a prominent businessman and informal investor from New Hampshire, claims that he "relishes the chance to 'bet on people'—to discover what makes them tick, to help them find their niche and then to back his judgement with cash" (Fenn 82).

In addition to supplying capital, many informal investors wish to assume an active role in the operations of the firm in which they have invested. Eighty-four percent of Wetzel’s New England Angels expect to participate in the operations of their respective companies, typically as a consultant or as a member of the board of directors (Wetzel: a 27). Eighty-three percent of the Angels surveyed by Gaston revealed that they would assume an active role in the firm’s day-to-
day operations. While 15% want to be on the board of directors and 29% wish only to provide consultation, 39% will actually work with the firm. A surprising 17% of the Angels plan to work with the firm on a full-time basis, and 22% will work part-time (Gaston 25).

Although Mr. Gaston asserts that "Entrepreneurs will find willing ears for proposals in almost any industry," it is interesting to note that the Angel population seems to favor certain industries. Unfortunately, the conclusions of the Gaston, Wetzel, and Haar-Starr-MacMillan studies are greatly diverse as to which industries Angels actually prefer. According to Gaston's survey, 39% of the Angel population is interested primarily in FIRE (finance, insurance, and real estate) firms, while 38% noted substantial interest in firms competing in the service industry. Next came retail trade, with 24% interest, and surprisingly, manufacturing in high-technology products came in with only a 23% interest factor. Other industries which enjoy Angel interest are construction, wholesale trade, and the manufacturing of consumer and industrial products (Gaston 24). Wetzel, on the other hand, asserts that his sample of Angels "reported a clear preference for manufacturing enterprises in general and for 'high technology' manufacturing in particular." The New England Angels reported that 57% of their actual investments were in manufacturing companies (28% in
high-technology, 20% in industrial, and 9% in consumer products). His study showed service firms as a distant second, with only a 12% investment factor. However, when their interest (not actual investment) was measured, the service industry fared much better. The Angels still showed a significant preference for the high-technology manufacturing industry, which claimed 64% support. Industrial manufacturing had an interest factor of 33%, and the service industry showed 30% interest (Wetzel: a 28). The Haar-Starr-MacMillan study agrees that informal investors prefer firms in the manufacturing industry (41%), with the high-technology products industry holding the most interest, at 28% (Haar 20). Although each of the studies vary, there is a definite trend in the interest level of firms competing in the high-technology manufacturing and service industries. In addition, Wetzel points out that even the least attractive categories (public utilities, natural resources/mining, communication and transportation ventures) hold at least the moderate interest of the business Angel population (Wetzel: a 28).

One thing that is agreed upon by all the studies is that business Angels typically invest close to home. The Gaston study reveals that 82% of the firms financed by the Angel’s surveyed are located within 150 miles of the investor, and 72% are actually within only a 50 mile radius of the Angel’s home or office (Gaston 37). The
Wetzel study concludes that 75% of the firms receiving backing from his New England Angels are within 300 miles of the investor, and 48% are within 50 miles (Wetzel:a127). Interestingly, the Haar-Starr-MacMillan study shows that, although it is most common for informal investments to be made relatively close to home, the Angels they surveyed (or the Angels surveyed by Gaston and Wetzel for that matter) showed geographic location of the firm as one of the least significant criteria to an accept decision. The Haar-Starr-MacMillan study goes on to suggest that "Perhaps the geographic proximity factor found in other studies is more a reflection of sheer physical accessibility between entrepreneur and investor rather than a formal selection criteria" (Haar 22). Or, perhaps the inconsistency can be explained by the less-than-efficient referral network of the informal market.

The Referral Network

Mr. Wetzel explains that "Entrepreneurs can expect little guidance in finding their way through the maze of channels leading to informal risk capital. By the same token, angels continue to rely largely on random events to bring investment opportunities to their attention. There are no systematic techniques for identifying clusters of individual investors or for assessing their
distinguishing investment objectives." It is not surprising then, that the typical channel Angels use to learn about investment opportunities is a network of business associates and friends. Over half of the New England Angels rated business associates and/or friends as a frequent source of investment information. Forty-one percent claimed that "active personal search" was a common source, while only 15% cited investment bankers as a frequent source for learning of new investment opportunities (Wetzel: a 31). The Angels in Mr. Gaston's study rated business associates first for frequency and reliability of investment information. Friends were rated a close second, and entrepreneurs ranked third. Investment bankers and brokers were rather low on the list for both frequency and reliability of information (Gaston 81).

The Haar-Starr-MacMillan study took a rather creative approach to the subject of referral networks. The east coast Angels were first asked if they normally refer an accepted investment to someone else. Fifty-two percent said that, if they chose to make the investment, they almost always referred it to someone else. Next they surveyed the referees to determine how many also invested in the referred investment. An astonishing 75% added their money to that of the original Angel. Next the researchers determined who dominated the east coast referral network. They found that "The referral network
in this study was dominated by business associates, friends, and a few investment bankers. Professional and financial sources (accountants; attorneys; business brokers; and commercial bankers) were more rarely contacted. Business associates were preferred by 23% of the sample Angels, while friends carried 21% support. Venture capitalists were included in the referral network of 14% of the Angels, and 12% mentioned investor colleagues. The study also concluded that "Relatives and professional relationships accounted for relatively few of the referrals." It is interesting to note that 85% of the personal colleagues who were referees invested with the referring Angel, while only 60% of the professional contacts chose to make the investment. This becomes especially important because the researchers found that the ventures invested in by the professionals tend to be screened more carefully and, therefore, are often more successful than those invested in by personal colleagues (Haar 22-23).

Wetzel’s research indicates that the majority of business Angels are not content with the existing "random event" channels of communication in the informal referral network. In fact, 34% of the New England Angels claimed to be totally dissatisfied, while only 8% said they are satisfied (Wetzel:a 31). Entrepreneurs are also displeased by the difficulty often encountered in their search for financial backing.
In an attempt to make the channels of communication more efficient, several "go-between" companies have been formed to initiate contact between deserving entrepreneurs and willing business Angels (Tannenbaum 88). Perhaps the best known of these companies is Venture Capital Network, Inc. (VCN). VCN, which is directed by William Wetzel, is a not-for-profit corporation that was formed through a joint effort by the Business and Industry Association of New Hampshire and the Office of Small Business Programs of the University of New Hampshire. According to Mr. Wetzel, "VCN: (1) solicits, compiles and profiles information describing opportunities for risk capital investment in new or emerging ventures; (2) identifies active, informal investors and profiles their distinguishing investment objectives; and (3) provides a timely, confidential and objective referral system serving both entrepreneurs and investors."

So far, VCN seems to be successful. In its first two years the company initiated 1,200 investor/entrepreneur contacts. However, because VCN's contact ceases at the introduction point, the actual rate of investment is unknown (Wetzel: b 95).

The gap between needy entrepreneurs and willing informal investors appears to be shrinking with the help of companies such as VCN. However, these companies, as well as the entrepreneurs and Angels, want to do more than just help fill the gap—they want to close it.
WORKS CITED


