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Angel group members' decision process and rejection criteria: A longitudinal analysis☆

Cécile Carpentier, Jean-Marc Suret *

Laval University, Québec, Canada

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ABSTRACT

This paper investigates business angel group members' decision-making from project submission to the final decision. Using a Canadian group's archival data on 636 proposals, we provide a detailed longitudinal analysis of the decision process. The rejection reasons generally refer to market and execution risk; this finding holds for every step of the process for proposals that pass the pre-screen. Angel group members focus more on market and execution risk than agency risk, similar to venture capitalists. Inexperienced entrepreneurs are rejected for market and product reasons. Decision-making by the studied angel group members differs from that generally described for independent angels.

1. Executive summary

Business angels (BAs) play a crucial role in financing the growth of entrepreneurial ventures by investing in numerous early-stage firms. Nonetheless, BAs finance only a tiny proportion of the proposals they receive, and few entrepreneurs get the opportunity to present their projects. Knowledge of the decision process and rejection reasons is incomplete because most results come from cross-sectional studies of decisions at a single step of the process, or rely on ex-post interviews or questionnaires. Moreover, previous studies analyzed BAs acting either independently or in informal networks. However, the angel market is changing: BAs have been forming structured angel groups to invest collectively in later stages of development and in technological sectors with shorter investment horizons, using more structured decision processes.

This paper investigates business angel group members' (AGMs) decision-making from project submission to the final decision. We collect, analyze and code the notes, comments and notifications recorded in a Canadian angel group's information system during the analysis of 636 proposals. We define the steps of the AGMs' decision process, and determine the final step reached by each project together with the rejection reasons. The angel group's archival data report what the gatekeeper or the AGMs really think or decide at the time of the event, and provide the reason given for rejecting each proposal. We thus study actual decision-making in its natural decision environment.

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* Corresponding author at: Laval University, Faculty of Administrative Science, School of Accountancy, 6226 Pavilion Palasis-Prince, G1V 0A6, Québec, Canada. Tel.: +1 418 656 7134; fax: +1 418 656 7746.

E-mail addresses: Cecile.carpentier@fsa.ulaval.ca (C. Carpentier), Jean-marc.suret@fsa.ulaval.ca (J.-M. Suret).

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The AGMs' decision process differs from the classical description of the process and criteria of independent BAs in several ways. Notably, AGMs largely attempt to control market and execution risk and favor an investment strategy focused on early exit that rejects inexperienced entrepreneurs. The gatekeeper plays a central role in the process; only a small proportion of the entrepreneurs interact with the AGMs face-to-face. This is mainly because many proposals submitted are out of scope of the AGMs' intervention, especially regarding location and economic sector. Generally, rejections occur before the first presentation and are based on proposals. Most of the projects pitched to AGMs are rejected during the informal analyses, meetings and discussions, but not directly after the presentations.

Projects that pass the pre-screen are rejected mainly for reasons related to the product and market strategy; the top management team's weaknesses are not a major rejection factor. The rejection reasons are very similar to those observed for venture capitalists (VCs) and fit the description of market and execution risk indicators. Specifically, these rejection reasons are related to the competitive conditions affecting the size, growth and accessibility of the market, or to the difficulty of execution of the product or technology. Few proposals are rejected for agency-related reasons.

We define six steps in the decision process. Except for the first step, where out-of-scope and incomplete proposals are rejected immediately, and the last step, where the term sheets are discussed, we observe neither strong nor significant differences between the rejection reasons. The rejection criteria used across the main steps do not differ as much as proposed in previous studies. This is consistent with a decision process focused on control of a single type of risk.

The probability of reaching an advanced step, and ultimately of being funded, is clearly related to entrepreneurs' industry experience, which dominates the effect of management and start-up experience. Funded entrepreneurs all have extensive industry experience, except for two cases where this experience is moderate. However, very few rejection reasons mention the lack of experience explicitly. Our results show that the relation between experience and success can be traced to the preparation of a more convincing market strategy. This is consistent with a process largely oriented toward the product and market characteristics, where most of the decisions are based more on proposals than on teams.

2. Introduction

BAs play a crucial role in financing the growth of entrepreneurial ventures by investing in numerous early-stage ventures (Brush et al., 2012; Maxwell et al., 2011). In the US, between 2001 and 2013, BAs invested about $22 billion per year in approximately 55,000 mostly early-stage firms. During the same years, the venture capital industry invested on average $7.2 billion annually in 1535 seed and early-stage firms.[1] Despite their intense activity, BAs finance only a tiny proportion of the proposals they receive, and few entrepreneurs get the opportunity to present their projects. Knowledge of the decision process and rejection reasons is incomplete because most results come from cross-sectional studies of decisions at a single step of the process, or rely on ex-post interviews or questionnaires. Moreover, previous studies analyzed BAs acting either independently or in informal networks (Haar et al., 1988; Kelly, 2007; Landström, 1998), yet the angel market is changing. BAs have been forming structured angel groups or other types of portals to invest collectively (Gregson et al., 2013; Mason et al., 2013; Sohl, 2012). This institutionalization of a growing part of the angel market has strong implications for early-stage finance (Sohl, 2012). In North America, angel groups are credited with a shift toward investing in later stages of development, a focus on technological sectors with shorter investment horizons, and the use of more structured decision processes (Paul and Whittam, 2010; Sohl, 2012).

Independent BAs and AGMs differ in several ways. BAs invest in seed or very early-stage companies operating in various industries, especially manufacturing, following referrals by friends or business associates (Haar et al., 1988; Mason and Harrison, 1996a; Morrissette, 2007; Sarasvathy and Wiltbank, 2006). Exit is not a major concern for independent BAs (Collewaert, 2012; Mason and Botelho, 2013). Although they face several agency problems (Fiet, 1995), they do not use detailed contracts (Ibrahim, 2008; Wong et al., 2009), but focus instead on involvement in the firm and on managers' personal characteristics (Fiet, 1995). In contrast, AGMs apply a more professional approach to investing than independent BAs do (Collewaert, 2012; Hsu, 2007; Ibrahim, 2008; Kelly, 2007; Sohl, 2012). AGMs generally invest in firms that have reached the revenues stage; in the US, only 2.2% of the projects are at the idea stage (Kerr et al., 2014). Sohl (2012) and Amatucci and Sohl (2006) contend that this shift may significantly change the angel market as a source of seed and start-up capital. AGMs invest mainly in high technology ventures (Angels Resources Institute, 2013; NACO, 2013), use complex contracts (Ibrahim, 2008; Sohl, 2012), have ample human and financial resources and often hire professionals who screen the many projects submitted through their website (Paul and Whittam, 2010). AGMs can conduct due diligence owing to their sophistication and diverse experience. In North America, they focus on exit (Mason et al., 2013).

The professionalization of the angel market and its focus on ready-for-market technology ventures are likely to induce large differences between the decision process of AGMs and that of traditional independent BAs. The difference between VCs' and independent BAs' decisions, described by Fiet (1995) and based on an agency framework, could be less relevant when BAs act in groups (Sohl, 2012). This evolution remains largely unexplored by academics (Mason et al., 2013). Therefore, we examine the extent that the decision process, rejection reasons and type of entrepreneurs ultimately financed by AGMs differ from those generally described for independent BAs.

Our approach overcomes several limitations of previous studies of BAs' decision process. These works adopt a post-hoc approach, based on interviews or surveys administered after the decision (Clark, 2008; Feeney et al., 1999; Landström, 1998; Mason and Harrison, 1996b) or use real-time methods. The post-hoc approach is likely to produce biased results (Maxwell et al., 2011; Petty

[1] Angel investor market reports from the Center of Venture Research, University of New Hampshire, various years, and National Venture Capital Association's dataset.