HOW SPECIFIC BUSINESS ANGEL MAKES HIS INVESTMENT DECISION. AN ITALIAN CASE STUDY

by Giuseppina Iacovello

1. Introduction

To finance his venture the entrepreneur can mobilise many types of capital. In general, he will begin by contacting his family and friends ("love money"); he can apply to a bank for a loan; he might also obtain the support of various types of organisations and networks, such as incubators, business development agencies, start-up clubs; finally, he can open his company"s capital to Venture Capitalists or Business Angels (Cerrthoux and Perrin, 2013). Early stage (seed and start-up) entrepreneurial ventures are likely to begin on a small scale, but have a high-risk profile.

The dimensions of the solutions adopted or adoptable by companies can vary according to a variety of factors, for example: financial autonomy, degree of formalization of arrangements with other companies, the time duration and the specific content of the agreement, the nature of shared activities, with different degrees of coordination and dominance. The challenges of innovation, in particular, and the imbalance of the financial structure, require companies to review their behavior.

Lack of funding (the equity gap) can lead to cash flow problems, missed opportunities, and even the failure of the fledgling enterprise (Van Auken, 2002). Early stage (seed and start-up) entrepreneurial ventures are likely to begin on a small scale, but have a high-risk profile.

Companies also manifest a need for human capital (know-how, experience, expertise) that enables them to acquire and consolidate a competitive advantage. Having access to both of these kinds of capital will not only give the entrepreneur the possibility to reduce the risks of inherent in the creation stage but also the chance to accelerate its development (Large and Muegge, 2008).

The inability of the individual production units to cope with the variability and variety of environmental situations and the desire not to restrict their activity, but rather to engage in a continuous process of innovation has resulted in the search for either new parties operating in the market or relations with other existing production units. The Business Angel (BA), an innovator who organizes the relationships between companies, is a form of non-traditional response to the complexity of the environment.

The BA brings financial resources as well as extensive knowledge acquired over time. Both can give the company a greater competitive advantage.

The acquisition of a considerable information and knowledge from the BA can put businesses in a privileged position compared to other, even large, businesses and promotes the implementation of successful strategies.

Awareness of the role of information in general and of the benefits deriving from the sharing of information of high quality is related to the cultural climate in the company (cultural distance), the difference in management styles (remote management) and to the differences in the management operating mechanisms (Fronterre, 1991).

Even though there is a plethora of research conducted on BAs in the US and the UK, there is a limited knowledge on the characteristics and investment behavior of Italian Business Angels.

The aim of this work is to highlight important factors that underlie the entrance of the BA in the company. More specifically, we want to identify the important criteria of BAs that would be subsequently used in the quantitative phase of the investment process.

Thus, the current study taps into areas within the domain of Italian BAs that have previously not been explored. This contributes to enhancing our understanding of Italian BAs.

The strongest link between the BA and the company can be perceived when they succeed in producing and sharing new knowledge formed in different contexts, regardless of their experience and information, through a common language. However, there are a number of generally recognized practical problems, relating to learning difficulties that have to be overcome so that the information can be formalized and made available and accessible. The characteristics of the loan and the peculiarities of the BA accentuate the differences in values, specific resources, social behaviors and information assets to be formalized and circulated inside the company.

The potential of the funder can be expressed significantly only gradually and through conflict or reticence of different kinds and origins. The BA, urged by the varied needs of customers, can provide the specialized information they possess, but also find themselves in conflict situations. The proper functioning of management requires that formal and informal relations should be marked by a system of values shared by all the actors: the high quality of the entrepreneurial function (motivation, culture, strategic awareness, knowledge and experience) is the essential condition for achieving the target of systematic interactions of any kind aimed at economic growth (Ferraris Franceschi, 1998). The obstacles to the spread of latent potential are to be found in the contradiction between the way in which the company achieves dominance in a market and the route taken by the BA in reducing the complexity of the environment. The risk of undermining the strengths of companies is significant and, in the face of this possibility, they have reluctance to give up their own positions in favor of transformations that might be "leaps in the dark is understandable."

The remainder of the paper is organised as follows: paragraph two outlines the background and literature review, paragraph three discusses the research method and paragraph four presents the empirical results and discussion. The final paragraph presents conclusions providing a critical review of alignment between theory and practice.

2. Background and literature review

Business Angels are individuals who invest in one or more high potential start-ups (becoming shareholders of the company) and also contribute their expertise in business management and their personal network of contacts (European Association of Business Angels Networks). Many scholars have noted the role of learning Asymmetries that offer advantages for the exploitation of opportunities (Corbett 2007; Rae and Carswell, 2001) and the accumulation, assimilation and use of knowledge that put the Entrepreneurial Business Angel (EBA) in a prime position to promote economic (also local) development (Wang, 2008; Levesque et al 2009).

The role of BA is fostered and developed to cover the equity gap suffered by start-ups in their early stages (Harrison et al., 2010). They occupy a critical position as providers of transitional funding when entrepreneurs have exhausted the sources of funds closest at hand (family and friends) but do not yet have a long enough track record to earn themselves access to venture capital or to bring in an industrial partner (Iruarrizaga and Santos 2013).

In many cases, BAs are entrepreneurs who have been successful and who want to continue to be involved in building new enterprises (Roach, 2010). They have both the wealth and the experience to help young businesses grow (Wright, Westhead and Sohl, 1998).

Other BAs are motivated by their desire to learn new things. Whether its learning about new technology before it reaches the market or learning how companies get started, many angels simply like the challenge of learning something new (Rodriguez, 2011).

The Center for Venture Research (Whittemore School of Business and Economics at the University of New Hampshire in Durham) analized the USA angel investor market for the first half of 2010. According to the research total investments were $8.5 billion. Although multiple industries receive capital from angels, in the first two quarters of 2010 the Healthcare sector received 24 percent of total angel investments which was the most funding received in any other sector. The other top funded sectors were

Biotech (20 percent), Software (12 percent), Industrial/Energy (11 percent), Retail (9 percent), and Media (5 percent) (Sohl, 2010).

According to the IBAN (Italian Association Business Angel) survey data, in 2010 most of the BA deals concerned firms in the ICT sector (20%) followed by business services (16%), entertainment (12%), bio and medical technology and energy and environment (10% respectively), see Table 1.

Tab. 1 - Sectors invested in by Business Angels in Italy (2010)

Sector	**Percentage**
ICT	20
Business Services	16
Entertainment	12
Biotechnology and Med Tech	10
Energy and Environment	10
Commerce and Distribution	8
Manufacturing	7
Finance and Insurance	6
Internet	5
Agro-Food	3
Other	3

Source: IBAN survey 2010

The entrance of the BA in the company has been analyzed broadly and significantly in the literature (Aernoudt, 1999; Van Osnabrugge and Robinson, 2000; Mason, 2006: Riding et al., 2007); most of the research has been empirically based, seeking to learn more about the attitudes, behaviour and characteristics of the angel population (often known as the 'ABCs' of Angels). In order to grow, many entrepreneurial firms must obtain financing from BAs, i.e. private individuals, such as Bill Gates, Steve Jobs, and Oprah Winfrey, among many others, who offer risk capital to unlisted companies in which they have no previous formal or family connections (Sørheim, 2005). For some research the relationship between the funding and the knowledge and skills they bring to the companies they invest in has been the subject of study; this relationship, in fact, has been interpreted to identify the profile of the BA. In particular, Avdeitchikova (2008) uses a criterion that categorizes BAs according to the weight of the contributions they make to the company, in terms of financial resources and non-financial resources (knowledge and expertise).

The first type of BA plays a "classical role" and contributes both financial resources and non-financial resources; the second plays a "knowledge-oriented role" in which the main contribution is non-financial. However, empirical studies disagree on the proportion of investments with non-financial resources: Mansson and Landström (2006) calculate it to be 75%; Harrison and Mason (1992) 69%; Reitan et. Sorheim (2000) only 32%.

Studies have placed emphasis sometimes on the "deal origination" and "deal evaluation"; sometimes, on a comparison of investment decision-making processes and investment criteria of BA and other types of investor (Mason and Stark, 2004); Finally, the factors that push these lenders to investment choices, from different perspectives (Clark, 2008; Landstrom, 1998; Ludvigsen, 2009; Mason and Harrison, 2003; Mason and Rogers, 1997).

The growing literature within the resource-based view of the firm has emphasised how a bundling of resources can create sustained competitive advantage (Prahalad and Hamel, 1990; Grant, 1991; Barney, 1991; Rumelt et al., 1991).

Economists have started to examine the factors influencing investments by BAs in risky assets such as shares and mutual funds and developed sophisticated econometric methods to tackle the challenges relating to survey data on investor portfolios (Perraudin and Sorensen, 2000; Guiso et al., 2003; Poterba and Samwick, 2003).

One of the general assumptions about BAs is that they are expected to be value-adding investors who, in addition to the supply of financial capital, also support the development of new ventures through their professional and personal knowledge and skills (Politis, 2008).

According to literature, BAs often seem to possess unique personal capabilities which enables them to generate ideas and creativity for the realization of entrepreneurial ventures (Van Osnabrugge 1998; Aernoudt 1999). Politis's work is very interesting and identifies limited, but complementary roles of value-adding investors: sounding board/strategic role; supervision and monitoring role; resource acquisition role; mentoring role (Politis, 2008). Thus, the importance of BAs derives not only from the amount they invest, but also from mentoring and other ways in which they partecipate in the firms (Riding, 2008).

Particularly interesting for the purpose of our work are the studies on the investment process of BAs (Mason, 2006: Riding et al., 2007; Smith, Mason and Harrison, 2010); it is iterative, notably during the pre-investment phase (Paul, and Wyper Whittam, 2007).

Many studies have concentrated above all on proposals for the implementation of the investment process (Van Osnabrugge, 2000); Robinson, 200; Heines et al. 2003; Paul, and Wyper Whittam, 2007).

It is clear that universal models can hardly be implemented purely and simply and this is the main criticism of the various studies. Many scholars have focused on the importance of the first phase during which the BA forms an opinion about the advisability of making the investment (Harrison and Mason, 2002; Douglas and Shepherd, 2002; Clark, 2008).

The entrepreneur's profile and experience are important factors that support the formulation of decisions and the implementation of the investment process by the BA (Paul, Whittam and Wyper, 2007). The pre-investment phase is materialised in two steps: *meeting the entrepreneur* and *initial screening*. During these two phases investors acquire more qualitative information about the entrepreneur. This can influence the investment decision in its mode of implementation or can modify objectives (for example, to target a new market rather than to consolidate the market in which the company is already operating (Sarasvathy, 2001; Wiltbank et al., 2009). The subject of this study is the pre-investment stage of the process.

Our research question is: what criteria can a BA use so that he or she will be more effective at screening potential investments at an early stage?

The question raised by this research is what leads BAs to make an investment? Can the different backgrounds, knowledge and experience of enterpreneur or manager lead the BA to change his/her mind?

3. Methodology

This work analizes the factors that push BA to investment choices. The basis of the work has been formulated on the following hypothesis: the non-financial value that a BA can bring to a company is the most important factor in a BA's decision to invest.

To explore and understand the role of the BA we chose to use an intensive research strategy: an in-depth study of reality; we limited our study to a single investor who met the exact criteria for what we refer to as a financial project.

The case study methodology is an interesting empirical approach to study a complex and contemporary phenomenon that evolves over time and still little known in the context where it takes place in such as the one under investigation to this study (Yin, 1984). The use of cases has also the advantage of allowing the deepening of aspects concerning the "how" and "why" of contemporary events and recent, on which the researcher has little control.

Past studies suggest methods to help researchers conduct rigorous analysis of these kinds of studies (Langley, 1999).

In accordance with the literature (Chen et al., 2010), we carried out one in-depth pilot contact in order to elicit early quantitative feedback and to refine our research design in the subsequent survey.

Data were collected by using a questionnaire which focused strictly on the criteria that BAs use to make an investment and on their order of priority at an early stage.

Understanding how BAs rank investment criteria and the relative importance of their perceptions helped us understand the investment process better.

We reviewed the existing literature and analyzed the questionnaires used to identify the investment criteria adopted by the BA; our questionnaire was developed mainly on the basis of the Van Osnabrugge model (Van Osnabrugge Angel Investment Criteria, 2000). Van Osnabrugges and Robinsons's study (2000) was conducted on U.K. Angels. The schoolars found that four out of their top five investment criteria related directly to the entrepreneur, (see: Table 2).

Table 2: Investment Criteria

Criteria	**Ranking**
Enthusiasm of the Entrepreneur(s)	1
Trustworthiness of the Entrepreneur (s)	2
Sales potential of the product	3
Expertise of the Entrepreneur/Quality of Management	4
Investor linked the entrepreneur(s) upon meeting	5
Growth Potential of the market	6
Quality of the Product	7
Perceived financial rewards (for investors)	8
Niche market	9
Track Record of the Entrepreneur	10
Expected rate of return	11
Product's informal competitive protection	12
Investor's involvement possible (contribute skills)	13
Investor's strengths fills gaps in business	14
High margins of business	15
Low overheads	16
Nature of the Competition	17
Ability to reach break-even without further funding	18
Low initial capital expenditures needed (on assets)	19
Size of investment	20
Product's overall competitive protection	21
Low initial cost to test the market	22
Venture is local	23
Investor understands the business/industry	24
Potential exit routes (liquidity)	25
Presence of (potential) co-investors	26
Formal competitive protection of product (patents)	27

Source: Van Osnabrugge and Robinson (2000)

Our question was about priority; we used numbers in a 1-to-5 rating scale; it was an effective method for measuring the relative importance of criteria. "5" was "extremely important," while "1" was "not at all important". The midpoint of the scale is "3". It represented "moderately important". "2" and "4" was slightly less and slightly more, respectively, than the midpoint—but less than the extremes.

Empirical evidence has been collected in the month of November 2014 through a contact with the current Business Analyst at an Italian Angels who remains anonymous (as BAI). Over time the organization has grown and now has more than 120 partners, who are leaders in their fields of expertise and wish to help entrepreneurs to maximize their own potential. At the same time, the partners have invested in more than 25 start-ups. No other organization of investors in Italy can rely on similar assets. For this reason, we choice this interesting case study.

4. Results and discussion

The purpose of our research was to identify the important (decision-making) criteria that BAs use in the early stage of the process of deciding to invest. Some very interesting results emerge from a reading of the rankings (see Table 3).

Table 3: Management Team Criteria (adapted by Van Osnabrugge model, 2000)

Management Team Criteria (rating 1-5)	
Passion of the team	4
Perceived sense of survivability of the team	4
How complementary the skills of the team are	4
Track record of individual team members	4
Openness of team for mentoring (coachabilty)	3
Experience of the advisors	3
How much experience the team has working together	3

Passion can be defined as "consciously accessible, intense positive feelings experienced by engagement in entrepreneurial activities associated with roles that are meaningful and salient to the self-identity of the entrepreneur" (Cardon et al., 2009; Singh and Drnovsek, 2009) and of the manager. The commitment to the new business idea and the ability to inspire confidence among future stakeholders, including employees, potential customers, and investors have a significant importance. Coachability lets managers listen to stakeholders, carefully consider feedback prior to responding, recognize their weaknesses, and willingly make changes to address those weaknesses. This type of behavior can be perceived as positive by angels. This increases the likelihood that the angels will agree to provide the entrepreneur with funding. BAI looks at the team's passion for and commitment to the new business idea; the investor also looks for teams of high-quality managers (he might be the enterprepreneur) with a track record of leadership and performance. Partnership is important.

According to the BAI, experience and coachability are less important than other characteristics of the manager during the meeting phase.

The most important characteristics of the BAI's investment are evidence of staying power and an ability to handle risk (see Table 4).

Table 4: Selected Investment Criteria (adapted by Van Osnabrugge model)

Selected Investment Criteria (rating 1-5)	
Sales potential of the product	5
Growth potential of the market	4
Expected rate of return	4
Low initial capital expenditures needed (on assets)	4
Size of the investment	4
Product's overall competitive protection	4
Potential exit routes (liquidity)	4
Trustworthiness of the entrepreneur (s)	4
Nature of competition	3
Expertise of the entrepreneur	3
Investor liked the entrepreneur (s) upon meeting	3
Quality of product	3
Perceived financial rewards (for investors)	3
Track record of the entrepreneur	3
Product's informal competitive protection	3
Enthusiasm of the entrepreneur (s)	3
Ability to reach break-even without further funding	3
Low initial cost to test the market	3
Investor understands the business/industry	3
Formal competitive protection of product (patents)	3
Venture is local	2
Investor's involvement possible (contribute skills)	2
Low overheads	2
Investor's strengths fills gaps in business	2
Niche market	2
High margins of business	2
Presence of (potential) co-investors	2

2

It is clear that the risk to the BAI is the sales potential of the product which is the guiding principle in the choice of investment. The characteristics of product and market appear to be critical and important as the general characteristics of every investment (liquidity, ROI, ROE, initial capital expenditures needed).

As expected, the key financial concerns are with high upside potential and high investment liquidity. The BAI recognizes that the payout is a priority; he still expects a handsome return on that investment. Of least concem was whether or not they were involved in the first round of financing and whether or not they would be expected to make subsequent investments.

The BA can perceive a particular entrepreneur as trustworth**y**; this increases the likelihood that the angels will agree to provide the entrepreneur with funding (Rotter, 1967; Mitteness C. R., Sudek R., Baucus M. S., 2010). In our case, this perception will ultimately impact the angel's evaluations of funding potential; it is associated with the strength of the entrepreneur decision to make the investment.

The BAI ascribes importance to the features that distinguish the company from potential competitors; attributes that convey competitive advantage include intellectual property protection, exclusive licenses, exclusive marketing and distribution relationships, strong brands, scarce human resources (i.e. knowledge and skills).

On the other hand, the BAI generally states that he/she is not particularly concerned whether the entrepreneur's personality is compatible or not. However, the results indicate that the BAI does in fact regard it as important, but not essential. Almost as important were leadership capability and a track record that is relevant to the venture.

Very interesting is the opinion about the relevance of the investor's possible involvement. The BAI does not believe that the investor's possible involvement can make a better positive contribution to the success of the investment.

It is of little importance whether the company is in a niche market or is not close to the headquarters of the BAI. In general, personality and experience concerns not are not predominant financial criteria.

5. Conclusion

Entrepreneurial venture creation is a dynamic process undertaken by high-growth businesses. It is defined less by absolute size, more by growth and the potential for future returns. Commonly, however, entrepreneurial ventures with high growth potential require funding far beyond that supplied by the founders. On the basis of these elements the BA uses different criteria to invest in a company. The investor looks for companies that can grow quickly and manage the scale necessary to succeed. The company must demonstrate a strategy to claim a significant market share or revenue: not all businesses will generate returns that justify angel investor funding.

Successful investing requires the BAs to find the right investments that suit their personal knowledge and interests. BAs also understand the risks involved. The funding gap is more of a capital gap than the capital/information gap in the seed and start-up stage, and it is undergoing a steady increase; without seed and start-up capital, many of these companies do not even get past the initial stages of development (Sohl 2003).

The empirical investigation conducted on the case appears to be the first step in a larger research that we are conducting on high-tech companies to understand the point of view of the companies that are approaching or have approached the BA. The second phase is essential for fully understanding the reasons for the appeal to the BA and the development of a general model of synthesis can be traced through rationalization of such attributes. The aim of such a model is to identify the causative factors (endogenous and exogenous) and intervening variables (exogenous) that lead to the use of the BA.

Their empirical findings suggest that there are no significant differences among the categories of factor in terms of the use of information sources, involvement in the company, co-investments, geographic preferences.

In general, personality and experience are not considered more important than the financial criteria, which are, moreover, regarded as more important than product or market criteria.

The key financial concerns are with high upside potential and high investment liquidity. The investor recognizes that the payout is most important factor; he still expects a handsome return on his/her investment.

The limitations of our empirical sample should be kept in mind. An important limitation of our study is that we have used a categorical variable as a measure of investment decision at the early stage of the process. An analysis of the influences on the magnitude of individual investments would represent a natural next step to our analysis. Most of the predictor variables used here have been dichotomous for the simple reason that it would be prohibitively expensive to collect more fine-grained data. For the same reason, we have not been able to examine many other important influences, such as wealth, background as a serial entrepreneur, exit from the company, the extent and quality of the individual's own social networks, or the individual's own family background, on his/her informal investment behavior.

At the moment, it is not possible to determine whether the BA wants to maintain such a relationship with the entrepreneur. However, it is important to note that no two are exactly alike or that BAs will have the same investment.

This paper will discuss an array of criteria. Because of there are a lot of components that go into fully understanding investing of BAs, our analysis will prompt further research into this important area.

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Abstract

The main purpose of this article is to improve understanding of the decision-making process of Business Angels (Bas), regarding in particular the criteria used in the first stage of choice of the investment. Empirical results indicate that BAs play a key role in facilitating the development of a business because of the financial resources they can bring and the human capital that can effectively support the entrepreneur's choices.

This article is based on an in-depth case study of an experienced BA operating in Italy. Future research will continue to examine the factors characterizing the BA's investments. Moreover, using larger samples it will be possible to test the results of this exploratory study

Riassunto

Il contesto competitivo ed ambientale teatro di decisioni e comportamenti aziendali complessi si presta ad analisi di indubbio interesse. All'aumentata e continua turbolenza ambientale ed alla maggiore complessità interna fanno eco una varietà di scelte che si prestano ad una non semplice né univoca interpretazione.

Negli ultimi anni, numerose aziende di fronte alle sfide che si avvicendano nel sistema economico si sono mosse (tra l'altro) verso l'incetta di forme di finanziamento diversificate.

Ci sono molti strumenti finanziari che offrono diverse combinazioni rischio/rendimento atte a soddisfare le diverse preferenze di un imprenditore. La disponibilità delle risorse, oltre che di origine bancaria o azionaria, può provenire da fonti alternative: Business Angels (BAs), Peer-to-Peer Lending, Asset-based Lending, Crowdfunding, Government Business Finance. Obiettivo del presente lavoro è analizzare i criteri che sottendono la scelta del BA d'ingresso in azienda. Il processo di investimento del BA si estrinseca in diversi fasi al termine delle quali si arriva alla valutazione dell'iniziativa imprenditoriale utilizzando parametri e informazioni qualitative (size and attractiveness of the market, management capabilities and functional skills, uniqueness of a product or service, market acceptance of a product and the degree of competitive threat in the marketplace) sui quali la dottrina si è variamente espressa. Lo studio ha inteso indagare gli aspetti considerati prioritari nelle scelte dei Business Angels nel momento in cui redigono un progetto di investimento.

Sulla base di una proposta avanzata in letteratura (*Van Osnabrugge Angel Investment Criteria)*, si è sviluppato il lavoro empirico secondo la metodologia del case study.

Jel Classification: M1 - Business Administration - M10 – General

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