Business Angels in WA – Are They Like Angels Everywhere?

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ABSTRACT

This paper examines the motivations, decision-making processes and behaviours of business angels in Western Australia. Drawing on the findings from a series of in-depth interviews conducted with business angels who invest in early stage start-up companies, particularly in the technology sector, the paper compares the international profile of business angels with the reality of business angels in WA. Findings suggest that the Western Australian business angel community differs in important ways from other business angels found elsewhere in the world. In particular, WA lacks a depth of experienced technology entrepreneurs who have the time and capability to assist early stage companies to grow and penetrate international markets with their technologies.

WHAT ARE "BUSINESS ANGELS"?

The term 'business angel' refers to a high net-worth individual who provides personal investment capital to business ventures and often appear out of the blue with badly needed capital in an almost divine form of intervention (Oats 1992; Fraser 1998). The first 'business angels' were known for bankrolling Broadway productions in exchange for the cut of the box-office revenue, but in recent times they have emerged as the most important source of risk capital available to early stage technology companies (Dwight 1999). Business angels may be defined as:

> *'High net-worth, non-institutional, private equity investors; That is, individuals who have the desire and sufficiently high net-worth to enable them to invest part of their net worth into high risk – high return entrepreneurial ventures in return for a share of voting control, income and ultimately capital gain.'* (Hindle & Wenban 1999)

Unfortunately, the interaction of early stage technology firms and angels has been likened to "a giant game of hide and seek with everyone blindfolded" (Hindle & Rushworth 1999). Little is known about the decision making of angel investors and most have a tendency to maintain a low public profile. For a resource rich state such as Western Australia, there has traditionally been a relative abundance of venture capital for large mining or resource projects. However, this has not been the case for other sectors within the economy, which are less, concentrated and frequently lack strong publicly accessible equity markets. For emerging ventures outside the traditional industry sectors, private investors are of key importance.

ANGELS IN THE VENTURE CAPITAL FOOD CHAIN

Business angels generally provide venture financing to start up companies at the earliest or 'seed' stage in the venture capital 'food chain'. Seed capital financing allows the development of a business *concept,* while start up capital financing generally allows product development and initial marketing to be undertaken by the early stage company (Golis 1998). The arrangement for the investment of funds varies considerably, but is generally more informal and unstructured at this early stage (Barnett & Mazzarol 2002).

Venture capital has been recognized as playing a vital role in stimulating Australia's economic growth, increasing employment opportunities (18 percent growth over average employment growth) and enhancing sales and profits (52 percent growth over average profit growth) for venture-backed companies in comparison with firms using other forms of capital (Coopers & Lybrand 1997). Within the United States, small, venture-backed entrepreneurial firms created over 24 million new jobs over the period 1979 to 1995 while job losses in larger companies numbered 4 million during the same period (Freear, et. al 1997). A similar pattern took place in the United Kingdom between 1994 and 1998, where venture capital backed companies experienced a 24 percent growth in employment against a national average growth rate of only 1.3 percent (Jury 1999). Such firms also experienced export grow rates five-times the national average.

Business angels have been identified as the largest single source of risk capital for entrepreneurial companies (Wetzel & Freear 1994). In the US, angels have been estimated to finance 30-40 times as many early stage companies as formal venture capital funds (Van Osnabrugge, 1998; Gaston, 1989). Within Australia, business angels were estimated in the 1990s to contribute around $9.3 billion in investment capital (Ernst & Young 1997).

WHAT THE LITERATURE SAYS ABOUT ANGELS

Research into business angels in Australia suggests that they are predominately male, middle-aged and are either highly educated or have only a basic education. Such individuals have an average annual income of $180,000 and a personal net worth of around $2 million. These angels invest an average of $200,000 in new business ventures and already hold 10 to 14 percent of their capital in entrepreneurial ventures (Hindle & Wenban 1999). International research suggests that business angels are experienced investors, who have reasonable financial skills and are confident in their ability to evaluate the merits and risks of prospective investments (Mason & Harrison 1996).

Business angels have diverse backgrounds, sources of personal wealth and different levels of financial sophistication. While some are active investors, most invest in only one or two ventures each year, and prefer to focus on start-up ventures in areas where the angel has personal experience as an entrepreneur (Prowse 1998). In addition to providing financial capital, the angel investor also provides access to networks of friends, family and business contacts for the new venture. Most business angels invest ‘close to home’ and insist on personal knowledge of the entrepreneur and usually invest in companies in industries with which they are familiar (Wiltbank & Sarasvathy 2002).

The Motivations of Business Angels

An often-quoted motivation for the angel investor participating in the informal capital market is the provision of what has been termed ‘psychic capital’ or the personal satisfaction of mentoring nascent and novice entrepreneurs in fledgling ventures (Wetzel 1981; Oats 1992). For instance, the results of one survey in the UK found that the ‘*opportunity to play a role in the entrepreneurial process’* was ranked as the second most frequently cited reason for making informal investments (after capital appreciation) (Mason & Harrison 1994). However, evidence from other international studies of the motivations of angels is not unanimous in its support of the role that this so-called ‘psychic capital’ plays in motivating a business angel’s investment decision.

Hindle and Wenban’s (1999) study into Australian business angels found that the most important financial factors that motivated investment were (in order of importance), rate of return, capital growth, cash flow, time to exit and tax benefits. Focusing in part of their study on the non-financial motivations particularly, the ‘potential for fun’ or ‘psychic capital’ motivation was found to rank last of the 14 factors considered by the surveyed angels. It was concluded that Australian business angels are “of serious demeanor”.

The role played by angel investors

There is evidence that the business angels may see themselves as playing important roles in the assembly of human, social and physical capital, in addition to the more obvious financial capital resources supplied (Ardichvili *et al* 2000). A study by Sapienza (1992) noted that there are three roles that are generally played by venture capitalists (including early stage capital providers), in their interaction with their recipient firms. The first is a *strategic* role in which they serve as a sounding board and contributor of strategic ideas. The second is an *operational* role, in which they provide key industry contacts, customers, partners and access to management talent. Finally, the angel plays a *personal* role, serving as friend, mentor and confidant (Sapienza & De Clercq 2000).

AIMS AND METHODOLOGY

A principal aim of this study was to investigate the nature of business angels in Western Australia to better understand the role such individuals play in what is a relatively isolated and sparsely populated region with a fairly thin industry-base. Further, the study aimed to investigate whether business angels in WA were motivated to provide 'psychic capital' or were of a more 'serious demeanor'. This was considered to be of particular importance as the absence of a deep and wide sector within most of the State's non-resource industries suggests that mentoring by angel investors may play a significant role within small entrepreneurial firms.

The key methodology used in this study was a multiple case study approach involving 15 individuals selected from among a list of prominent angel investors within the WA venture capital community. Each individual was selected against the definitions of angel investors outlined in the literature and were known to have a track record of making multiple investments over time. Each individual was approached on a confidential basis and interviewed for a period of between one and two hours using a common, semi-structured interview protocol that examined motivations, decision-making processes and behaviour. Given the small size of the business angel network in WA, these cases are considered to be highly representative. These interviews were approached using the 'replication logic' recommended by Yin (1994). Although data triangulation and verification was limited by the confidential nature of the subject matter, the small size of the WA angel investor community meant that bias or inaccuracy among any particular respondent could be checked against the perceptions of other respondents who frequently described common investment deals from their perspectives. Further, a researcher who has personal experience within the venture capital sector and was able to provide an expert opinion on the reliability and validity of the information supplied undertook the interviews.

FINDINGS

The typical profile of the WA business angels emerging from these case studies was of a male, aged between 50 and 59 years, who had a relatively high level of formal education. All but one case had an undergraduate degree and most had either a Masters or Doctoral degree. Most held an average of 5 percent equity in their various investments. The number of investment deals made by these angels ranged from 4 to 24 with the average around 12 deals. These deals were commonly between \$50,000 to \$100,000, although some had invested as little as \$10,000, others as much as \$500,000 in seed capital for start up ventures. Each of the cases were asked whether they had any intention of making any further investments in the next 12 months and with one exception (who has recently moved into a potentially conflict of interest situation), all replied that they were open to making further investments. No pattern was evident as to the number of angel investments that would be made by each of the cases in this period, although all acknowledged that regardless of their intentions, if the "opportunity" was interesting enough or appeared prospective, additional investments would be considered. While the case study angels could reasonably have been expected to weight their portfolios in favour of resource and energy industries (which are perhaps more 'traditional' for WA and perhaps best reflect a stronger collective business focus for the State), the range of industries was very diverse. In fact, only a small proportion of investments made were in early stage mining or resource industry related ventures, and included ventures in the life sciences, debt factoring, software and even toys.

While this profile seems to be consistent with the image of business angels identified by other research (Hindle & Wenban 1999) there were some noticeable differences. Each respondent was asked:

> *"If you had to choose one motivating factor for why you participate in the provision of angel capital – what would it be?"*

With only one exception, the response from the business angels' was a motivation of making money – that is the "*potential for a big win*" in the words of one angel or "*shit loads of money – ten times our money*" in the words of another respondent. When asked the open question concerning their motivation for being involved in the provision of angel capital, twelve of the fifteen cases qualified their 'single motivation' response with a "but" - examples of which included:

> *"…but it must be interesting"*
> *"…but I'm also interested in seeing businesses start up in WA. If I was just after the money, I wouldn't do it"*
> *"…but I like to be involved in building companies"*
> *"…but it's different from investing in the stock market – it's personal".*

These responses suggest while these angels continued to be motivated primarily by the financial motivation there were other factors influencing their participation that were also important and which necessitated a qualification of their response (even though there was only meant to be 'one motivating factor'). To test the importance of the non-financial motivations two separate strategies were used during the interviews to probe the angels' response. First, a series of additional questions were posed to each angel, which drew out additional possible motivating factors and asked the respondent to comment on whether they were important. Secondly, a question from Hindle and Wenbans' (1999) study was employed to crosscheck each angel's response using a different survey medium and question. These additional questions made clear that there *is* some sort of 'psychic capital' associated with the angel's investment habits (comments such as "*you get caught up with the people*", "*I quite like helping people out*" and *"…it's like being a painter or a writer, you don't want to just stop at 60"* were common), but the non-financial motivations took a definite 'back-seat' to financial motivations.

Utilizing the Hindle and Wenban (1999) survey question, the majority of the angels interviewed struggled to select a non-financial motivating factor from this list of items, suggesting that many of the designated factors were in fact decision criteria, not motivators. They also suggested that the 'interest', 'personal involvement' and 'giving something back to the community' factors should have been included in the list. Notably, it was clear that the "potential for fun" motivating factor rated more highly than in Hindle and Wenban's study. It is likely that the reason for this is that many of the angels equated "having fun" more with whether the investment needed to be "interesting" or be "personal" in some respect.

Roles played by business angels

The roles played by the WA business angels in the cases were not found to fit the typical classifications identified in the literature. Rather than making an active commitment to the firm's in which they invested the angels were found to play relatively little direct role in these ventures. It seems WA business angels largely have very little involvement in their investments by choice. As a rule, the business angels interviewed in this study never became directors of the companies that they invested in. This was a reflection both of the potential liability that they would assume and the relative "value add" that they thought they could provide to the companies in that role. These angels were never involved in the day to day running of the business, and would monitor and check on their investments infrequently and generally took a 'hands- off' approach to their investments. This seemed to be a reflection of the trust that they placed in the entrepreneur or management team, and the fact that most angels largely did not have any relevant industry experience to lend. Interestingly, the deep business experience and contacts possessed by the angels were not usually offered and many angels believed that this sort of involvement would be "interfering".

The WA angels also acted as a 'sounding board' to management of their investment companies, but only as and when required by management. In practice, this meant that the angels were happy to take phone calls from their investment companies and attend meetings, but they did not expect to be proactive in the offering of advice. They also didn't generally view their role as an advisor to the company, except perhaps with respect to matters involving capital raising. This was necessarily a consequence of their relative lack of experience in the industry addressed by their investment firms as well as a reflection of where most angels saw their skill strength and “value add”.

CONCLUSIONS AND IMPLICATIONS

The findings from this study support the pattern of previous research into business angels undertaken both within Australia and overseas. In terms of personal characteristics and financial motivations, business angels in WA appear little different from their counterparts in other locations. Good financial returns for their investments seem to be the principal factor motivating these angels, and they assess such investments in similar ways to angels in other parts of Australia or overseas. However, WA angels also appear to be motivated by the opportunity to “give something back to the community”, “support entrepreneurs” and be involved in something “interesting”. To this extent they appear to have a desire to offer ‘psychic capital’.

The biggest surprise and consequently, greatest concern arising from this study is the *role* that is played by the majority of WA angels, as compared to their international (and perhaps National) counterparts. This over-abundance of ‘professional informal capital investors’ (as opposed to more ‘hands-on’ or industry experienced angels), has significant consequences for the potential success of early stage entrepreneurial ventures in WA and the WA economy as a whole. For instance, most early stage technology companies are generally forced to ‘go it alone’ when it comes to developing their strategy, creating an internationally competitive product or service, attempting to enter global markets, endeavouring to engage industry partners or establish distribution or support channels, and seek ways to grow outside the limited market of WA. The mentoring role of business angels has been found to be an important factor in assisting early-stage ventures (Leonard & Swap, 2000). A reluctance by WA angels to ‘get involved’ with the venture firms in which they invest may be a potential impediment to successful growth for such companies.

It is perhaps not possible in the short term to source a pool of experienced business people in various industries who are prepared to become involved in early stage entrepreneurial firms, and guide the critical market definition, product or service creation, market entry and capital raising activities. Few options are available to fill the identified skills gap until the pool is naturally populated with available angels. WA business angels should recognise the potential value that they can provide to start up ventures not only in terms of financial capital, but also ‘psychic capital’.

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