Chapter 4

The role of policy in facilitating angel investment

This chapter reviews policy approaches for seed and early-stage financing and discusses some potential next steps for the OECD's work in this area. It provides an overview of different types of public interventions. It then focuses on specific public policies for promoting angel investment, providing examples from countries around the world. These include both supply and demand-side measures. On the supply side, these include tax incentives, co-investment funds, support to angel associations, networks or groups and the training and development of angel investors. On the demand side, these include investment readiness for entrepreneurs and developing the entrepreneurial ecosystem.

While there are clearly a number of gaps in the seed and early-stage investment market, including funding gaps, information gaps and even experience gaps (EC, 2002), there is still some debate about whether or not these constitute a "market failure". Policy makers in some countries have sought to address these market gaps through both demand and supply-side measures, although mostly the latter. These have been in the form of both debt and equity instruments. After many years of leveraging debt instruments, public sector interest has grown in utilising equity instruments.

Following the recent financial crisis, access to finance for start-ups has become a growing concern. With banks hesitant to extend loans to start-ups with no assets or credit history, equity has become increasingly important.

Overview of public intervention in seed/early-stage financing

Fostering financial markets

The financial system has a central role in fostering innovation and growth. Policies and reforms of financial institutions and markets can facilitate financing of entrepreneurial firms. Evidence shows that start-up, small and medium sized companies are more constrained by financing and other institutional obstacles than large enterprises, which is exacerbated in many developing countries by the weaknesses in the financial systems (Beck, 2007).

An effective integrated market for financial services is necessary to provide more capital for investment, including equity sources such as angel and venture capital. Efficient legal investment structures and stock markets are necessary to recycle and redeploy financial wealth. Secondary stock markets, geared towards smaller firms, play an important role in entrepreneurship and innovation. In addition, it is important that financial securities legislations do not inadvertently impede the creation and growth of early-stage ventures.

Removing fiscal regulatory barriers

These vary by country but often the tax and regulatory system is to complex and/or has hidden disincentives for young innovative firms and/or investors. Many countries are working to address these issues. In Germany, an Expert Commission has been set up to assess innovation incentives for high-growth firms. In Australia, as part of the Corporate Law Economic Reform Program, the government reduced regulatory barriers that were restricting sophisticated investors, like business angels, from investing in SMEs.

Box 4.1. Corporate Law Economic Reform Program (CLERP)

Australia has undertaken a number of review processes of financial sector regulation in recent decades. The Corporate Law Economic Reform Program (1997-2007) was one of these review processes and was designed to improve productivity and promote business activity and economic development.[1] As part of the CLERP reforms, access to capital was made easier for small businesses by introducing a range of measures to assist small and medium-sized enterprises (SMEs) including enabling companies to raise up to AUD 5 million using an Offer Information Statement, up to AUD 2 million from 20 private investors and amounts of less than AUD 500 000 from individual 'business angels' without a prospectus.[2] This facilitated SME fundraising by reducing regulatory barriers and compliance costs associated with meeting the information requirements that would otherwise apply to raising funds.

1. "Regulatory Efficiency and Effectiveness: Case Study from Australia - Overview of recent regulatory review and reform of Australian financial sector regulation" 25-26 October 2007 *www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DAF/CMF(2007)18/PART1&docLanguage=En*

2. "Corporate Reform Economic Reform Program", *www.treasury.gov.au/documents/264/PDF/clerp.pdf*

Policies for increasing debt financing

Government programmes in some countries have tried to help overcome these funding gaps in different ways. One way in which government has intervened is by providing direct funding to credit constrained small, young and innovative firms through loans or grants. Governments sometimes act as guarantors for loans through loan guarantees programmes targeted to firms below a certain age or size.

Loans and loan guarantees

Public support programmes for small firms to get easier access to external finance are widespread across OECD and non-OECD economies. This type of support can take the form of direct lending to young and small businesses or start-up subsidies to encourage people to start a business. Government can provide support by providing loan guarantees which provide a form of insurance to lenders against the risk of default. However, evidence on the effectiveness of these programmes is scarce relative to their extensive use across countries and is mixed. Evaluations have mainly focused on additionality, *i.e.* to what extent the programmes have benefited firms that would have not been able to access loans otherwise, and the level of default.

Grants

Normally grants are provided to firms in a competitive manner rather than automatically. This is especially the case for grants for innovation activities. The selective process for grants has been recognised as having an additional positive effect for those firms receiving support in that it provides a screening device for lenders on the quality of the project/firm. SBIR was launched in the United States in 1982 and is a highly competitive programme that encourages small business to explore their technological potential and profit from its commercialisation.

Other countries have developed SBIR-type instruments including the United Kingdom, Netherlands and others. More recently in France, the innovation agency OSEO has begun to catalyse funding for innovative start-up companies with a new approach to de-risking the development and commercialisation of novel technology (Science Business, 2010). One third of OSEO's funding is through a grant and two thirds through a loan. In addition, the total amount is limited to 50% of the start-ups funding needs to ensure that other investors are also engaged.

Policies to promote equity financing

As discussed earlier, outside equity such as angel or venture capital investment, is typically only appropriate for high growth-oriented firms. The majority of measures to promote equity financing in the past decades have focused on stimulating the venture capital market although some have also applied to the angel market, which will be discussed in greater detail in the following section.

Tax incentives

Increasingly, tax incentives are being used in a number of countries as a way to address asymmetries in the treatment of profit and losses (Poterba, 1989; Gendron, 2001; Cullen and Gordon, 2007) which can help in removing barriers and encouraging more investment in start-ups. This is particularly important for venture and angel investors who take a portfolio approach to investment knowing that many of the investments will fail and hoping that some will succeed. Tax incentives for angel investors are discussed in further detail in the next section.

Direct investment through funds, co-investment funds and fund-of-funds

Another common approach of the public sector is to facilitate the growth of venture funding, whether directly, through funds or co-investment funds (in which public money is used to encourage and leverage private investment), or through fund-of-fund vehicles (a "fund of funds" is an investment

strategy consisting of holding a portfolio of other investment funds rather than investing directly in shares, bonds or other securities). When public funds are deployed, they should be channeled through existing market-based systems, namely private funds, and shaped with a clear market approach to yield the intended results (Lerner, 2010). In addition, the public contribution should be limited to less than 50% of the total funding (EVCA, 2005). Experience in Europe has demonstrated that public intervention itself, without the leveraging of private money (institutional investors), will only serve to grow an unsustainable venture market (EVCA, 2010).

Public funds should only be utilised where a tangible or imminent market failure in the private sector is evident. These vehicles should be designed in line with the market needs. Furthermore, in order to assess their accuracy and efficacy, a periodic review should take place and adjustments made as needed. At the same time, there should be a focus on development of the market, rather than solely on a provision of financing. This requires creating the proper incentives and supporting the development of the necessary quality, skills and experience in the venture firms to match international norms (Lerner, 2009).

Box 4.2. Yozma Fund, Israel

The government effectively created the Israeli VC market by investing USD 100 million in 10 VC funds over the period of 1992-1997. The goal was to attract private funding from experienced international venture capitalists. In parallel Yozma started making direct investments in startup companies. This marked the beginning of a professionally managed venture capital market in Israel.

Each new VC fund had to be represented by three parties: *i*) Israeli VCs "in training"; *ii*) foreign VCs; and *iii*) an Israeli investment company or bank. The 10 Yozma funds raised over USD 200M with the help of the government funding. Those funds were bought out or privatised within five years and now constitute the backbone of the Israeli venture market. In addition many other new VC firms have been created.

Many countries have studied the Yozma fund model. The key success factors appeared to be two-fold. First, the government shared the risk but offered all reward to the investors, which was extremely attractive to experienced foreign investors. The government retained 40% of the equity in the new fund but the partners had an option to buy out the shares after five years if the fund was successful. The second success factor was that the government exited from the programme once it has served its purpose rather than continuing the programme indefinitely.

Source: Yozma Fund website: *www.yozma.com* and "Start up Nation" (Senor & Singer 2009).

The Yozma Fund in Israel (see Box 4.2) is an often referenced example of effective government policy for developing the local venture capital community. It was targeted on building the market by bringing in experienced venture capital funds from outside of the country to work in partnership with local venture capital firms. Public funds were used to catalyse and leverage private funds and the public support was withdrawn after a set period of time to avoid crowding out of the private market.

The concept of co-investment funds, to promote both angel and venture capital investment has been spreading across OECD countries and will be discussed further in the following section.

Targeted angel financing policies

Policy interventions in the angel market have been relatively recent starting in the early 1990's in the United Kingdom and the late 1990s in the other parts of Western Europe (Mason, 2009) and, more recently, other regions around the world.

While policy makers have increasingly become interested in growing angel investment in their countries, there have often been internal debates regarding whether policies and programmes which support these high net worth individuals is justified. While the empirical evidence of the impact of angel investment on productivity and economic growth may currently be lacking due to scarcity of data, several arguments could be considered.

For policy makers to intervene in a market, there often needs to be evidence of a "market failure". In the seed and early-stage financing market there is a clear financing gap as highlighted earlier. While a financing gap is not necessarily a "market failure", the funding gap has been persistent and has grown over time triggering greater attention from policy makers.

In terms of market failures, there is a well-documented information asymmetry in the seed and early stage between entrepreneurs and investors. Entrepreneurs have more information about the prospects for the success of the business than potential investors and may, whether intentionally or unintentionally, misrepresent it. This requires the potential investor to conduct a costly due diligence process to avoid adverse selection. On the other side, firms have less information about the investment process and the expectations of investors. During and after the investment process, neither party has transparency on the actions of the other which might impact outcomes. In addition, the costs to the investors of structuring, negotiating and monitoring contracts, in order to avoid moral hazard, can be high relative to the size of the investment (Mason, 2009).

Information asymmetry is particularly pronounced for young technology-based firms. These firms have little or no track record and often lack collateral which otherwise could be used to overcome information problems. It can also be difficult to assess the potential of innovative new products.

Another potential argument for government intervention relates to the potential spillover effects of angel investment, as angel investment contributes to greater economic growth. Estimates indicate that companies backed by angel investments have been important contributors to job growth. In the United States, estimates suggest that approximately 250 000 new jobs were created in 2009 by firms supported by angel investment, representing 5% of new jobs in the United States (Sohl, 2010). Recent research in the United States also shows that young firms which have had angel financing have an increased probability of survival and improved performance and growth by 30% to 50% on average (Kerr, Lerner and Schoar, 2010).

Other potential rationale for supporting the angel market is the fact that angel investors have much lower cost structures than venture capital funds, are able to make smaller investments and are more geographically spread (Mason, 2009). This means they are able to invest in areas in which venture capital firms would not.

One of the challenges for policy makers is not only to determine which policies to implement but whether policies should be implemented at the national, regional or local level. Given the local nature of angel investing, there is no homogeneous national angel market. The level, sophistication and dynamics of angel investment can vary greatly across regions within countries and therefore policies must take this into account. In fact, in a number of countries such as Canada and the United States, angel policies are implemented at the regional rather than the national level.

This section highlights the various types of policy interventions utilised to support the development of the angel investment market in various countries around the world. Most of the policy measures are focused on the supply side, however, demand-side policies are also important. Moreover, the proper framework conditions need to be in place, including appropriate legal and administrative arrangements that minimise burdens for new and young firms.

Supply-side measures

Tax incentives

One of the ways in which policy makers can encourage angel investment is through tax incentives for private individuals investing in specified types of investments and businesses (Mason, 2009). This includes tax relief on invest-

ment, capital gains and losses (including write-offs and roll-overs). The goal of these tax incentives is to increase both the number of angel investors as well as the amount of capital invested. Both in countries with and without specific tax incentives, the interviews highlighted a need for greater clarity about tax rules as they relate to investments in start-ups.

This section highlights tax incentives implemented at the national level in several countries and the table below summarises those examples to more clearly show the types of incentives used. However, it should be noted that this chart does not include all countries nor does it include countries with tax incentives at the regional or local levels, such as the United States and Canada. In additional, some countries, such as New Zealand and Switzerland, do not have any tax on capital gains.

Table 4.1. Summary of national angel tax incentives in selected countries

Country	Tax deduction on Investment	Tax relief on capital gains	Roll over or carry forward of capital gains	Roll over or carry forward of losses
France	25% (with cap of EUR 20 000-40 000/year) + 75% wealth tax reduction (with a cap of EUR 50 000/year) *Also applies to investments in other EU member states			
Ireland				
Israel	Treated as capital loss			Yes, but with limits
Italy		If reinvested in start-ups within 24 months		
Japan				
Portugal	20% (not to exceed 15% of income)			
United Kingdom	30% on a max of GBP 500 000 (to increase to GBP 1 million in 2012)		Can be deferred if invested in qualified EIS company	

Note: This table does not represent a comprehensive review of all programmes globally.

Box 4.3. Enterprise Investment Scheme (EIS), United Kingdom

The Enterprise Investment Scheme, or EIS as it is also known, was introduced by the British government to encourage inward investment in small and medium enterprises. There are various tax reliefs available to potential investors, which are designed to encourage investment into these types of opportunities, which otherwise may struggle to secure funding.

The maximum taxation relief which is available is GBP 500 000 per tax year, and an investment can be carried back to the previous tax year, in addition to the current tax year at the time which the investment is made.

There are two broad types of EIS investment opportunities:

- Companies – An EIS company must have a maximum capitalisation of no more than GBP 2 million at the time of inception.
- Fund – An EIS fund must have a maximum capitalisation of no more than GBP 7 million at the time of inception. An EIS fund will then go on to invest in a number of EIS Qualifying Companies on your behalf.

Investment into an EIS company, must be into a "small company", the definition of which is as follows: A gross assets test, where the gross assets of the company cannot exceed GBP 7 million immediately before any share issue, and GBP 8 million immediately after shares are issued.

Investors will receive ***income tax relief*** on 30% of the amount invested, this is offset against an investors income tax bill when they come to do their tax return. So for example, if an investor is to invest GBP 10 000, then they would be able to offset GPB 3 000 against their income tax bill for either the current or previous tax year. At the time of writing, the 30% taxation relief is subject to state aid approval from the European Union. Therefore investors will initially receive 20% relief, with a further 10% to be received once state aid approval is granted.

For income tax relief to apply investors would need to hold their shares for a minimum of three years, otherwise their previous income tax would fall due. In addition, the company in which investors choose to invest will need to continue a "qualifying trade" for a minimum of three years from the date of investment.

In addition, investors are able to ***roll capital gains*** which have been incurred into an EIS company. So for example if an investor has exited a significant shareholding or sold some property which had increased in value over a period of time from the initial purchase price, then they could roll this gain into an EIS company. This creates a deferral of the capital gain, meaning that it would only be at the point when the gain is realised that the capital gains tax would be incurred.

Where a positive return is generated through investment in an EIS company, upon the subsequent exit, this return would ***not be subject to capital gains tax***. Investors are also eligible for inheritance tax relief, providing they have held their shares for a minimum of two years prior to the date of their death.

It is possible that if an investor is to invest in an EIS company, and if the value of the shares which the investor purchases' subsequently drop, it is possible for investors to claim ***share loss relief***, on the price which they paid for their shares, providing that the company has continued a qualifying trade for the required period.

Source: *www.enterpriseinvestmentschemes.co.uk*.

The United Kingdom has had a programme, the Enterprise Investment Scheme (EIS), in place since 1995 and is the most often cited example of a well-functioning angel investor tax incentive programme (see Box 4.3). The programme has been evaluated every five years and, each time, the thresholds have been increased and the programme tweaked to help it more effectively reach its intended goals. Following a review earlier this year, the United Kingdom government increased the taxation relief available to investors in EIS schemes up to 30% on the amount invested. A NESTA study conducted in the United Kingdom a couple of years ago showed that 80% of investors surveyed used the Enterprise Investment Scheme (EIS) at least once and 57% of investments made use of EIS. In addition, investors indicated that 24% of investments would not have been made without EIS (Wiltbank, 2009).[1] Earlier evaluations of EIS were also positive and suggested significant additionality in terms of the amount of money invested (over 50%) as well as a positive impact on the companies in which they invested (Mason, 2009).

A number of other countries also offer tax incentive programmes including France, Ireland, Japan, Israel and others. In France the high level of tax deduction on wealth taxes (called ISF, France is one of the few countries that still has wealth taxes) brought in many financial investors instead of the targeted angel investors however, the percentages have recently been reduced from 75 to 50% with a limit of EUR 45 000.

In Ireland, tax incentives are provided under the Business Enhancement Scheme (BES), which provides a tax incentive on the initial investment but no protection on any potential upside later. Japan introduced an angel tax incentive as early as 1997, with amendments in subsequent years to make the tax incentives more appealing (see Box 4.4).

Portugal and Israel have recently launched programmes. In Portugal, the new "Tax Benefits Law", approved in 2010, enables informal investors, individually certified by the Portuguese SME and Innovation Support Institute (IAPMEI), to receive tax deductions of 20% on investments in seed and early-stage companies.

In Israel, a new "Angel Law" allows investment deductibility, over three years, from any income source on investments of NIS 25 000 to 10 million in private high-tech companies, registered in Israel, with a limit of NIS 5 million per individual per company. The high-tech companies must meet certain criteria in terms of revenue and R&D expenses. In addition, the initial investment is considered as capital loss on the day of investment (Peshin, 2011).

Box 4.4. Angel Tax System in Japan

Japan, recognising the important role angel investors play in the creation and development of start-ups, introduced tax incentives designed to promote angel investment. Since 1997, when it adopted an angel tax system, Japan has added a series of amendments. In 2003, it introduced the three following measures:

a) For a year when an investor makes angel investment, he or she can defer the amount of the equity which does not exceed gains she realised in the year from sale of other stocks to the point of time when it is sold.

b) If he or she achieved any gain from sale of the equity, the taxable capital gains are halved.

c) If he or she sold the equity with loss, the loss is permitted to be carried forward three years from the following year.

Angel taxation in Japan, however, is only used for a small amount of investment. In 2006, the favourable tax treatment only applied to angel investments of around JPY 1 300 million in total. Even in 2005, when the all-time record was set, it failed to reach JPY 2 500 million. Recent records show angel investments appear to fluctuate in line with changes in prices in the stock market. The linkage is believed to take place because the treatment of investment being deterred for the year when the equities are purchased, mentioned above in (a), is linked to gains realised in the year from sale of stocks.

Against such a background, the government and the ruling coalition parties, recognising that more attractive incentives must be offered to increase angel investment, have decided to introduced an "income exemption system" as part of the 2008 amendment of the tax code. Under the system an angel who made an angel investment in a start-up established within the past three years which satisfies specific conditions is allowed to deduct from his or her total income for the year of investment the amount of money substantially equivalent to the investment (less JPY 2 000, with the upper limit of JPY 10 million), and he or she can choose either the new exemption system or the existing treatment.

Introduction of the income exemption system should provide a greater incentive for people who refrain from selling any stocks and, naturally, have no profits made in trading, though such people have so far been refused tax advantages offered for the year of investment. It is also supposed that people in parts of Japan who intend to support a "company with high potential" in its foundation, including friends of the founders, should be encouraged by the tax treatment in quite an effective way to make investment, and that it should make great contribution to the revitalisation of local communities.

Source: Japanese Ministry of Economy, Trade and Industry (METI), 2011.

In Italy, there is a tax exemption on capital gains deriving from investments in start-up companies, provided by private investors (Business Angels), if reinvested in other start-ups (belonging to the same sector) within 24 months. Sweden and a number of other European countries are currently discussing the introduction of tax incentives for angel investors. Finland had advanced a proposal several years ago but it has not been implemented.

Pros and cons of tax incentives

While tax incentives can have a positive effect in terms of increasing both the number of investors as well as the amount of investment, there are also some potential downsides, including fiscal considerations particularly in the tight budget situation facing many countries following the recent financial crisis.

Tax schemes can also be complex and may have some unintended consequences. Providing greater incentives for high net worth individuals may increase the number of financial investors but not "angel" investors, *i.e.* the ones who are presumably providing expertise and contacts in addition to money. In addition, there is a danger of intermediaries distorting tax schemes to reduce investment risks (Mason *et al.*, 1988). It is therefore important that programmes are evaluated on a periodic basis and the necessary changes are put in place to adjust the incentives as necessary.

The introduction of tax incentives for angel investors has been a topic of heavy debate in a growing number of countries. Those against tax incentives argue that they are "expensive" and cite the lack of political justification to provide advantages for wealthy individuals, particularly in today's economic climate. Those in favour point to evidence in the United Kingdom and other countries of the increase in both the amount of angel investment and number of angel investors. They also counter the notion that tax incentives are "expensive" by pointing out that the amounts involved are small and the upside, in terms of increased potential tax revenues (more investment, more companies, more jobs and growth), can more than cover the cost. Regardless of the amounts involved, policy makers will want to ensure that any tax incentives provide a net economic benefit.

Tax incentives can be a "blunt" instrument (*i.e.* difficult to target effectively), as seen in the French example earlier, so careful design, monitoring, evaluation and adjustment is necessary to ensure the intended results are achieved. The lack of robust data on the angel investment market does not help as it makes it difficult to create evidence-based policies. Some countries have tried to correlate the additionality of these programmes in

terms of economic growth and employment and have found positive results but, of course, the direct causality is difficult to prove.

More work is needed in assessing additionality as well as the net cost and benefits of tax incentives as well as the methodologies employed. This is beyond the scope of this report but could potentially be covered in future OECD work.

Co-investment funds

In some countries, policy makers have launched co-investment funds to address the seed/early-stage equity financing gap and to help develop and professionalise the angel investment market. Typically these programmes work by matching public funds with those of private investors (on the same terms – *pari passu*), who are approved under the scheme.

Table 4.2 provides an overview of co-investment fund programmes targeting angel investors in various countries. Most of the highlighted programmes below focus on angel investors but some include other investors such as venture capitalists. It should be noted that a significant amount of time in planning (and, in many cases, securing all the necessary approvals) was necessary before the funds were launched. Further details about several of the programmes are provided in the following text.

Co-investment funds have become increasingly popular in recent years, due in part to the perceived success of such a programme in Scotland which some other countries have used as a model for creating co-investment funds in their country. Box 4.5 provides further details about the Scottish Co-Investment Fund (SCF). A Scottish Enterprise commission evaluation showed that over half of SCF investee companies felt their chances of raising capital would not have been possible without SCF and 78% stated that the fund was vital to their survival (Harrison, 2009). This study also showed that SCF has had a positive economic impact on the companies they have supported in terms of turnover, gross value added and employment.

New Zealand has had co-investment funds in place for a number of years. Initially, they set up a co-investment fund for venture capital investment (VIF in 2002) and later created one focused on angel investment (SCIF in 2005, see Box 4.6 for further details) which was modelled on the Scottish Co-investment Fund. The rationale for the funds was based on the financing difficulties of start-ups with high growth potential (innovative, technology-based firms) at the seed and early stages.

Table 4.2. Countries with co-investment funds targeting angel investors

Country	Name and year established	Overview
Finland	Finnvera's Seed Fund Vera Ltd (2003)	Finnvera's Venture Capital Investments serve as the hub for public early-stage venture capital investments. Finnvera makes direct investments in early-stage innovative enterprises through its subsidiary Seed Fund Vera Ltd.
UK – Scotland	Scottish Co-Investment Fund (2003)	For both angel and VC investors GBP 72 million equity investment fund, partly funded by the European Regional Development Fund (ERDF).
Netherlands	TechnoPartners Seed Facility (2005)	Loan facility that can equal a maximum of 50% of the fund's investments, up to a maximum of EUR 4 million. Once revenues are generated, the fund will only have to pay back 20% until it has earned back its investment. After that, the fund will have to turn over 50% until TechnoPartner has earned back its investment. If the fund keeps receiving revenue, the additional income is divided between the fund and TechnoPartner on an 80%-20% basis.
New Zealand	Seed Co-Investment Fund (SCIF) of the New Zealand Venture Investment Fund Ltd (2005)	The Fund provides NZD 40 million of matched seed funding to support the further development of early-stage investment markets through a co-investment fund alongside selected Seed Co-Investment Partners.
Denmark	Vaeksfonden Partner Capital (2007-10). The fund closed last year due to lack of angel investment.	Provided a maximum of 50% of the needed capital (on average 10-40% of start-up equity). USD 5-20 million in total syndication. Evergreen fund but expected time to exit of 3-5 years. Targeted IRR 20%. Targeted 4-5 investments per year.
Portugal	Co-Investment Fund for Business Angels (2009)	The fund was modelled on the TechnoPartners fund in the Netherlands, particularly in terms of the distribution of returns (and therefore the incentives for investors)
UK – England	A new GBP 50 million co-investment fund is in the process of being created (2011)	Funded by the UK Government's Regional Growth Fund, the fund will invest alongside business angel networks or syndicates into eligible SMEs. The fund will operate by investing on the same terms as angel networks and syndicates.

Box 4.5. Scottish Co-Investment Fund (SCF)

Founded: 2003

Geographic scope: Scotland

Scope: Angel and VC investment

Size: GBP 72 million equity investment fund, partly funded by the European Regional Development Fund (ERDF).

Funds managed: SCF is part of a portfolio of funds managed by Scottish Enterprise:

- SCF: invests between GBP 100 000-1 million in deals up from GBP 500 000-1 million. The SCF invested GBP 12.3m in 63 deals during 2009/10.
- Scottish Seed Fund: invests up to GBP 100 000 in deal sizes up to GBP 500 000. The Scottish Seed Fund invested GBP 1.7 million in 21 deals during 2009/10.
- Scottish Venture Fund: invests GBP 500 000-2 million in deals between GBP 2-10 million. The Scottish Venture Fund invested GBP 16.7 million in 18 deals during 2009/10.

Model: SCF is a *pari passu* investor alongside private sector investors. No public sector investment in a managed partner fund. SCF does not find and fund its own deals. It forms contractual relationships with active business angel syndicates and VC fund managers from the private sector. Those partners find the opportunities, conduct the due diligence, negotiate the terms of the deal and commit their own resources. Partners are vetted and SCF automatically matches all qualifying investments from registered partners subject to eligibility.

Structure: SCF funds are not placed in a Limited Partner agreement with the partners. Instead the agreed funding is legally guaranteed by SCF and funds are only drawn down once an investment has been legally concluded and subject to meeting all of the criteria. Partners are paid a flat fee of 2.5% of the SCF funds invested and are awarded partnership status with SCF for three years (with funds drawn down over that time period, reviewed every six months and with an annual partner review).

Process: Company approaches SCF partners for investment and goes through screening and evaluation. Partner notifies SCF and they check eligibility (size, sector, location) and gives approval of co-investment if deal goes ahead. Partners set up deal. SCF invests pari passu (equal risk, equal terms between public and private investors and therefore respecting EU state aid rules), in whatever instrument is used (type of share, loan stock, convertible preference) and invests pro-rata with the partner on the same terms and conditions.

Operating principle: Operate at minimum cost to the public finances on a fully commercial basis (and therefore with no subordination of the public funds).

…/…

Box 4.5. Scottish Co-Investment Fund (SCF) ***(continued)***

Criteria:

a) Company is incorporated, has less than 250 employees, net assets less than GBP 16 million and are in an "approved business sector". Deal must be less than GBP 2 million, involving an equity interest, with an approved SCF investment partner, predominated located in Scotland (main or head office).

b) SCF can invest up to GBP 1 million in any one company, either in tranches or multiple rounds and total deal size must not exceed GBP 2 million. The investment must be matched by the partner on an equal basis. SE can't own more than 29.9% of the voting rights of the company and public money can't be more than 50% of the total risk capital funding.

c) Partners can be VCs and corporate investors. Partners from the rest of the UK and/or Europe are also allowed.

Sources: Mason (2009), Scottish Enterprise (2010) and *www.scottish-enterprise.com*.

New Zealand has had co-investment funds in place for a number of years. Initially, they set up a co-investment fund for venture capital investment (VIF in 2002) and later created one focused on angel investment (SCIF in 2005, see Box 4.6 for further details) which was modelled on the Scottish Co-investment Fund. The rationale for the funds was based on the financing difficulties of start-ups with high growth potential (innovative, technology-based firms) at the seed and early stages.

The overall policy objective of the New Zealand Seed Co-investment Fund (SCIF) is to support the development of the angel equity finance market in the country by developing a greater professional capacity in the market for intermediating funds between investors and technology-based start-ups, increasing the depth of specialist skills needed to assess and manage early-stage investments, increasing the scale and enhancing networks for early-stage investment, catalysing investments that would have not have been made without the programme, minimising fiscal risk and covering costs. An impact evaluation is scheduled for 2011/2012. This will include an evaluation of the outcomes of the programme, the level of additionality associated with the outcomes of the programme and the unintended consequences, both positive and negative (New Zealand Ministry of Economic Development, 2007).

Box 4.6. The New Zealand Seed Co-Investment Fund (SCIF)

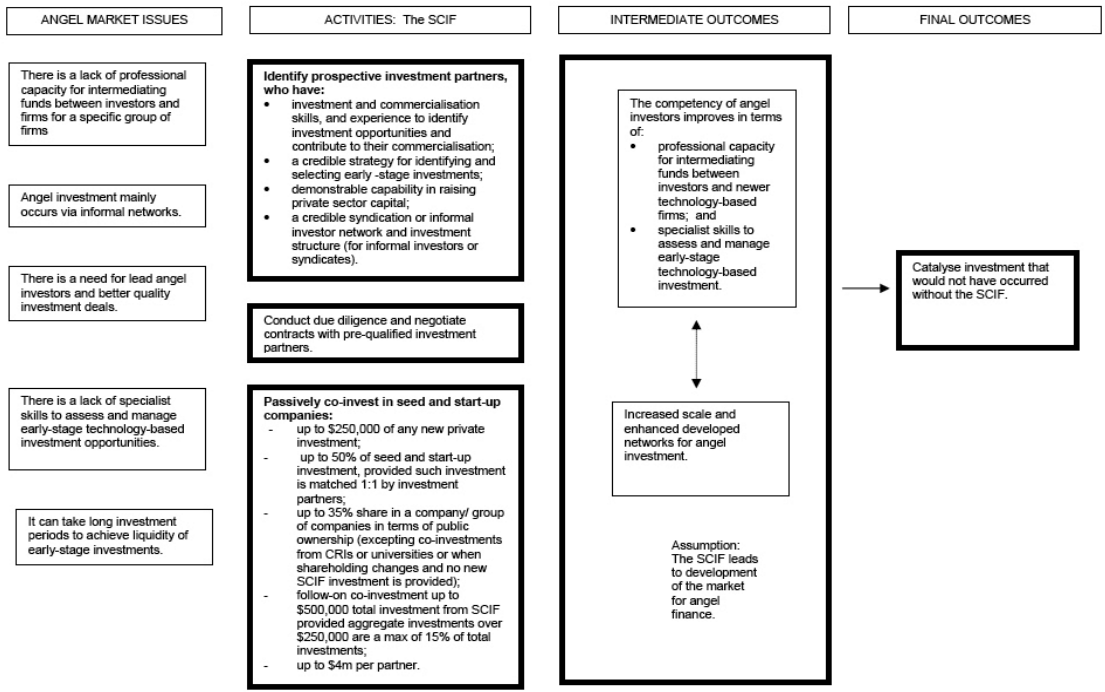
The Seed Co-Investment Fund (the Fund) is managed by the New Zealand Venture Investment Fund Ltd (NZVIF), and is an equity investment fund aimed at small to medium sized businesses at the seed and start-up stage of development that have strong potential for high growth. The key objectives of the Fund is to enhance the development of angel investor networks, stimulate investment into innovative start-up companies, and to increase capacity in the market for matching experienced angel investors with new, innovative start-up companies. The Fund commenced in July 2005 and provides NZD 40 million of matched seed funding to support the further development of early-stage investment markets through a co-investment fund alongside selected Seed Co-Investment Partners.

Key features of the Seed Co-investment Fund:

- A total of NZD 40 million will be available for investment through the Fund over a 5-6 year period;
- The Fund will operate for a period of 12 years in total, with an expected investment period of 5-6 years;
- Seed-stage and start-up investments will be eligible for the Fund;
- Investment alongside selected private investor groups ("approved co-investors");
- NZD 4 million total per co-investment partner;
- Investments through the Fund would be limited to a maximum investment of NZD 250 000 in any one company or group of companies; with the possibility of another NZD 250 000 in follow-on capital at the discretion of NZVIF;
- 50/50 matching private investment is required for the Fund to invest;
- To act as a direct investor on the same terms as the co-investment partner;
- Any investments must be made in New Zealand businesses. A New Zealand business is defined as having the majority of assets and employees in New Zealand at the time that the initial investment is made;
- To act as a direct investor on the same terms as the co-investment partner;
- The Fund will exclude investment in property development, retailing, mining and hospitality industry businesses.

Source: *www.nzvif.co.nz/seed-co-investment-overview.html*

Figure 4.1. New Zealand SCIF Logic Model



Source: New Zealand Ministry of Economic Development (*www.med.govt.nz*).

An added benefit of the SCIF is the collection of data on the angel investment market in New Zealand. According to the New Zealand Young Company Index, more than NZD 53 million was invested in young companies in 2010 by angel investors, representing an increase of 5.3% from the previous year. In 2010, 47% of the deals were syndicated, representing a jump from 2006 when only 27% of the deals were syndicated (New Zealand Young Company Finance, 2011).

Other countries are launching or considering launching co-investment programmes. The challenge is that angel syndicates or groups need to already exist or be created so that the co-investment fund can work with an entity of some form, with one lead investor serving as the contact point, rather than dealing with a set of individual investors themselves.

Box 4.7. Netherlands TechnoPartner Seed Facility

Date launched: 2005

Rationale:

Technostarters have contributed more and more to the growth in productivity, offering, in fact, more growth potential than 'regular' start-up companies. For many technostarters, the lack of sufficient risk capital during the early business stage, the "equity gap", can prevent them from establishing their companies.

Capital providers tend to refrain from investing in technostarters because the risks are too high and the returns too low, especially when the relatively long investment period is taken into account. This called for the Seed Capital Arrangement for technostarters (Seed facility), one of the action lines set up by the TechnoPartner Action Programme.

Operating model:

The objective of the TechnoPartner Seed facility is to encourage and mobilise the bottom end of the Dutch risk-capital market in such a way that technostarters are able to meet their capital requirements. Closed-end venture capital funds are eligible for the Seed facility. Participating funds which invest in high-risk technostarter businesses can apply for a loan at TechnoPartner.

The Seed facility loan can equal a maximum of 50% of the fund's investments, up to a maximum of EUR 4 million. Once revenues are generated, the fund will only have to pay back 20% until it has earned back its investment. After that, the fund will have to turn over 50% until TechnoPartner has earned back its investment. If the fund keeps receiving revenue, the additional income is divided between the fund and TechnoPartner on an 80%-20% basis.

Source: Dutch Ministry of Economic Affairs (EZ).

In Portugal, the government decided to launch a Co-Investment Fund for Business Angels at the end of 2009 due to the low level of investment in seed stage capital by the Portuguese venture capital industry and what the policy makers identified as the crucial role of business angels at the early stage of financing. Portugal based the fund on the model of the TechnoPartners Seed Fund in the Netherlands (see Box 4.7). The goal of the fund in Portugal is to stimulate business angel activity, allowing it to grow and thus contribute to the development of innovation and a new generation of Portuguese companies. In its first six months of operations, the angel investments made through the new Portuguese co-investment fund have surpassed EUR 3 million.

According to policy makers in the Netherlands, the Technostarters Seed Facility has functioned well and helped boost funding for early-stage technology firms. The facility matches funds from both venture capital firms and angel syndicates. They identified the key success factor as the three phase payback scheme, which provides earlier payback to the private investors and potentially higher reward if the companies perform well.

In England, a new GBP 50 million co-investment fund is in the process of being created as the result of a successful bid to the UK Government's Regional Growth Fund. The fund will invest alongside business angel networks or syndicates into eligible SMEs and will invest on the same terms as angel networks and syndicates.

Belgium and Finland have had co-investments programmes in place for many years. In Finland, the government has long been a player in the seed and early-stage market through Sitra, the Finnish Innovation Fund. Veraventure Ltd was established in 2003 as a venture capital investment company serving as the hub for public early-stage venture capital investment. In addition to Finnvera's seed fund, Vera, the government has recently established a new EUR 45 million fund focused on the commercialisation of innovations. Unlike in past schemes in Finland, the government will only invest in these companies if the private sector invests, therefore the investment decisions will be made mostly by the market and private sector.

The European Commission, through the European Investment Fund, has been active in the seed and early-stage market through their JEREMIE programme. Through that programme, a EUR 8 million co-investment fund focused on angel investors has been established in Lithuania, which apparently has begun to help develop the angel market after previous local efforts to develop a business angel network failed. In addition, the EIF has recently launched a pilot angel co-investment programme in Germany. While most co-investment funds are structured to invest alongside angel groups, networks or syndicates, this pilot will provide co-investment with

approved individual angel investors. If successful, the programme will be rolled out to other countries across Europe.

Pros and cons of co-investment funds

Co-investment funds can help develop the local financial community by increasing deal capacity of investment partners and attracting new investors. However, the Scottish Co-Investment Fund is the only programme which has been formally evaluated to date. While most countries with co-investments funds in place spoke during the interviews about additionality and spillover effects of these programmes, further evaluations would be useful to better establish causality and the cost/benefit of the government funding.

During the interviews conducted as part of this research project, many people indicated that co-investment schemes can be an important driver in building, growing and professionalising the angel market by providing a more structured investment process. However, the countries with successful programmes have cited the pre-existence of angel groups as one of the key success factors of the co-investment funds. This should be taken into consideration by countries with less developed angel markets.

In Denmark, an angel co-investment fund was established by the Danish Investment Fund, Vaekstfonden, in 2007. This was a few years after the national Danish Business Angel Network (DBAN) was established which was later merged with the existing Danish Venture Capital and Private Equity Association (DVCA). As a result, there was less attention given to seed and early stage given the DVCA's focus on their core membership of venture capital and buyout firms. While Vaekstfonden has had success in the venture capital segment of the market (see Box 4.8), the angel co-investment fund, Partner Capital, was not successful as there were too few angels making too few investments. The Partner Capital of Vaeksfonden was closed at the end of 2010.

Box 4.8. *Vækstfonden* (The Danish Investment Fund)

Vækstfonden is a state investment fund, operating independently, which aims to create new growth companies by providing venture capital and market capacity building. Since 1992 Vækstfonden has, in cooperation with private investors, co-financed growth in 3 700 Danish companies with a total commitment of approx. DKK 10 billion. Vækstfonden invests equity or provides loans and guarantees in collaboration with private partners and Danish financial institutions. The companies which Vækstfonden has co-financed since 2001 represent a total turnover of approximately DKK 27 billion and employ approximately 22 000 people all over the country.

Source: Vaeksfonden website: *www.vf.dk.*

During the interviews, it was highlighted that models working in one country can not necessarily be copied directly in another country. Local conditions need to be taken into account and the model adjusted appropriately. Both the timing (*i.e.* making sure there is a functioning angel market already existing in the country) and structure of the terms of the co-investment fund will make the difference between success and failure. In addition, it was noted that government funding should not be more than 50% otherwise there is a risk of crowding out the private sector.

Support to angel associations, networks and groups

Over the past decade, a number of governments have supported the development of the angel investment market through the provision of some financing for angel networks, groups and associations or federations. In most cases, the goal of the funding was to address information asymmetries in the market between angel investors and entrepreneurs. Much of that support was intended to help start these organisations with the goal of later transitioning them to the private sector.

National angel associations/federations of networks

National angel associations, or federations of networks, play a very important role in developing the angel market in a given country by raising awareness about angel investment, collecting data, providing training and liaising with policy makers. In many countries, the development of an "organised" angel market often starts with the creation of the first network or group. Other groups and networks might then begin to form and one of them may evolve into playing a broader development role for the industry within the country.

Over the past 5-10 years, national associations or federations have been created as umbrella organisations for the growing number of groups and networks within a country. In Annex B, there is a list of most of the national associations or federations that exist today, including regional ones. Given the lack of clear definitions in the market, sometimes it can be difficult to separate a network from a national association or federation. Some national associations/federations started as networks but later learned that, to represent the industry nationally, they could not mix the two roles (representation and investment match-making).

Box 4.9. Typical role of a national association or federation of networks

Raising awareness of the industry

National and regional associations or federations produce reports and materials explaining how the angel market functions and help entrepreneurs and others identify which groups or networks exist.

Representing the industry to policy makers

These organisations also play an important role in liaising with policy makers to explain how the industry is evolving and identify barriers or opportunities to facilitate its development.

Training and development of angel investors

Increasingly, a number of these organisations are developing training and mentoring programmes for their members. The PAI programme developed by ACEF has been licensed in many countries.

Developing professional standards

National and regional associations or federations are increasingly focusing on developing the quality, rather than just the quantity of angel investors by developing standardised processes and guidelines.

Providing a platform for the sharing of practices (annual conference, workshops, etc.)

Most of these organisations hold events to bring together members of the angel community for networking and the sharing of practices. Annual conferences, in particular, also help raise visibility for the industry.

Collecting data from member organisations

Most national and regional associations or federations collect data from their members, which are groups, BANs and individual angel investors. While not all angel investors are members, the data provides a useful picture of developments in the "visible" angel market within the country.

Source: OECD (2011).

Table 4.3. Initiation years of angel associations or federations around the world

0-5 years	5-10 years	10+ years
Portugal (2006, 2007)	Canada (2002)	UK/Scotland (1993)
Russia (2006, 2009)	US (2004)	Europe/EBAN (1999)
Australia (2007)	UK/England (2004)	Italy (1999)
China (2008)	Chile (2004)	Germany (2000)
Spain 2nd (2008)	Spain 1st (2004)	France (2001)
New Zealand (2008)		South East Asia/BANSEA (2001)
Ireland (2009)		
Israel (2009)		
Netherlands (2009)		
World/WBAA (2009)		
Latin America (2011)		
Finland (2011)		
Turkey (2011)		

Source: OECD (2011).

Associations are typically set up as non-profit associations and usually require some outside funding to get started. In the United States, the Kauffman Foundation supported the creation of the Angel Capital Association (ACA) in 2004 and later the Angel Capital Education Foundation (ACEF) which is now called the Angel Resource Institute (ARI). In other countries, the few national associations or federations that exist often had public support in getting started. In some of those cases, the market was still too young and the association was not able to build enough momentum to develop.

In a number of countries, such as Denmark and Sweden, nation-wide networks of BANs were created as a pilot project over a period of a few years but then funding was stopped and the BANs were merged with national venture capital and private equity associations with little to no motivation and funding to support and develop the angel market. In some other countries, there are two or three "national" associations which might dilute efforts or cause some confusion in the market.

In a number of countries, what started out as the first BAN in a country is moving towards becoming a national association seeking to further develop the angel investment market in their country and connect with angel organisations in other countries and regions. National associations are increasingly collaborating and sharing best practices. Regional federations such as EBAN (Europe), BANSEA (South East Asia) and the newer LAAI

(Latin America) and WBAA (World), are playing important roles in bringing existing and aspiring associations together to learn from each other.

Business Angel Networks (BANs)

In Europe, the initial focus was on the creation of BANs to play a match-making role between potential angel investors and entrepreneurs addressing the information asymmetries in the market. EBAN was created in 1999, with European Commission support, as a federation of BANs across Europe. This was followed by national BANs or associations in several other countries including Italy in 1999, Germany in 2000, France in 2001 and the United Kingdom in 2004 as well as the growth of BANs within countries.

After initial support from the European Union and, in many cases, on-going support from national governments, the number of BANs in Europe grew dramatically but the success and investment activity of these BANs varies. BANs have broader membership criteria than angel groups, which consist only of angel investors. BANs often include service providers and others who are either not investors at all or who are financial, not angel, investors and therefore are unwilling and/or unable to provide the necessary assistance to entrepreneurs that normally accompanies angel investment. EBAN, the pan-European association for the industry, is working on developing a set of professional standards, including criteria for determining the activity level of BANs, which can also serve as benchmarks for BANs.

While angel networks can help to address the information asymmetry problem, evidence is still lacking in terms of the track record of individuals BANs. A study in Belgium showed that angel investors would not have known about 82% of the deals in which they invested had it not been for the business angel networks (Collewaert *et al.*, 2010). Meanwhile, it was noted in the interviews that sometimes the best investment opportunities are channelled to the better known angel investors who may not need or have an incentive to co-invest through BANs.

Operating models and sustainability

Associations, networks and even groups have costs associated to conducting their work which, in a number of countries, particularly in Europe, government has helped to support in the early years of operation. As outlined earlier, there are differences in the roles and operating models of associations, networks and groups. However, for each, building a self-sustaining operating model can be a challenge. Therefore government support can be very helpful but it should be linked to clear milestones and measures to ensure that the organisation is filling a real need.

With less public money available due to tighter public budgets in countries around the world, angel associations, networks and groups have been seeking new operating models to ensure sustainability. Given the market development role and data collection role of national associations, in particular, it is important that these organisations find the necessary resources to continue their work. In markets in which angel investment is new, time is needed for the BANs and groups to gain traction and also for investors to be "trained" and/or mentored in angel investing, as it differs dramatically from being an entrepreneur or a financial investor (see next section).

At the same time, there is a trade-off between encouraging the development of the angel market and attracting too many people who are not really angel investors. In the early stages of the market development, support for networks and, in some cases, groups, can be useful to raise awareness and get the market started. However, this support should be linked to measures of intended outcomes. In particular, there should be some measures in place to make sure that supported networks or groups are actively contributing to the development of the angel market and growth of angel investment over time (subject to market conditions).

As mentioned earlier with co-investments funds, there needs to be some level of organised angel activity, in the form of groups, networks or very active individual angel investors, before certain policy measures can be a catalyst for further developing the market. One of the key success factors for the development of associations, networks and groups identified during the interviews, was initiation by local private players. It is difficult for the government and also for well -intentioned foreigners from outside a country or region to "create" an angel market without leadership from local private angel investors.

Training and development of angel investors

Training of angel investors is extremely important for professionalising the industry as well as for attracting new angel investors. However, it is an area often overlooked by policy makers. Because angel investors are typically experienced entrepreneurs and business people, it is assumed that they also know how to invest. However, investing in start-ups is very specific and therefore training and learning from experienced angel investors is a very important part of the process. Angel investors need to be trained because being an investor requires different perspectives, understanding and skills to being an entrepreneur. This is not dissimilar to the need for experienced managers to receive training to enable them to operate successfully as non-executive directors.

Training and mentoring therefore play very important roles in turning interested accredited investors into successful angel investors. Entrepreneurs and angel investors prefer to learn from practitioners. In addition, they want to learn the most relevant items for their immediate needs and therefore prefer short workshops and/or mentoring from experienced practitioners as opposed to longer courses from academics, agencies or others.

Box 4.10. Power of Angel Investing (PAI) Training Programme

The *Power of Angel Investing* is a series of education programmes about angel investing, developed by the Ewing Marion Kauffman Foundation, with content provided by angel experts and angel group leaders from across the United States. The Angel Capital Education Foundation (ACEF) distributes the education programmes for the Kauffman Foundation. Lead instructors are experienced practitioners certified by ACEF as experienced angel investors. The seminars and workshops are targeted for audiences of investors, economic development professionals, university leaders, service providers and entrepreneurs.

Courses include:

- Angel investing overview
- Starting an angel organisation
- Angel investing basics for economic development professionals
- Doing the deal: term sheets
- Due diligence
- Valuation of early-stage companies
- Trends in raising capital
- Early exits

Source: www.angelcapitaleducation.org/education/

The first two courses outlined in the box above are more general seminars geared towards new/prospective angels or for broader members of community. These could include a variety of key players in the local entrepreneurial ecosystem, including community leaders; entrepreneurial support professionals who are interested in promoting angel investing in their communities; leaders of organisations that support entrepreneurs through mentoring, coaching, education, and connection to resources; university leaders and directors of entrepreneurship, innovation, or emerging technology initiatives in academic institutions; professional service providers who work with entrepreneurs or investors who want to learn best practices in angel group development. In addition to the set of topics listed in the box above, other popular topics for angel investor seminars include post-investment

relations with entrepreneurs and other investors and how to build a strong board of directors.

Experience from the United States indicates that seminars tend to work best when they are limited to about 20-30 people. These programmes are held in a variety of venues, which are often offered by sponsors (companies, universities and others). Financial support and sponsorship for these programmes might come from national, regional, local government or agencies, universities, foundations or companies (banks, law firms, head hunters and other service providers for start-ups).

At the same time, experienced trainers suggest that courses should not be offered for free, emphasising the importance of charging a fee to make sure the participant is committed to the programme. Fees in the United States for a half day seminar might run from USD 50-200 depending on the level of sponsorship. For full day, a seminar might be USD 150-400. It was noted in the United States that multi-day programmes are typically not popular with angel investors.

While angel investors, whether new to the market or not, may not like the notion of "training", many people in the interviews pointed to the importance of ensuring that angel investors have the necessary skills as well as understanding of the investment process. As mentioned earlier, the effectiveness of these programmes will depend on who is conducting the training. During the interviews, many people stressed the importance of having experienced angel investors provide the training.

The ACEF Power of Angel Investing (PAI) courses are licensed by a growing number of countries around the world although with adjustments made to the content to adapt to the local context. For example, the Australian Association of Angel Investors (AAAI) which has put an emphasis on the development of the angel market since it was founded in 2007, originally licensed PAI. In addition to running an annual conference, the AAAI has developed and continues to develop its own training programmes and resources to complement and, in some cases, replace the ACEF materials with content relevant to the Australian context. More than six training workshops have been run each year in cities across Australia.

At their annual conference in 2011, the AAAI also launched a new Fellows programme. The AAAI believes that by enabling its members to be more successful as investors, more entrepreneurial businesses will be successful and the members will derive greater returns from their investments. This success will then encourage members to continue to invest in similar activities, thus promoting increased and ongoing investment and a sustainable "virtuous cycle" of investment driving the Australian innovation economy.

Other approaches to training and building the market can include inviting expert or "master" trainers to a country for an extended period of time to work with the local angel communities, run some initial training programmes and help raise awareness about angel investment. In 2010, New Zealand invited experienced angel investor and trainer, Bill Payne, to visit for several months to work with the industry, policy makers, conduct training programmes and speak to the media.

In the interviews conducted as part of the project, people from countries across the world emphasised the need to develop human capability – both on the investor and the entrepreneur side (see next section).

Demand-side measures

Investment readiness of entrepreneurs

Investment readiness programmes for entrepreneurs is another area policy-makers have supported in a number of countries. These are programmes which help entrepreneurs develop their business plans and presentations to a level which answer the most pertinent questions for investors – such as the vision, business model and skills balance within the team as well as business development and access to market plans.

Programmes for entrepreneurs are typically focused on "pitching" the company and investor readiness but can also include some of the topics highlighted in the section above including an overview about angel investing and/or programmes on deal negotiations, term sheets, valuation and exits. In many countries, these programmes are run at universities, incubators/ accelerators and/or by specialised agencies.

These programmes address the entrepreneur's side of the information asymmetry issue by helping entrepreneurs better understand the expectations and needs of investors and prepare themselves accordingly, which in turn can result in greater success in securing funding.

Supporting the development of an entrepreneurial culture and ecosystem

As quoted from an article in *The Economist*, "If we learn anything from the history of economic development, it is that culture makes almost all the difference" (Economist, 2009). All the programmes and policies put in place to build an entrepreneurial economy won't have an impact if only a small proportion of population in a country want to be entrepreneurs.

Education and culture

During the interviews, many people cited the lack of an entrepreneurial culture as a critical barrier to entrepreneurship. Education and awareness-raising play important roles in changing culture over the longer term. Introducing entrepreneurship into the educational system at all levels (primary, secondary, higher and vocational education) can help develop the entrepreneurial skills, attitudes and behaviours (World Economic Forum, 2009).

Programmes such as Global Entrepreneurship Week,[2] in which over 115 countries around the world now participate, are vehicles for engaging key stakeholders within countries, building networks, raising awareness about entrepreneurship and providing local information about key aspects of creating and growing firms, including financing.

Entrepreneurial ecosystem

As highlighted earlier, angel investors and entrepreneurs operate in a broader ecosystem in which various players such as accelerators, incubators, universities, entrepreneurship centres, venture capital firms and service providers (lawyers, accountants, investment bankers and others) play important roles. During the interviews, it was continually pointed out that a healthy entrepreneurial ecosystem is critical for successful angel investing.

If there is a well-functioning entrepreneurial and financial ecosystem, the actions of any one group are likely to have positive spill-over effects for their peers (Lerner, 2010). Government intervention can play a catalytic role both in facilitating the functioning of the ecosystem and targeting actions to trigger its further development. However, these actions should provide incentives for the engagement, not the replacement of the private sector and should be conducted in a manner conducive to the market (EVCA, 2010).

Policy makers in Finland have sought to catalyse growth entrepreneurship as part of the ecosystem through a new accelerator programme called Vigo (see Box 4.11). The programme was inspired by Israel but developed for the market in Finland. The aim of the new accelerator programme is to attract more international talent from overseas, by offering an attractive financial upside, to help the companies successfully grow. There is strong representation from serial entrepreneurs, high level investors and entrepreneurs on the board of Vigo and as mentors.

Box 4.11. Vigo business accelerator programme, Finland

Vigo is a new type of acceleration programme designed to complement the Finnish innovation ecosystem. It bridges the gap between early-stage technology firms and international venture funding. The Vigo programme was founded by the Ministry of Employment and the Economy in March 2009 with the aim to bring together serial entrepreneurs, private financing and public innovation funding.

The backbone of the programme is formed by the Vigo accelerators, carefully selected independent companies run by internationally proven entrepreneurs and executives. These accelerators help the best and the brightest start-ups to grow faster, smarter, and safer into the global market. The accelerators are not consultants – they are co-entrepreneurs who invest in the companies they work with to guarantee common goals and passionate development effort. As independent companies, the accelerators negotiate agreements on a case-by-case basis with the target companies and investors, including the investment amounts, activities and objectives, ownership shares, possible service fees, etc.

The target companies have access to both private and public funding sources. Private sources include venture capital funds, business angels, and the accelerators themselves. The public funding of the programme consists of funding from Tekes, and Finnvera (see resp. *www.tekes.fi* and *www.finnvera.fi*). All fund providers make independent funding decisions, but the process is co-ordinated and streamlined. Standard criteria are used in the programme for public funding *i.e.* there are not any programme specific public funding instruments.

There are currently six accelerators in the programme with the intention of expanding the programme towards the end of 2011. So far the combined portfolio is about 40 companies and they have raised about EUR 70 million of funds. Out of this roughly two thirds come from private sources out of which more than half from international angels and VC's. The programme has been running effectively now for about 18 months. The portfolio companies have so far employed several hundreds of professionals. The deal flow is considered sufficient and good in quality by the accelerators.

Source: *www.profict.fi*

An entrepreneurial economy consists of individuals and institutions in an interconnected system (Schramm, 2006) in which multiple stakeholders play a role in facilitating entrepreneurship and innovation. This includes business (large and small firms as well as entrepreneurs), policy makers (at the international, national, regional and local levels), and educational institutions (at all levels but particularly at higher education institutions).

However, even more important are the linkages between these institutions – the functioning of the entrepreneurial ecosystem. Too often these links, whether between universities and businesses or between entrepreneurial and large firms, do not function well or in some cases even become bottlenecks. The key to the facilitating an entrepreneurial ecosystem is therefore in facilitating better linkages between these actors, not necessarily in building

infrastructure. The links in the entrepreneurial ecosystem are primarily through personal networks or "social capital". A growing body of research demonstrates the critical role that social capital plays in high-growth ventures (Stuart and Sorenson, 2010).

Box 4.12. Social capital

Social capital (Coleman, 1988; Burt, 2000) is defined as the importance of networks of strong personal relationships that provide the basis of trust, co-operation and collective action (Nahapiet and Ghoshal, 1998). It is further distinguished between three facets of social capital, being structural, relational and cognitive. Structural social capital describes the configuration of linkages between people and units, while relational social capital describes the personal relationships that people have developed through a period of interaction.

A University of Cambridge research study explored the Cambridge high-technology cluster with individuals as the principal focus (rather than companies and industries which have traditionally been the units of analysis), shedding a new light on entrepreneurial processes. This research investigated serial entrepreneurship in the cluster using a family-tree and interlocking directorships approach. It reveals a mini-cluster of Cambridge entrepreneurs as the key influence on the success of the cluster growth process and their links between the companies as the structural and relational social capital of the cluster. In particular, there was a high-level of relational social capital in Cambridge arising from the association of individuals who worked together in other companies' over time. The high-level of structural social capital was the result of interlocking directorships, supplemented by clustering of VC investments and by membership of business angel groups and networking organisations (Myint *et al.*, 2005).

Government needs to create a proper regulatory framework in which entrepreneurship and the entrepreneurial ecosystem can thrive. However, government policy alone is not enough to develop an entrepreneurial ecosystem. Policies are often broad and responsibility for implementation lies with other actors who should also be engaged in the process of developing the policies and implementation plans. NGOs, foundations, agencies and other intermediaries play key roles in the entrepreneurial ecosystem by functioning as "champions" or connectors between the different sectors.

In the United States, the entrepreneurial ecosystem was developed over time through an on-going and interactive series of steps taken by the public and private sectors. In Israel, the high technology-focused entrepreneurial ecosystem was a product of a series of actions over a sustained period of time, not one policy or programme. There is growing interest and research in how

entrepreneurial ecosystems develop and the roles of the various stakeholders. The OECD may want to consider work in this area.

Implementing policies

Many countries do not have any policies to encourage and support angel investment. However, interest has been growing and more countries have been looking to implement policies at the national and/or regional levels. In the United States, many states are starting to adapt tax incentive policies. In Canada, provincial policies and incentives have been in place for a while. In Israel, the new angel law (described in the section on tax incentives above) has been approved and is in the process of being implemented.

The experience and sequencing of policies has varied greatly in countries around the world. It is important to assess the local environment and to seek to implement the relevant instruments for the appropriate timeframe. Evaluation of the policies is critical in making sure they are having the intended outcomes and to enable the necessary modifications to be made along the way.

As discussed earlier, tax incentives can encourage more people to become angel investors as well as encourage existing angel investors to invest more. At the same time, the right balance needs to be found to make sure that the people receiving the incentives are angel (*i.e.* experienced entrepreneurs or business people with an interest in helping the start-ups) not only financial investors. Tax incentives can help build a pipeline of new investors and angel groups. It is important to keep a flow of new angel investors coming into the market as existing angels can become fully invested and focused on existing rather than new investments for periods of time.

It is important to raise awareness about angel investment and its role in the seed and early-stage market, particularly relative to venture capital which tends to attract greater attention and focus by policy makers. To that end, support of angel associations, networks and groups can help build the market. Once there is a stable level of angel activity, it is useful to have a single national angel association or federation which can stimulate collaboration between local networks and groups and represent the needs of the angel market to policy makers with a common voice. Throughout the process, the training, mentoring and development of angel investors is important to make sure that those participating in these activities have the necessary skills and willingness to invest in and help start-ups.

Once a functioning angel market has been established, co-investment funds can help in leveraging and encouraging more private investment. The requirements and standardised process of co-investment funds also help to develop and professionalise the angel market. As mentioned earlier, these funds need to be designed in a way that they provide the right incentives to

the private sector without cumbersome restrictions. Many countries are looking into establishing such funds and have sought to learn from the existing models as they design their own.

At all stages, it is important to help entrepreneurs better understand the financing options available as well as the expectations of potential investors. Investor readiness programmes help entrepreneurs anticipate the needs of investors and prepare for presenting or "pitching" to them.

It is also important to help develop the exit market by building links between angel groups and companies which might be potential M&A partners. Exits are one of the key challenges for the industry at the moment. With the current state of the financial markets, IPOs on stock exchanges are rare and therefore the only option for high-growth entrepreneurs and their investors to realise the gains from the company are to sell or merge it with another company at the appropriate time. To that extent, programmes that help develop international networks or connections between start-ups and larger companies can be helpful.

Finally, it is important, both for practitioners as well as for policy makers, to have more comprehensive data on angel investing to determine how the market is evolving and monitor results. National associations or federations are already playing a useful role in collecting data available through the groups or networks in their country. In addition, associations and federations around the world have recognised the need not only for national data collection but also for internationally comparable data collection. The World Business Angel Association (WBAA) has been working with national angel associations across the world to further discuss this issue and identify possible ways to proceed.

Some countries have conducted research, through surveys or mappings, to better quantify and understand the angel market in their countries. These studies are important as they go beyond the data from the "visible" portion of the market collected through associations, groups and networks. These efforts should be assessed more thoroughly to identify some methodologies which could be used more broadly.

Conclusions and further work

Angel investment is growing in countries around the world and is a critical source of seed and early-stage finance which deserves greater attention. This report has sought to explain what angel investment is, how it works and why it is important. It has also highlighted developments in angel investment around the world and outlines areas in which policy makers can support this important source of finance, highlighting current policies in several OECD and non-OECD countries. Policies and government support can help facilitate the development of the angel market if structured in the right way. However, they cannot create the market. There must be a vibrant angel investment community and well-functioning entrepreneurial ecosystem.

Research

Angel financing continues to be an under-researched area with many possibilities for further work (Kerr, Lerner and Schoar, 2010). For example, research could be undertaken to examine the various forms of angel investment (individual angels, angel groups, angel networks, super angels) and the outcomes of each which would shed further light on potential policy implications. In addition, further work could be conducted to examine the international growth of angel financing, both in terms of how angel financing has developed in different contexts around the world but also in terms of the increasing role international syndication might play as angels move into larger deals to fill gaps left by venture capitalists.

Further research is also needed to identify the barriers for women engaging in angel investing. The OECD's current "Women Economic Empowerment" project, which is analysing gender issues in education, employment and entrepreneurship, could provide an important contribution to this topic. Work has also been conducted by EBAN and other groups. Continued work in this area is needed as well as actions to encourage more women to become angel investors.

Data and evaluation

Most importantly, work is needed on the data methodology and collection front. Methodologies need to be developed to better measure and evaluate angel and early-stage investment so that the appropriate policies can be put in place to address potential market failures (Mason 2009). Given the difficultly in collecting data on angel investment and the lack of comprehensive and comparable numbers, it is extremely difficult for policy makers and practitioners to measure progress and determine appropriate actions. Norway and Sweden have recently undertaken extensive studies in

this area which serve as examples of how angel data might be collected by other countries in the future. EBAN and the ACA have also initiated major data initiatives. An organised effort between countries, whether through the OECD, WBAA or another organisation, could provide a valuable window into the seed and early stage of the market which will help guide further action.

Angel investment plays a critical role in early-stage financing, more so than venture capital, and therefore should receive increased focus from both the policy and the research community. Much more work is needed to understand the dynamics, success factors and challenges of angel investment as well as the impact angel investment has on economic growth, productivity and job creation.

Notes

1. The data in this NESTA/BBAA study is drawn from a survey of 158 UK-based angel investors in late 2008. They have invested GBP 134 million into 1 080 angel investments between them, and have exited 406 of those investments. The sample is limited in its size and its focus is entirely on those who are members of groups.

2. For further information on GEW, visit *www.unleashingideas.org*.

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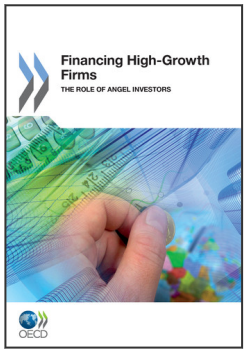

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