Journal of Corporate Finance xxx (2018) xxx–xxx

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Angel network affiliation and business angels' investment practices

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ARTICLE INFO

Article history:
Received 19 October 2016
Received in revised form 18 December 2017
Accepted 27 December 2017
Available online xxxx

JEL classification:
G24
G32
M13*Keywords:*
Business angels
Business angel networks
Venture capital

ABSTRACT

This paper provides preliminary evidence on the effects of membership in a business angel network (BAN) on the investment decisions of the members. Using a novel dataset containing qualitative and quantitative information on 810 angel or angel-group backed investments in 619 companies by 330 unique business angels from 2008 to 2014, we show that BAN membership generates valuable information, networking, monitoring, and risk reduction effects, which ultimately affect the share of personal wealth committed by each angel investor and their equity stake in the targeted company. These results extend our knowledge of the investment behavior and characteristics of business angels, a relatively opaque funding source that is rapidly gaining prominence in support of new ventures and the development of the global economy.
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1. Introduction

In the past few years, both academics and practitioners have devoted increased attention to understanding the dynamics of business angel (BA) investments. Market data for both the US and Europe show that business angels[1] have become a major segment of the capital market industry, comparable to professional venture capitalists (US ACA, 2015; EVCA, 2014; EBAN, 2015; Kraemer-Eis et al., 2015; OECD, 2016). As such, BAs have become crucial enablers of the development of new firms and a driving force of growth (Lahti and Keinonen, 2016; OECD, 2016, Mason, 2009). Despite this recent attention, our understanding of the BA investment is still limited. In particular, little is known about the investment practices of BAs once they join semi-formal organizations such as BA networks (BAN) and angel groups (AG). This study aims to fill this gap.

BAs are: "*high net worth individuals who invest their own money in small unlisted companies, with no family connections, typically assuming a minority equity stake as well as active involvement in portfolio companies*" (Mason, 2008). BAs are among the most appealing actors in the ecosystem for entrepreneurial businesses, considering their capability to fill the so-called "funding gap" between the demand and supply for early-stage equity capital (Mason and Harrison, 2000; Johnson and Sohl, 2012; Capizzi, 2015). First, BAs satisfy a certain size investment need (usually in the range of 100 k–300 k euros) that is not typically considered interesting or profitable for venture capitalists because of the relatively high costs of due diligence, contracting, and monitoring

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[1] Additionally called "informal investors" (Wetzel, 1986; Freear et al., 1992; Landstrom, 1993; Harrison and Mason, 1996; Van Osnabrugge, 2000), to differentiate them from venture capitalists and other financial intermediaries who invest capital raised from third parties.

https://doi.org/10.1016/j.jcorpfin.2017.12.029
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associated with very early-stage businesses (Jeng and Wells, 2000; Carpenter and Peterson, 2002; Mason, 2009). Second, alongside capital injection, BAs provide valuable non-monetary resources such as industrial knowledge, management experience, mentoring, and personal networks (Harrison and Mason, 1992; Landstrom, 1993, Politis, 2008).

Over time, angel investors have increasingly organized into associations—also referred to as groups, networks, or clubs, depending on the level of their internal structure (Mason, Botelho and Harrison, 2013)—usually on a geographic or industrial basis. The objectives of such organizations range from increasing the deal flow by sharing presentation pitches from potential entrepreneurs to performing joint due-diligence work on potential investment opportunities, ultimately reducing transaction costs (Mason, 2006; Sohl, 2007; Paul and Whittam, 2010; Gregson et al., 2013; Lahti and Keinonen, 2016). These associations have grown to regional, national (for instance, ACA in the US, BBAA in the UK, and IBAN in Italy), and even continental proportions (among them, EBAN and BAE in Europe), increasingly differentiating among each other in terms of rules of engagement, internal structure, quality, variety, and cost of the services provided. Thanks to BANs and AGs, the informal venture capital market is currently much more visible and, hence, easier to access on both the demand and supply sides (Mason, Botelho, and Harrison, 2013; Cumming and Zhang, 2016).

Despite their growing sophistication and importance as capital providers, there is very little evidence on the impact of BANs on the investment process of BAs. Most existing research is based on anecdotal evidence or case studies (May 2002; Payne et al., 2002; Mason, 2006; Johnson and Sohl, 2012; Ibrahim, 2008; Brush et al., 2012; Kerr et al., 2014; Collewaert and Manigart, 2016; Croce et al., 2017).

In this study, we focus on BA investment choices, trying to isolate the differential role played by BAN or group membership on BA investment practice. In particular, we investigate whether and how being members of semi-formal organizations affect the share of angel personal wealth invested in a given deal or the amount of equity stake in portfolio companies. Looking at a unique dataset that encompasses qualitative and quantitative information on 810 investments for 619 unique companies by 330 unique Italian BAs from 2008 to 2014, our study, for the first time, provides evidence of significantly different investment practices by angels who participate in BANs compared to unaffiliated angels investing as single, independent investors. We find that being part of an angel network has a significant effect on investment practice, increasing angels' propensity to invest more of their wealth. Furthermore, BAN membership generates sizeable diversification benefits for angels: a larger deal flow and access to network screening and monitoring skills affect angel portfolios by reducing the individual stake in each company in a classical diversification exercise. When we control for the possibility of co-investing within a BAN, both angel capital committed and investment deal size decrease. Finally, BAN membership mitigates the effects on investment practices of certain angel-specific factors such as post investment hands-off approach and non-contractual based monitoring.

Given the possible endogenous nature of the choice of joining an angel network, we perform a host of robustness checks including a set of two-stage instrumental variable regressions and propensity score matching regressions. Results are qualitatively unchanged, thereby providing support to our research design and our conclusions.

Our findings have interesting normative implications that may be useful for policymakers in creating new and effective measures aimed at stimulating entrepreneurship and contributing to the development and growth of economic and social systems (Baldock and Mason, 2015; Kraemer-Eis et al., 2016).

The remainder of the paper is structured as follows: the second section derives the research hypothesis to be tested from the literature dealing with BAs and informal venture capital. The third section presents the dataset and specifies the variables used to perform the empirical analysis, the results of which are shown and discussed in the fourth section. The final section addresses concluding remarks and suggestions for future research.

2. Hypothesis development and related literature

Our research program adopts as its main unit of analysis the amount of own risk capital invested by individual business angels. Prior literature on both venture capitalists (Lerner, 1998; Jeng and Wells, 2000; Cumming and Johan, 2013) and informal investors has commonly operationalized this measure as either the overall amount of capital invested (Maula et al., 2005; Wiltbank and Boecker, 2007; Lahti, 2011; Collewaert and Manigart, 2016) or the amount invested in a single deal as a share of a given BA's personal wealth (Harrison and Mason, 2002; Mason, 2006; Sohl, 2007; De Gennaro and Dwyer, 2014; Landström and Mason, 2016). These metrics try to capture the extent of the commitment of BAs to financing new ventures. In light of these results, in this study, we adopt as a first metric, the percentage of wealth invested ("*Wealth%*").

However, we believe that a second measure can provide insights useful for identifying the perceived risk drivers and their impact on the asset allocation decisions of informal investors. Accordingly, following prior research referencing mainly private equity and venture capital (Gompers and Lerner, 2000; Hellman and Puri, 2002; Kaplan and Schoar, 2005; Cumming and Walz, 2010), we add a second proxy for BA invested capital that measures the amount of capital invested as a share of the post-financing equity capital of the targeted company ("*Participation%*").

Building on these measures as the main dependent variables, we develop the expected effects of BAN participation as follows.

2.1. BAN membership and investment decisions

One major evolutionary trend observed in the informal venture capital market over the past two decades addresses the growing relevance of associations of BAs, either structured or semi-structured, ranging from loose networks of individual investors to

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