

Australia's Informal Venture Capitalists: An Exploratory Profile

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ABSTRACT

In Australia, as it is all over the world, finding and acquiring equity capital is one of the major problems facing entrepreneurs who are starting or growing entrepreneurial ventures. The informal venture capital market, made up of high net worth non-institutional private equity investors (or 'business Angels') provides risk capital directly to new and growing businesses and has been shown to be considerably more significant than institutional providers as a source of finance for entrepreneurial businesses. Building upon and comports with Angel research undertaken internationally, this study generated and evaluated data resulting from an investigation of Australian business Angels which focused upon three primary research questions: (i) *Who* are Australia's Informal Venture Capitalists (Business Angels)? (ii) *How* do they behave? (iii) *What* are their investment criteria? Analysis of answers resulting from a survey of 36 carefully screened respondents produced a descriptive profile, depicted in twelve key graphs, of Australian Angels' identifying characteristics, patterns of investment behaviour and investment criteria. The study initiates Australian Angel research into the developing international continuum of formal Angel research and can serve as the generator of empirically sensible hypotheses for future research and theory development.

INTRODUCTION

This paper reports a project which employed a convenience sampling technique compatible with similar international investigations to develop an exploratory and suggestive profile of Australia's business Angels.¹ Four objectives motivated the study. First, the research was designed to *complement* the 'Angels' research done by others including Freear, Sohl and Wetzel (1992); Wetzel (1983, 1986, 1994) from the USA and Canada; Harrison and Mason (1991, 1992, 1994); Mason and Harrison (1992,1993,1994a, 1994b, 1994c, 1995) from the UK and Landstrom (1993) from Sweden thus helping to augment the existing world-wide picture of Angel characteristics and behaviour. Second, was a desire to *extend* existing research by scrutinizing and enhancing the methodology of Angel research presently developed and previously employed. A third aspiration was to help to *define* Angels with greater regional clarity. In the words of William E. Wetzel (1981), it would 'put some boundaries on our ignorance' of business Angels in Australia by producing a tentative generic profile of Australia's Angels. Development of such a preliminary formal construct - summarizing identifying characteristics, investment criteria and investment behaviour - might advance understanding of Australian Angels because previous regional discourse on the topic has been more anecdotal than scholarly. Finally, it was intended that the emergent, tentative construct might produce well-grounded propositions for subsequent hypothesis testing and thus serve as the initial study in a structured chain of research.

To position this investigation within the continuum of international Angel research the key reference is a comprehensive summary of the 'state of the art' provided by Freear, Sohl and Wetzel's (1996) paper, *The Informal Venture Capital Market Milestones Passed and the Road Ahead*. Their discussion follows and updates Freear and Wetzel's examination of the informal venture capital market published in the *State of the Art of Entrepreneurship* (1992) which presented an eight item agenda. The investigation reported in this paper comports with agenda item two:

'More research is needed into the ABC of angels - their attitudes, behavior and characteristics. This research should shed light on questions about the existence of

¹ For the purposes of this research 'Informal Venture Capitalists', synonymously called 'Business Angels' or just 'Angels' can be defined, uncontroversially, 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.

categories of angels, i.e. subsets of angels that display common characteristics.' (Freear, Sohl and Wetzel 1996: 2)

Following this precept, the present study focussed upon three primary questions.

- *Who* are Australia's Informal Venture Capitalists? The answer requires formal classification of their identifying characteristics.
- *How* do they behave? The answer requires classification of observed investment behaviour patterns.
- *What* are their investment criteria? The answer requires formal classification of the attributes of a new venture that attract Angels to a potential private equity investment.

RESEARCH DESIGN

Survey Methodology

By definition, formal study of informal venture capital is bound to be difficult. Research performed in the United States of America and the United Kingdom has shown that high net worth non-institutional investors are very difficult to identify. There are no public records of their investment transactions, there are no directories of individual investors and they have a strong preference for anonymity (Wetzel 1981; 1987). It has been postulated that this desire for anonymity is based upon a fear of being identified and then deluged with investment proposals (Haar *et al.* 1988). Freear, Sohl and Wetzel (1996: 2) state:

'.... access to quality data remains the biggest single obstacle to research in this field'

Most samples for surveying Angels have been convenience samples. Studying the literature and examining previously-used convenience sampling techniques for Angel research, reveals three major approaches. Each has been given a nickname. First is the 'big list big assumption method' [refer to Freear *et al.* (1992; 1994b)]. As the nickname implies, this can generate a large sample size but only by assuming that the characteristic which is at the heart of the list (e.g. all people on the list are owners or mortgagors of high-value domestic property) also indicates that the list respondents fit the definition of Angels. They may not. The second sampling method was nicknamed the 'investee introduction method' (refer to Aram 1989; Freear *et al.* 1990; Harrison *et al.* 1992; Mason *et al.* 1994b; Freear *et al.* 1995). Here, the directors of companies which have Angel investors supply the researchers with an introduction to them. The great virtue is that data is collected from respondents who definitely *are* Angels. The great weakness is remoteness from any possibility of claiming randomness in the sample

group thus obtained. Finally, there is the 'targeted snowball' approach [first reported by Wetzel (1981) and refer to Postma and Sullivan 1990)]. This approach starts by identifying some genuine Angels willing to be surveyed and asking them for referrals to other Angels they know. This 'rolls the snowball' until the researchers reach either the limits of their time resources or the limits of the referral capacity of survey participants. The literature also reveals various combinations of these three and other methods. The combination of postal survey with 'targeted snowball' approach has been quite common (Harrison *et al.* 1992a; Landström 1993; Mason *et al.* 1994b).

Defining and Distinguishing Respondents

The informal venture capital market is made up of high net worth, non-institutional, private equity investors. These are individuals with sufficient financial resources to enable them to invest some of their capital in high-risk, potentially high-return, unlisted entrepreneurial ventures. However, the ability to invest in entrepreneurial ventures does not necessarily coincide with a willingness to do so or a history of having done so. Some high net worth individuals do not invest at all; they are content to live off their capital passively - in the sense of having it managed for them. These individuals would be classified as 'high net worth *non-investors*'. Of those with a high net worth who do actively invest their own capital, there is a proportion who only invest in institutional investment vehicles, such as stocks and bonds. These were classified as 'high net worth *institutional investors*'.² High net worth, non-institutional, private equity investors are distinguished from high net worth institutional investors because they are willing to make a *direct* equity investment in an entrepreneurial venture - they do not use an intermediary.

Data Collection Technique

To identify the sample of Angels in Australia, the researchers used the 'targeted snowball' approach and attempted to combine this with a limited number of depth interviews³. The experiences of Harrison *et al.* 1992a; Landström 1993 and Mason *et al.* 1994, indicated that the targeted snowball method was likely to yield the highest response in the shortest time. The addition of depth interviews to a set questionnaire 'menu' potentially increased the capacity for richness in open-ended responses.

² The concept of 'institutional investors' must not be confused in its specific context in this paper with the more general notion of 'institutional investors' being large, formal financial intermediaries such as investment funds and trusts.

³ A systematic approach to using depth interviews as a formal research technique is provided in Walker (1985).

One member of the research team - Wenban - is an Angel in his own right. The use of his personal network of known Angels, enabled the recruitment of seven 'missionaries' – Angels who knew of several other individuals who may have been classified as high net worth non-institutional private equity investors and who were willing to participate in the study. All missionaries were given as many questionnaires as they thought they could distribute through their own networks. This was supplemented by the assistance of the Chamber of Manufactures of New South Wales, who distributed questionnaires through their network of Angels. A total of 74 questionnaires were distributed. The participants were asked to fill them out and then return them in an attached addressed and stamped envelope. In order to respect the non-institutional investor's desire for anonymity (Wetzel 1981; 1987; Haar *et al* 1988), and thus to obtain the greatest possible response rate, there was no method of identification of individual respondent identity. The majority of the data was collected in the second half of 1995. Quality control checks and attempts at depth interviews took place in early 1996.

Survey Instrument

Overview. The questionnaire was designed using, as a basis, questions taken predominantly from survey questionnaires used by Freear and Wetzel (1988), Freear *et al.* (1992) and Mason and Harrison (1994d). However, most of these questions were extensively modified to make them more appropriate to the Australian setting. The overall design of the survey instrument - a questionnaire in seven sections - was such that it would cull the respondents; systematically eliminating those that did not fit into the definition of high net worth non-institutional private equity investors established above. Given the space constraints affecting this paper, the survey instrument is not reproduced in full but is available to bona fide scholars upon written request to the authors.

RESULTS SUMMARY

Survey Response

Of the 74 questionnaires distributed, 48 were returned, one of which was incomplete. Five of the remaining 47 were completed by high net worth individuals who had no intention of investing in the next twelve months, thus being classified as high net worth *non-investors*. Six of the remaining 42 were of high net worth but had not considered allocating any of their capital to entrepreneurial ventures; thus being classified as high net worth *institutional* investors. The 36 remaining respondents were thus all classified as high net worth non-institutional private equity investors; true Angels. The response rate for this study was 36 of 74, or 48.65%. This figure comports closely with that achieved by other researchers using similar methods of

identification and distribution. Landström (1993) achieved a response rate of 42% using a combination of the investee introduction method and the snowball method. Based on the results of this research, the following is a profile of Australia's business Angels..

Identification Characteristics and Investment Behavior Summary

If a picture is worth a thousand words, a graph may be worth at least five hundred! The exploratory profile of Australian Angels is contained in 12 key graphs which depict the key survey results. This section will present each graph and a brief summary of the findings surrounding it. The next section will discuss implications.

Figure 1
AGE PROFILE

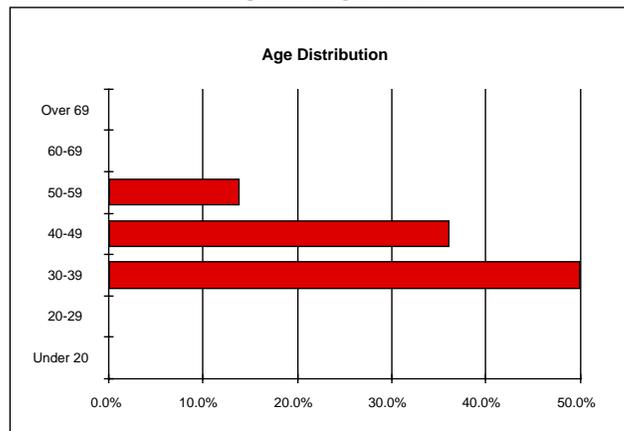
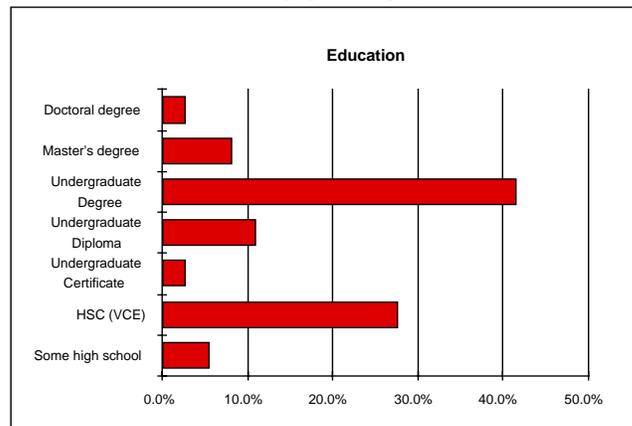


Figure 2
EDUCATION



Respondent Australian Angels were male, middle aged, and fell into two distinct levels of education. They were either highly educated, that is, up to undergraduate degree level, or had only basic education, that is high school graduation or less. There were very few with education levels between, or on either side of these two groups. They came from a diverse range of backgrounds - predominantly science and business. They rated themselves as 'general

managers' and 'people managers' and most had been involved in several start-up ventures before. They read the *Financial Review* and *Business Review Weekly* as well as publications peculiar to their trade or specialty.

Figure 3
INCOME

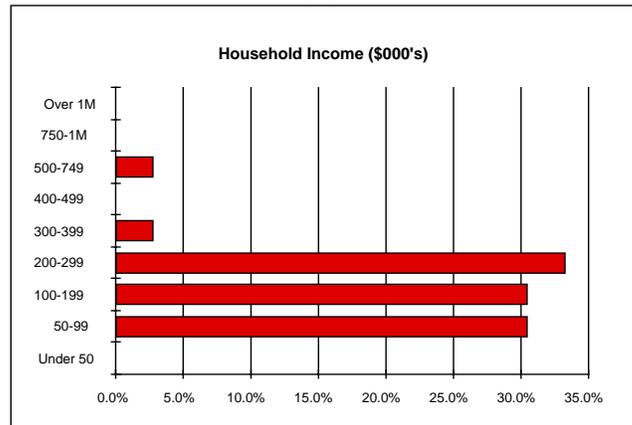
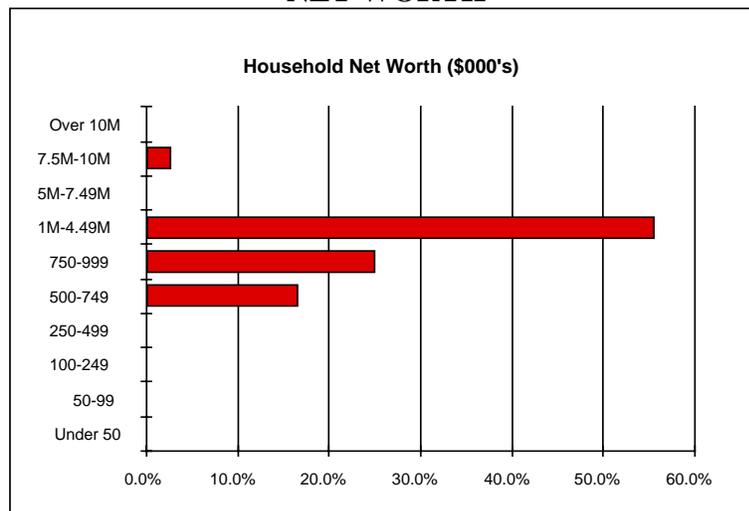


Figure 4
NET WORTH



Respondent Australian Angels had an average income of around \$180,000 per year and a net worth of around \$2 million. This gave them the ability to invest around \$200,000 in entrepreneurial ventures which they intended to invest within the next twelve months into between two and three ventures. These investments would occur as either a 'cherub' investment of one or two tranches of between \$20,000 and \$50,000 or a single 'seraphim' investment of between \$200,000 and \$500,000 (see discussion, in the final section, below).⁴

⁴ 'Cherub' (for small investors and 'smaller angels') and 'seraphim' (for large investments and 'bigger angels') were category descriptors that the authors were unable to resist.

Figure 5
AVAILABLE CAPITAL

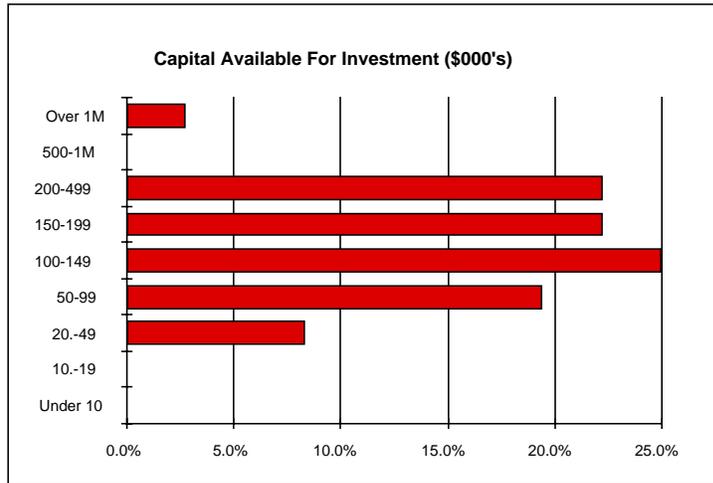


Figure 6
INTENDED DEPLOYMENT

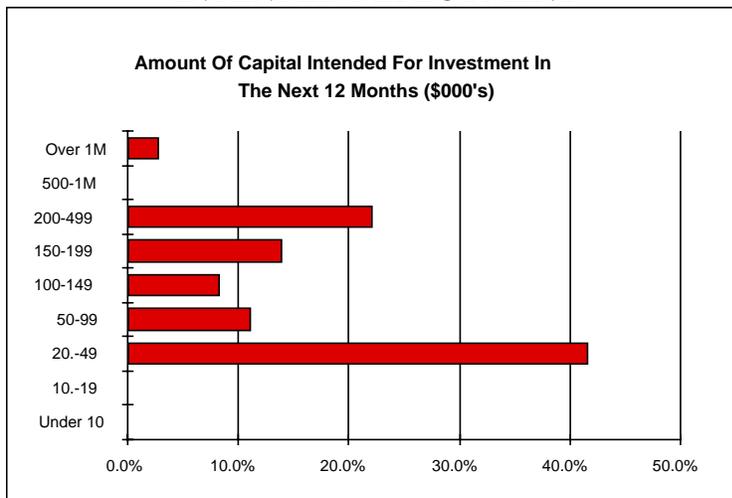


Figure 7
EXISTING ANGEL INVESTMENT PROPORTION

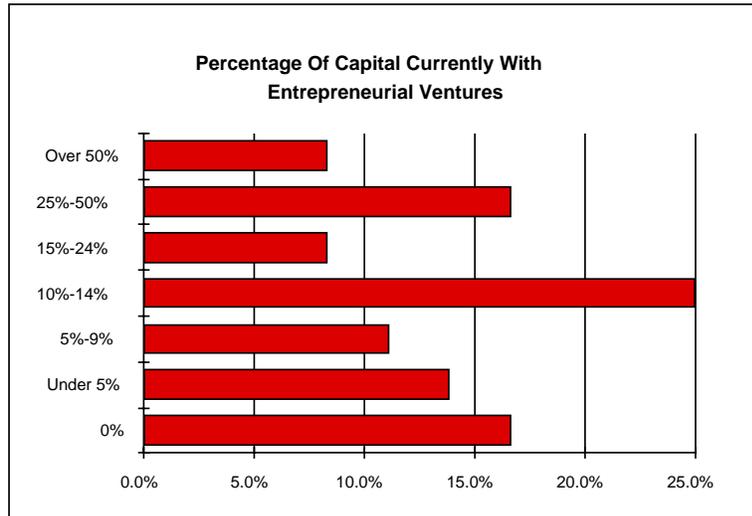
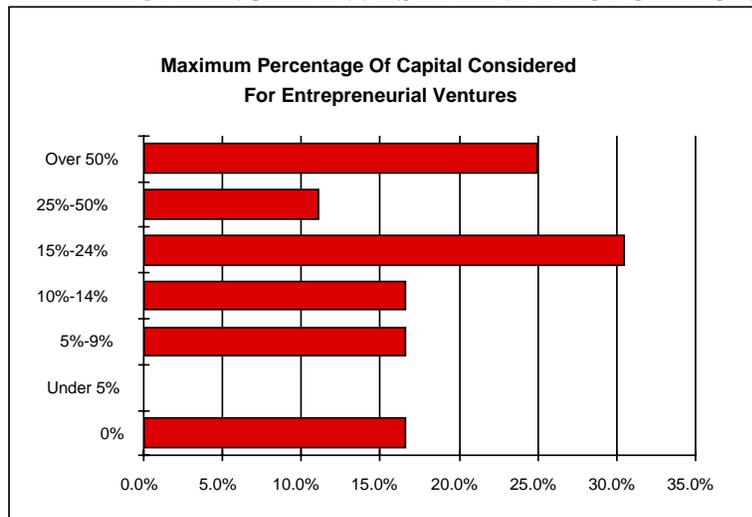


Figure 8
MAXIMUM ANGEL INVESTMENT PROPORTION



Most of the surveyed Australian business Angels currently had between 10% and 14% of their capital already invested in entrepreneurial ventures. While this amount had been more likely to remain the same or increase rather decrease over the five years prior to survey, the majority were looking to increase this exposure to between 15% and 24%. During the two years preceding the survey year of 1995, these Australian Angels had been gradually increasing their tendency to invest after becoming very cautious through the early 1990's. This clear pattern of Angel investments actually made versus Angel investments considered is illustrated in figures 9 and 10.

Figure 9
CONVERSION RATES

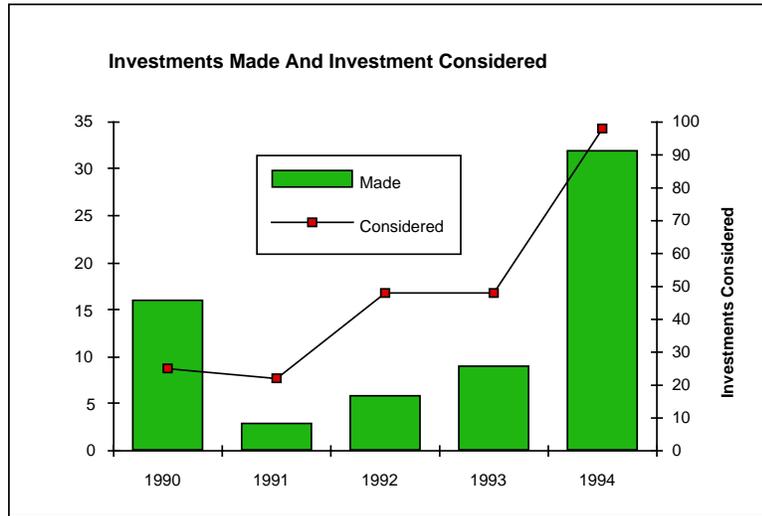
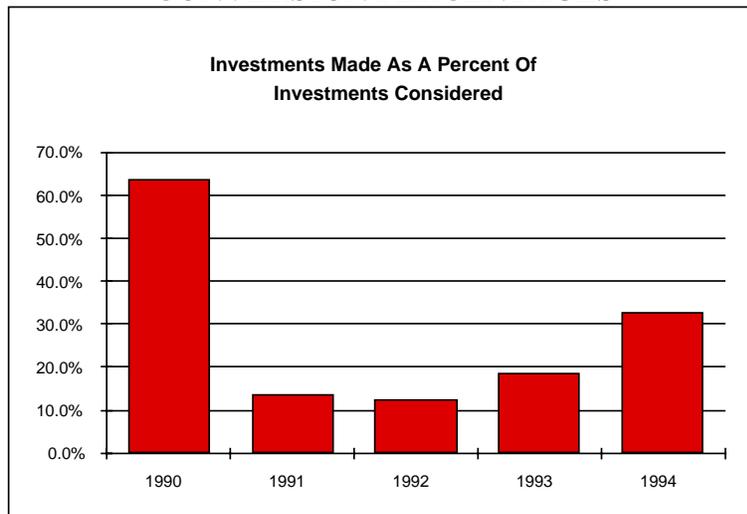


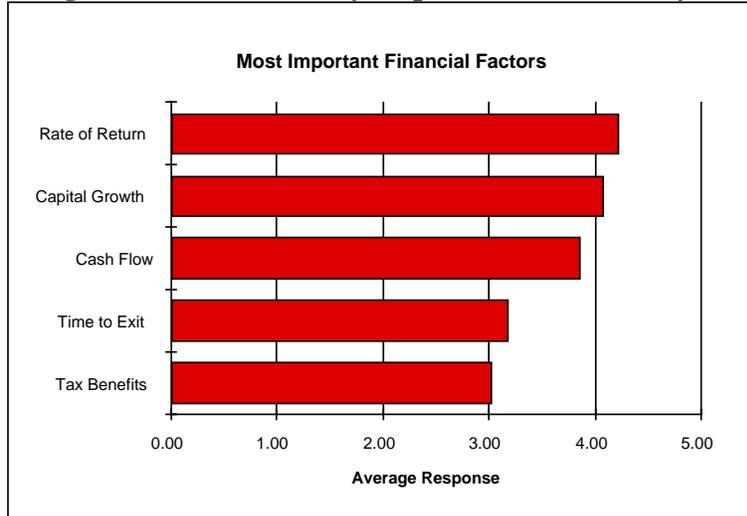
Figure 10
CONVERSION PERCENTAGES



Investment Criteria: Summary of Attractiveness Factors

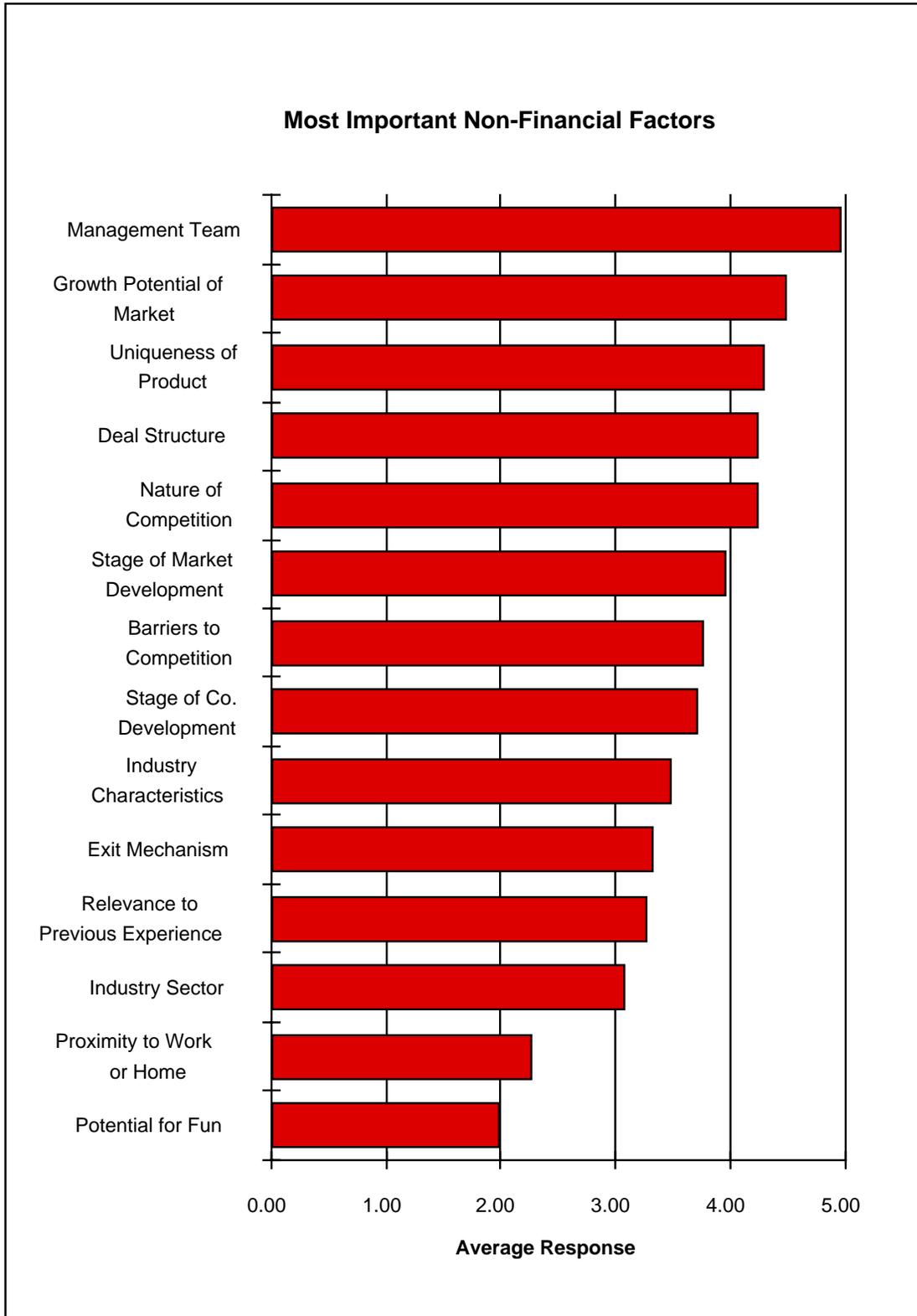
Following international precedent, factors attracting Angels to invest in entrepreneurial ventures were divided into two groups: financial and non-financial.

Figure 11
RATING FINANCIAL INVESTMENT STIMULI
5-Point Rating Scale from 5 = 'Very Important' to 1 = 'Very Unimportant'



The most important financial new venture attractiveness factors for Australian Angels were, in order: rate of return; capital growth; cash flow; time to exit and tax benefits. Surveyed Australian Angels required a minimum rate of return of 20% and their capital was required to increase by a factor of two by the time they expected to exit the venture - three years. If new, the venture was required to be cash flow positive within 18 months of start-up and respondents expected to be able to take advantage of some tax benefits, possibly in the form of write-offs or negative gearing.

Figure 12
RATING NON-FINANCIAL INVESTMENT STIMULI
5-Point Rating Scale from 5 = 'Very Important' to 1 = 'Very Unimportant'



The most important non-financial entrepreneurial venture attractiveness factors for Australian Angels were, in order: management team; growth potential of the market; deal structure and nature of the competition (both equal); uniqueness of the product or service; stage of market development; barriers to competition; stage of company development; industry characteristics; exit mechanism and relevance to previous experience (both equal); industry sector; proximity to home or work and finally, potential for fun.

Surveyed Australian Angels required the management team to be competent, committed and experienced in the field. There needed to be ample growth potential in the market, which the Angels preferred to be already growing at the time of their investment. They preferred that the management had some equity to ensure commitment, yet they usually sought enough equity themselves to ensure a degree of influence over the direction of the venture. They required well established barriers to entry from competitors and they preferred to invest in the early stage or growth stage of company development. Unsurprisingly, the earlier the stage of company development in which they made their investment, the greater degree of control and return they required. The remaining non-financial factors showed such a large variation in the responses of the Angels that, with a sample of this size, no clear pattern was discernible.

RESULTS DISCUSSION

INFERENCES AND IMPLICATIONS OF THE INVESTIGATION

- **Limitations of the Sample.** The 36 respondents who constitute the 'true' angels surveyed in this project do not represent a statistically valid random sample. The 'survey' fundamentally constitutes qualitative rather than quantitative research amounting to 36 small case studies robust enough to justify some strong inferences within the boundaries articulated by Yin (1989, *passim*) for the nature of case research and the validity of inferences drawn from it. Within these limitations, the study has demonstrated that Australian business Angels have characteristics that distinguish their identity and behaviour from both other types of Australian investors and overseas Angels.

- **The Failure of Depth Interviewing.** The Angels who participated in this survey did so with the strictest insistence that their absolute anonymity must be totally assured. On the advice of William Wetzell, the researchers endeavoured to draw out reasons, explanations and even anecdotes to add flesh and color to the bare bones of the answers given to the questions in the core survey instrument: an attempt to add color to a black and white portrait. Results were stark and disappointing. Face to face interviewing just did not generate the hoped-for depth of

insight. Respondents were taciturn and reluctant to embellish the answers recorded on the survey instrument. A typical response was:

'If I tell you any more than you've got already, people will know who I am.'

Despite all limitations, the study's profile of Australian Angels is a useful adjunct to a developing area of research.

- **Sex.** The totally male sample shown in this survey appears to be fairly typical of Angels elsewhere. The overseas research has shown male dominance to the order of over 95% (Mason and Harrison, 1995). During the preliminary search for respondents, the researchers did hear of a female Angel, but were unable to contact her to include her in the study. Given the size of the final sample, the inclusion of even one female would have produced a male to female ratio somewhat closer to that achieved overseas.

- **Age.** Australian Angels appear to be younger than the average overseas Angel. Even though the age range was closely aligned with the foreign figures, the weighted average of this sample gave a much younger figure. It is difficult to find reasons beyond the two most obvious: that Australian Angels really *are* younger (doubtful), or that there was a bias in the sample that produced this figure (more likely).

- **Education.** The levels of education of Australian Angels produced a very striking internal contrast. Australian Angels were either highly educated, at least to bachelors level, or they were barely educated past high school. Further analysis of the data showed that those who were educated to the higher levels were generally younger than those who were educated to the lower levels. Yet there was not such a clear relationship between the education levels and either the net income, net worth or amount available for investment. The picture that emerges is one of two distinct groups. The first is of the older Angel who did not necessarily go past high school, but then probably went out to work, or into business very soon after leaving school. One can postulate a group of people who are now in their fifties or early sixties, who have been working or have been in business since they left school. They have probably either worked their way up through an organisation to take it over, or they have started from scratch and built up wealth using 'street smarts'. These are what might be called 'graduates of the school of hard knocks'. At the other end of the scale are the younger, more highly educated young professionals. These people have probably gone on to university after high school, and then started in their professional career, quickly catching up to their older colleagues in terms of wealth by virtue of their high earning capacity. There is some credence given to this scenario by the fact that those with the highest income did not necessarily have the highest net worth.

- **Wealth Accumulation.** Australian Angels superficially appear to be better at accumulating wealth than their foreign counterparts. Mason and Harrison (1995) report that the average UK Angel's net worth is approximately 6.78 times their annual family income, while the same ratio for the US is 8.33; for Sweden it is 10.00; and for Canada it's 7.69. Respondent Australian Angels had an average net worth 11.70 times their annual household income. There are three possible explanations for this. First, that this really is the case. Second, that it is due to the relatively small sample size producing bias. The third and most likely reason is that the range on the questionnaire was too wide. Section II, question 2 asked respondents for their household net worth and the most frequently selected option was '(g) \$1M – \$4,49M'. When a weighted average was calculated for the scores, it is possible that this wide range produced an artificially high average, thus biasing the results.

- **Two Distinct Angel Categories.** While the amount of capital that Australian Angels have available for investment is fairly uniformly spread across a range of between \$50,000 and \$500,000, the amount that they intend to invest creates two distinct Angel categories. One group could be called 'seraphims' - or big angels - because they intend to invest between \$200,000 and \$500,000. The other group might be called 'cherubs'. These are the 'baby angels' who intend to invest only in tranches of \$20,000 to \$50,000. Cherubs differ from the 'potential Angels' or 'virgin Angels' identified by Freear, Sohl and Wetzel (1994b) in that they *have* invested before; they simply invest on a smaller scale.

- **Hierarchy of Financial Attractiveness Factors.** The responses to the questions on financial attractiveness factors displayed a definite order and consistency, represented not only by average response but also by the standard deviation of those responses. Thus it appears that there was a high level of agreement among the respondents regarding the relative importance of these factors. However, the same pattern was not evident in responses to all questions regarding Angels' requirements for minimum acceptable performance of each financial attractiveness factor. For example, the standard deviation indicated a high level of disagreement over the minimum rate of return (SD 9.9377), but a high level of agreement over the time required to reach positive cash flow (SD 0.5040) and the required rate of capital growth (SD 0.7082). The most likely explanation for this would be the confusion that was evident among the respondents about the terms 'rate of return' and 'capital growth'. It became evident from the depth interviews that some respondents had been using the two terms synonymously. Hindsight now indicates that the survey instrument would have been improved by provision of a list of definitions at the start of the questionnaire to ensure uniformity of terminology among respondents. There was such a small difference between the responses for 'rate of return' and 'capital growth' that it is

conceivable that they could easily be reversed given either a larger sample or more clearly defined terms.

There was no such ambiguity with the responses for 'time to reach positive cash flow'. Although the standard deviation for this response was relatively high compared to 'rate of return' and 'capital gains', there was still very little doubt about its position in the hierarchy. There was general agreement about preferred 'time to reach positive cash flow' - approximately 18 months – making these Australian Angels far less patient investors than their international counterparts or the 'textbook' Venture Capitalist.

• **The 'Mixed Bag' of Non-financial Attractiveness Factors.** The non-financial factors showed a strong pattern of agreement on some issues and great variety on others. The key non-financial factors which Australian Angels took into consideration when evaluating an investment opportunity were:

- the management team,
- the growth potential of the market, and
- the uniqueness of the product or service.

This pattern is identical to that observed by Mason and Harrison (1994a). These considerations are reflected in the reasons that informal investors reject investment proposals, the most important of which are associated with perceived weakness in the entrepreneur or management team, limited growth prospects for the business, and limited market for the product or service (Mason and Harrison 1994c). Beyond the confines of the initial questionnaire, the depth interviews of this study revealed that Australian Angels place a very high level of importance on 'investing in the people - not the product'.

Although several previous overseas studies have cited 'potential for fun' and 'proximity to home or work' (Wetzel, 1981; Gome 1995) as important non-financial investment-inducing factors, the Australian survey found them to be the least significant of the fourteen 'pre-fabricated' options provided on the questionnaire. It can safely be said that Australian business Angels are of serious demeanor: fun is not a prime investment motivator. Neither is 'proximity to home or work'. A possible explanation for this could be that Australians are accustomed to travelling long distances for all aspects of their daily lives.

• **Speculation on Informal Versus Formal Venture Capital Market Sizes.** What is the portent of a small number of Angels (thirty six) intending to invest a large number of dollars (over 7.5 million) in a twelve-month period? The majority of respondent Australian Angels who had a percentage of their capital invested in entrepreneurial ventures wanted to increase their

involvement. They had been gradually increasing both the number of opportunities that they considered and the number of opportunities in which they invested. This trend seems to have been increasing steadily since it reached a low in 1991. The official Australian Development Capital Association survey [Arthur Anderson (1996)] identified only \$103 million spent on early-stage investments by the institutional Venture Capital industry in the 1995-1996 financial year.

There is an almost overwhelming temptation to extrapolate from the 36 Angels of this survey and their \$7.5 million earmarked for private equity investment to the thousands of Angels believed to exist and state that the Australian Informal Venture Capital Market is greater than the Institutional Venture Capital Market by several orders of magnitude. Of course, the temptation must be resisted because no direct quantitative extrapolation to a value of the Angel market is yet possible. It is a task beyond the confines of this study. Future research, a meta-study, might usefully weave the findings of this study into a continuum with: the arguments of Martin (1997); data yet to emerge from the Australian Stock Exchange's creation of its 'Enterprise Market', an internet based service for matching Entrepreneurs and Angels; data from various State and Federal matching services and other sources. This paper will not undertake any part of that large task beyond observing that a prognosis on the health of the Australian informal venture capital market based on this study, would tend towards strong optimism.

- **Towards Further Research.** Angel market value estimation is the area most seriously in need of further investigation. Beyond the meta-study mentioned above, there are three approaches that could help to provide the statistically valid random samples needed to yield significant quantitative market estimates. The first approach would be to create an Australia-wide Angel-Entrepreneur Introduction Service and establish the data base as part of its mission. But this implies a long time span until reliable quantitative research can be conducted. The second possibility would be to co-ordinate the current efforts of the various Chambers of Commerce throughout Australia, using their existing data bases of Angels [see WSROC (1995)]. This would achieve a much larger, and possibly less biased, sample. It would also eliminate the duplication so evident in the current approaches. The third approach would be to build a national data base of Angels by contacting them anonymously via the various professional societies of accountants and solicitors. With further investigation of chambers of commerce and professional bodies' data bases it might be found that the infrastructure already exists that would allow Australia to create a national survey and data base of business Angels.

In the meantime, there is at least a beginning: a descriptive profile of the ABC (attitudes, behavior and characteristics) of Australian Angels called for in the second of Freear, Sohl, and

Wetzel's (1992c) eight point research agenda and re-iterated in their (1996) review of the literature and milestones achieved in the field. Particularly as depicted in the twelve graphs of the previous section, the results of this study are comparable to the state-of-the-art internationally. They provide a sharp sketch of what Australia's Angels are potentially like. Of course, this portrait of the Australian Angel is not a true photograph of a proven perpetrator. It is more like an identikit picture of an alleged suspect. But it can be of great benefit to the continuing search. The elements of the sketch may now provide a template for hypothesis generation. To test hypotheses and thus progress from a pattern of description to causal explanation in the Angel field, the greatest difficulty remains access to a statistically valid random sample of a population which jealously guards its privacy.

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