DIÁLOGOS SETORIAIS UNIÃO EUROPEIA BRASIL

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RELATÓRIO

CREATING A FAVOURABLE ENVIRONMENT FOR BUSINESS ANGELS: WHAT BRAZIL CAN LEARN FROM THE EU EXPERIENCE

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LIST OF ACRONYMS

ABVCAP	Associação brasileira de venture capital
ACA	Angel Capital Association (US)
AIM	Alternative Investment Market (London)
Alternext	NYSE Euronext equity market for small and medium enterprises
ANBID	National Association of Investment Banks
ANBIMA	Brazilian Financial and Capital Markets Association
BA	Business Angel
BAN	Business Angel Network
BBAA	British Business Angel Association
BM&FBovespa	Brazilian Stock Exchange
BNDES	Banco Nacional do Desenvolvimento
BRL	Brazilian Real
BVCA	British Venture Capital Association
CEO	Chief Executive Officer
CG	Corporate Governance
CRD	Capital Requirements Directive
CVM	Comissão de Valores Mobiliários
EBAN	European Business Angel Network
ECB	European Central Bank
EC	European Commission
ECF	European Co-investment Facility
EIB	European Investment Bank
EIF	European Investment Fund
EIS	Enterprise Investment Scheme
EU	European Union
EVCA	European Private Equity and Venture Capital Association
FENABA	Federation of Business Angel Associations (Portugal)

FESE	Federation of European Securities Exchanges
FINEP	Financiadora de Estudos e Projetos
GDP	Gross Domestic Product
GEM	Global Entrepreneurship Monitor
GP	General Partner
GVcepe	Private Equity and Venture Capital Research Center
IMF	International Monetary Fund
IPO	Initial Public Offering
IRB	Internal Ratings-based
IRR	Internal Rate of Return
ISME	Innovative Small and Medium-sized Enterprises
IT	Information Technology
LP	Limited Partner
MAB	Mercado Alternativo Bursátil (Spain)
MCTI	Ministério da Ciência, Tecnologia e Inovação
MDIC	Ministry of Development, Industry and Foreign Trade
M&A	Mergers & Acquisitions
NASDAQ	ational Association of Securities Dealers Automated Quotations
NVCA	National Venture Capital Association (US)
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-Operation and Development
P/E ratio	Price-earnings ratio
PE	Private Equity
PNEN	Política Nacional de Empreendedorismo e Negócios
SEBRAE	Serviço Brasileiro de Apoio às Micro e Pequenas Empresas
SEIS	Seed Enterprise Investment Scheme
SMEs	Small and Medium-sized Enterprises
VC	Venture Capital
WBAA	World Business Angel Association

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The views expressed in this report as well as any errors or inaccuracies are the author's sole responsibility.

I - INTRODUCTION

The low stage of the economic cycle that Europe has endured since 2008 has led to a rising attention to the promotion of entrepreneurship, regarded as a source of innovation, economic expansion and much needed employment. However, new ventures are ill suited to traditional sources of financing such as bank loans, as the absence of assets prevents the use of valuable property that can be used as collateral. Raising equity outside the inner circle of the entrepreneur's family and friends becomes thus a core priority. Therefore, venture capital and business angel investment are key components of the eco-system required to the flourishing of promising new ventures. The problem is that their capacity to raise funds is sensitive to the volatility of economic cycles, especially in the case of venture capitalists. As they obtain most financial resources from insurance companies, pension funds and other institutional investors, they see their funding turn dry in periods of economic pessimism and bearish stock markets.

Business angels, who depend on their own savings, tend to be more resilient although they too are not immune from the general economic climate. Their higher flexibility, resilience and longer term commitment to the new ventures make them a highly important type of investor. Policy makers have long been concerned with drafting regulation and supporting initiatives that can efficiently enhance the number and size of the business angel activity.

The more developed Anglo-Saxon capital markets, providing easier and more rewarding exits, have also fostered and earlier consolidation of both VC and BA activities, which cross-fertilize each other. However, the last decade has led to a significant expansion and, above all, a stronger coordination of European BAs. This development was supported by efficient policies that have led several Continental European countries to reach a level of activity that is not much smaller than that achieved in the US and the UK. Other parts of the world, namely Brazil, could exploit their potential more efficiently if a larger pool of skilled BAs could provide capital, mentorship and networking that are required by entrepreneurs, especially those more focused on technological ventures.

This study is organised as follows. The next chapter describes the evolution, organisation and activity of European Angels, up to the exit stage. It includes a brief overview of the link between BAs and VCs as well as the role played by the emerging crowd funding. Chapter 3 describes the main policies aimed at supporting and regulating BA activity, including legal, fiscal and financial tools such as public/private co-investment. Chapter 4 provides an overview of the Brazilian BA industry, as well as the regulatory context to identify the major obstacles and limitations faced by a fast growing activity, by comparison with the European case. Finally, chapter 5 summarizes the main conclusions and provides a set of recommendations for the improvement of the environment surrounding the Brazilian BA industry.

II - BUSINESS ANGELS IN EUROPE

II.1 BUSINESS ANGELS AND ALTERNATIVE FORMS OF EQUITY INVESTMENT

Angel investors, business angels or informal investors are usually defined as high net worth individuals who invest in new ventures in exchange for an equity stake or convertible debt (OECD, 2010). The former “angels” were Broadway sponsors of theatre productions. Spina (2012) popularized the equivalent version of “investidor-anjo” in Portuguese. He added, as most analysts of the BAs’ role that these supporters do more than investing in new ventures, as they provide intellectual in addition to financial capital. BAs must also have some practical experience that is worthy for the new ventures, including networking, as well as managerial and technological skills. A recent study (Kerr, Lerner, & Schoar, 2010) has found that BA backed new ventures exhibit higher survival, additional fundraising outside the angel group and faster growth with improvements that range between 30% and 50%.

The expression “informal investor” aims at differentiating BAs from venture capital firms (VCs), who are formal investors. Although both provide equity or convertible debt to new ventures, VCs invest capital granted by a pool of institutions who expect formal reporting on the selected investments. This triggers significant differences between the two types of investors. As they must provide careful evidence of the quality of the research that has justified a positive answer to an investment request from an entrepreneur, VCs must undertake a heavier “due diligence” of the new project, usually involving its own staff and a pool of external experts, such as former executives with experience in that specific industry. This process is time consuming, often taking no less than four to six months, and costly. Given the fixed nature of the due diligence cost, VCs are reluctant to evaluate business opportunities that require little investment, even if they seem promising. They also feel uncomfortable with investing at a very early stage, as they prefer to support start-ups with some level of business activity. Osnabrugge (2000) carried out a pioneering study, in the UK, of 143 BAs and 119 VCs, finding clear evidence that VCs reduce agency risks through ex-ante analysis, the principal-agent approach, while BAs carry out more ex-post investment, the incomplete contracts approach. The following table presents the average values obtained from some variables related to ex-ante and ex-post investment decisions:

Table II.1. Venture capital versus business angel investing

	Venture Capital firms (n=119)	Business Angels (n=143)
Size of firm funded	£3.2Million	£0.29Million
Average Investment	£0,95Million	£0.055Million
Investor's initial equity (%)	31.7%	23.6%
Cost of due diligence as % of amount invested	1.3%	0.67%
Number of independent references taken on the entrepreneur	4.2	0.96
Weeks taken between first meeting the entrepreneur to investment decision	12.3	8.8
Visits per month	1.58	3.15

Source: Osnabrugge (2010)

These findings provide clear evidence that BAs invest in much smaller ventures – they also invest at earlier stages as shown in table II.1, take smaller stakes and undertake a faster and less rigorous due diligence process. However, they provide a much more intense follow-up of their investments, with 3.15 visits per month in Osnabrugge's sample. A study of 1,137 exits by Wiltbank and Boeker (2007) found evidence that the level of participation was positively related to BA rates of return – "angel investors that interacted with their portfolio companies at least a couple of times per month by mentoring, coaching, providing leads and/or monitoring performance experienced higher returns". This does not mean that BAs could entirely neglect ex-ante scrutiny of the investment opportunity and the entrepreneurial team. The same study also found that more hours of due diligence led to greater returns.

A more recent source of financing aimed at new ventures is crowd funding, made feasible on a larger scale by the pervasiveness of internet platforms. Traditionally, crowd funding has been used to channel charities donations related to causes or initiatives supported by a large pool of individuals. One early example of crowd funding was the campaign launched by Joseph Pulitzer in 1884 to help finance the Liberty Statue which ran out of funds for the Statue's pedestal (the statue had been offered by the French at an estimated cost of $250,000. He rose over $100,000 from 125,000 people in about 6 months. Recently, crowd funding has also provided the possibility of "funding a project or venture by raising many small amounts of money from a large number of people", Prive (2012), in Forbes.

A number of platforms such as Kickstarter or Indiegogo in the US, Wefund or BankToTheFuture in the UK, or PPL in Portugal are competing in an already crowded market place. In the US the JOBS Act has been published to support an activity that has been endorsed by President Obama as having the potential to significantly support innovation and entrepreneurship. Although crowd-funding has the potential to support those initiatives that attract the interest of the large public it

faces two drawbacks: the first is the risk that an eventual high profile failure or scam comes to tarnish the reputation of this tool that can not be heavily regulated without limiting its potential; the second is that crowd funding faces the same agency problems of public corporations – highly fragmented ownership precludes a strong involvement by individual contributors. This marks a sharp difference with BAs who have a sufficiently high stake in the new venture to be able to extract the reward required to spend time and effort with the new venture. Likewise, BAs who select the projects and industries they invest in provide a more efficient allocation of scarce resources as the capital flows to activities where it is more likely to yield higher returns – an outcome that can not be guaranteed with crowd-funding alone.

Bernett (2013) cites the Crowdfunding Industry Report who estimates the global size of the industry to rise from about $2.7 billion in 2012 to $5.1 billion in 2013. Although the bulk of crowdfunding is still of the donation-based type, Bernett predicts the more recent investment crowdfunding, where “businesses seeking capital sell ownership stakes in the form of equity or debt”, to rise in the future.

Investment crowdfunding or crowd investing is also expanding through recent platforms such as Crowd Cube (UK) and Seedrs (UK and Portugal). These platforms have counted on the active cooperation of BAs and use the same support mechanisms such as the UK Seed Enterprise Investment Scheme (SEIS) that is presented in chapter III.

If investment crowdfunding platforms become successful, new ventures will have easier and earlier access to equity financing and to capital markets, especially those focussed on smaller firms such as Alternext and AIM. However, crowd investing is likely to be more successful in those ventures that capture the support and reputation granted by well-known BAs. Therefore, these two forms of equity financing are more likely to become complementary rather than alternatives as is the case between venture capital and angel financing who often invest together. By investing at an earlier stage, the role played by BAs is likely to become even more relevant as catalyser of other types of equity financing.

II.2 FINANCING INFRASTRUCTURE FOR EARLY STAGE INVESTMENT

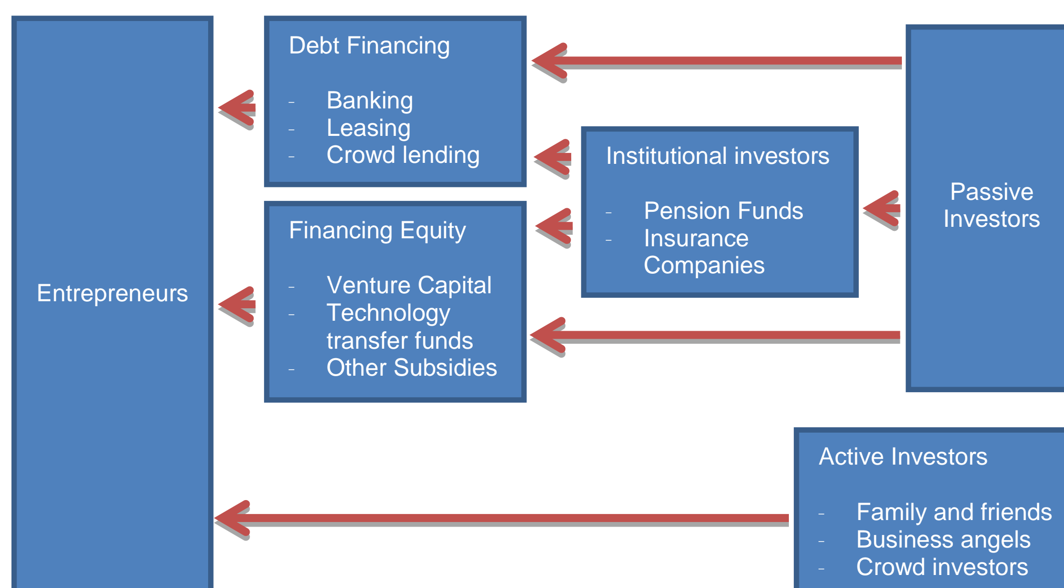
The financing infrastructure provides alternative modes to bring capital from savers to entrepreneurs. In most countries banks play a key intermediary role as they take deposits that they later use to lend capital to corporations. Although the interest paid is generally low, deposits offer safety, as banks are often backed by governments, in case of financial distress. Moreover, a specific government run insurance covers deposits of an amount that does not exceed €100,000 in all euro-zone countries, according to the Directive 94/19/EC that established this policy to be implemented by the end of 2010.

Other financial institutions, such as insurance companies and pension funds, compete with banks in attracting savings, usually promising a higher return in exchange for higher risk. These institutions may also invest in VC firms. Individuals may also invest in bonds or shares, through the stock market, directly or buying

stakes in investment funds. However, these savers can be regarded as passive investors as they are not directly involved in the management of their investments. They may enter and exit, but not influence the investment choices that are left to the professional managers of the institutions to whom they trust their savings (Fig. II.1).

This contrasts with the entrepreneurs and their families, as well as the business angels and crowd investors, who play an active role in the choice and, to a varying degree, the management of their investments. The higher effort and risk as well as lower diversification enjoyed by active investors demand a higher expected return.

Figure II.1. Financing Infrastructure of Entrepreneurship

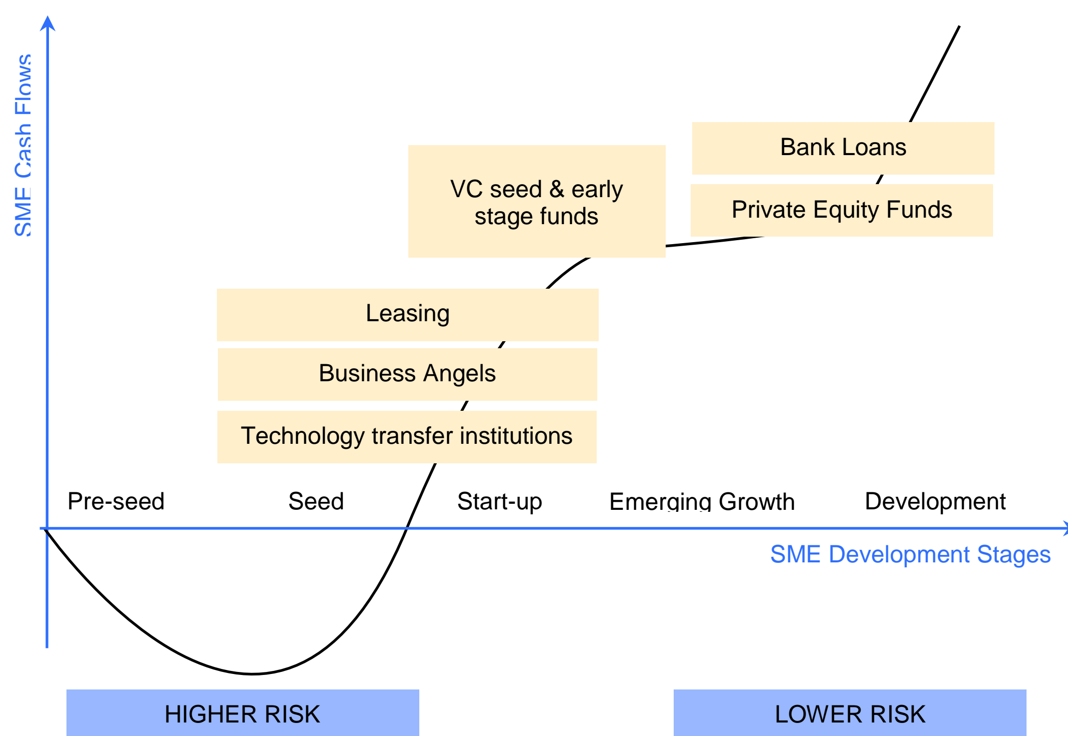


Source: Adapted from Esperança & Matias, (2010).

Risk and expected return tend to rise as we move from the top to the bottom of figure II.1. However, entrepreneurs are at a clear disadvantage at attracting bank loans or other relatively cheap sources of financing, especially for seed and early stage ventures, as they lack assets that can be given as collateral and face a high level of uncertainty about their future prospects. Moreover, debt financing does not provide the upside return that is attached to the more successful ventures while bearing significant risks, therefore discouraging potential lenders. In a context of financial crisis, the availability of loans to early stage firms is even scarcer. A new breed of lending intermediation is emerging, in the form of "crowdlending", but is still scarce in Europe. Platforms such as Google Ventures or Dealstruck provide debt financing to new ventures and small and medium firms, thus allowing savers to obtain better returns than they would get in time deposits.

The business life cycle plays a significant role in determining the available sources of financing. As new ventures mature and internal cash-flows become larger, the need to access external financing declines and the number of available sources also expands. The relationship between investment stage and source of financing is summarized in figure II.2:

Figure II.2. EIF tool kit for SME's



Source: Adapted from Kelly & Kraemer-Eis (2011),

As venture capital funds are available only at a later stage, usually when the company is already active in the market place, there is a gap between the pre-seed stage, that usually consumes the entrepreneur's as well as the proverbial family, friends and fools (fff)'s funds and the access to VC funds. Regular bank loans, bonds and other sources of debt financing are even less accessible until the venture acquires assets that can be used as collateral for external lenders. Although leasing may come at an earlier stage, as the assets are the lessor's legal property and technological ventures may access research grants, BAs play a very significant role at these earlier stages.

II.3 HISTORY AND EVOLUTION

Business angels have existed for a long time. Indeed, “affluent individuals who invest in new ventures in exchange for an equity stake” can be traced far back in history. What has changed dramatically in the past decades has been the organisation and cooperation of BAs. They have developed earlier in the US. Data for 2009, from the Center for Venture Research, from the University of New Hampshire, estimate that 258,200 US BAs invested $26 billion, in 57,120 entrepreneurial ventures, having created about 200,000 new jobs (Sohl, 2010). These data show that an average investment of $455,000 created an average of 3.5 jobs.

Comparing data across countries is extremely difficult as there are no stabilized metrics and many business angels are not associated to networks and may not report on their activities. The European business angel network EBAN (table II.9) estimated in 2012 a total of about 261,000 BAs in Europe, 26,105 of which joining 460 networks. The annual investment was estimated at about €4 billion, a substantially lower figure than that estimated for the US. European BAs working together in syndicates invested an average of €200,000 per deal, with individual angel investments ranging from €15,000 to €400,000 (EBAN, 2010).

The cooperation of individual angels was fostered by the European Commission who, in 1999 supported the establishment of EBAN, a not for profit association representing the interests of BAs business angels networks (BANs) seed funds and other entities involved in bridging the equity gap in Europe (OECD, 2011).

Angel networks expanded rapidly across Europe, as national policies also supported BAs, using mainly tax incentives and co-investment funds. The total size is still estimated to be smaller than in the US but is growing at a fast pace. The following table compares the total size of the VC and BA markets in Europe and the US.

Table II.2. Estimates of angel and venture capital markets, 2009, (millions USDs)

	Europe	United States
BAN	391	340
Investment per round	199,193€	218,480$
Total estimated investment in 2009	3-5 billion €	$17.7 billion
VC invested in seed (EVCA/NVCA data)	4 billion € (615 companies)	1.7 billion € (312 companies)

Source: EBAN (2010b)

The estimate of the total size of the BA market is a bold attempt in which the wider part is very hard to quantify accurately, as only BAs associated to networks tend to disclose information on investments and exits. EBAN and ACA (US) try to extrapolate from data provided by associated BAs in order to make a crude guess

of the total size of the BA market. Venture capital investments are easier to measure as VCs have to report to their shareholders and provide the associations (EVCA, Europe) and (NVCA, US) with information about annual investments. EBAN (2010b) compares data from these sources, for year 2009, showing that in the US BA investment in seed capital is now substantially larger than VC investment, while it may have reached a similar level in Europe.

Currently, BANs are expanding in other parts of the world. BA activism throughout Europe, especially in the last decade, led to the creation of the World Business Angels Association in October 2007, after a meeting in Estoril, co-organised by the Portuguese Business Angels Federation (FNABA), the European Business Angels Network (EBAN) and the US Angel Capital Association (ACA).

II.4 ORGANISATION

The last two decades have registered a significant expansion of business angels networks (BANs) throughout the world. Europe has been particularly active, given a favourable institutional climate and the initiative of a vast number of individuals, many with managerial experience, in specific industries that they now privilege as BAs. BANs are angel networks that may be organised according to two main types (OECD, 2011): member led and manager led.

Member-led BANs select a lead angel investor or committee on a volunteer and perhaps rotating basis. Members are responsible for the group and actively participate in various roles in the screening and investment process. The organisational structure may be informal (a group of individuals loosely associated under no specific legal structure) or take the form of a non-profit organisation, limited liability company, corporation or limited partnership. The members may hire a part-time or full-time administrative person to support the group on operational details. According to the OECD, this model is relatively inexpensive, and insures a high level of commitment from members, although it may lack consistency and be less sustainable.

Alternatively, **manager-led** BANs are run by a paid manager who may be supported by administrative staff. The organisational structure is more formal than for a member-led group and takes the form of a non-profit organisation, limited liability company, corporation or limited partnership. Angel investors can often also invest additional money through “side car funds”. In these BANs, professional managers are responsible for most activities of the group, cooperating with and organising the BAs.

The manager usually makes a preliminary screening of applications. Those that he regards as having some potential are then channelled to the members who are more likely to be interested according to their preferences and expertise. The manager is often eligible for carried interest in the fund, a share of the future return on the investment, above the recovered capital and, usually, a previously defined rate of return. This model aims at providing an incentive to identify and facilitate investments in the most promising companies. In some cases, the staff can receive

a small (2-3%) percentage of the committed capital of the group as fees (Kauffman Foundation, 2004).

OECD (2011) regards this model as potentially more effective in screening good projects and generating good matches between angels and entrepreneurs. However, it is usually more costly and many BAs enjoy being more actively involved from an early phase of the screening process. Independently of the organisational mode a typical angel investment process follows the following steps as summarized in OECD (2011), based on ACA, EBAN and Tech Coast Angels Materials:

Figure II.3. Typical angel investment process

- Deal sourcing – Can be proactive or reactive. Most deal sourcing comes through members, through their networks and interactions with other players in the ecosystem (service providers, VCs, incubators, accelerators, etc.).
- Deal screening – Applications are normally centralised and managed with a software package (angelsoft is often used). Initial deal screening can be informal (conducted by some of the members) or formal (conducted by the group or network manager).
- Initial feedback/coaching – Companies making the initial screening will be contacted and may receive some coaching regarding the expectations of investors and how to better present the company.
- Company presentations to investors – Selected companies may then be invited to present to the members at an event, normally held once a month. Typically 2-4 companies present. The investors then discuss aspects of the company and potential deal in a "closed" session.
- Due diligence – Due diligence is normally done on a formal basis and includes: a competitive analysis, validation of product and IP, an assessment of the company's structure, financials and contracts, a check of compliance issues and reference checks on the team.
- Investment terms and negotiations – If members remain interested, term sheets need to be prepared and the company valuation negotiated. Increasingly, angel groups and networks use standardised term sheet templates. The company may then present to the members a final time.
- Investment – Interested members can then form a syndicate to invest in the company. The final documents are drawn up and a lawyer is often engaged in the process. There is a formal signing of documents and the agreed-upon funding is collected.
- Post-investment support – After the investment, investors often monitor, mentor and assist the companies with expertise and connections. In addition, the investors often work closely with the company to facilitate an exit (IPO or M&A) at the appropriate time."

Source, OECD, 2011, figure 2.1, p.34

BA activity has been facilitated by the development of the entrepreneurial ecosystem throughout Europe. The two ends of the value chain illustrate this fact: generating deal flow is at the beginning of BA activity. Universities, large firms and government agencies have contributed to enhance the level of deal sourcing by supporting research, incubators, accelerators, business plan and new venture competitions and a broad range of meetings and events that have facilitated the meeting and interaction between investors and entrepreneurs. At the other end of the value chain, exit has been facilitated by the active operation of venture capitalists, private equity firms and large corporations who, in parallel with capital markets, provide exit routes that may reward the capital and effort committed by BAs, often from a very early stage of the new venture creation.

Access to promising projects and deal flow generation are fundamental for BAs. However, many aspiring entrepreneurs with potentially good ideas fail to present well founded business proposals. To tackle this problem, a number of accelerators have been created, all over Europe. Accelerators are start-up incubators, usually for-profit, that provide founding teams with mentoring, training, networking and even some financing, usually under €50,000, in exchange for an equity stake in companies that bid for their support through a competitive application. They differ from traditional business incubators who are usually supported by public funds and may charge a small rent, but don't take equity from companies. Y Combinator and TechStars were pioneer accelerators with a reputation for being highly selective. A number of seed accelerators has been recently created throughout Europe: Ibusinessangel.com (2012) registered 14 accelerators in the UK, 6 in Spain, 4 in Ireland, 3 in Germany, 2 in Denmark, Estonia, Finland, Israel and Italy and 1 in France, Greece, Lithuania, Portugal, Sweden and Ukraine. Accelerators usually provide intensive support for a period of about 3 months, enabling the teams to write a business plan and develop the skills for efficient presentation to potential investors.

II.5 ACTIVITY AND INDUSTRY PREFERENCE

The statistics on Angel activity are scarce and unreliable as many investments are not reported by the "invisible" BAs. However, EBAN carries out regular surveys whose output reflects the activity of organised angels. Table II.3 presents information, from EBAN's (2010b) Statistics Compendium, on number of BA Networks, number of BAs, investment reported, and number of deals, for selected countries, in 2009. This study is based on 219 replies out of the 396 angel networks addressed.

Table II.3. BA activity – Country breakdown

	nº of replies	nº of deals	Angels in networks	Amount invested by the angels	Average Investment per deal	Average Investment per angel
UK[1] (Except Scotland)	23	306	4585	38.100.000€ incl. Co-investment 69.785.000€	124.500 €	15.220 €
France[2]	68	382	3650	59.000.000 €	154.450 €	16.164 €
Italy[3]	11	179	350	31.400.000 €	175.400 €	89.714 €
Netherlands	11	109	2375	25.320.000 €	232.290 €	10.661 €
Belgium	2	36	272	6.823.579 €	189.550 €	25.087 €

Source: EBAN (2010b).

[1] Information from BBAA members only
[2] Information from France Angels members only
[3] Information from IBAN members only

Some patterns are visible – BAs' profile still varies significantly across Europe – high numbers of BAs do not necessarily translate into high activity. Italy has a relatively low number of registered BAs, but their average investment in 2009 was the largest, with €89714 per BA.

BAs do not share uniform preferences, given their diversified backgrounds and experiences. A new breed of BAs, "impact angels" have a more social concern and focus on ventures that can change life styles and tackle social problems . EBAN (2011) defines early stage impact investing as for profit businesses that have the objective of creating positive social and environmental impact or "doing well and doing good at the same time". This report estimates that the bulk of investments in energy/environment and healthcare sectors can be classified as "impact investments" so its total size should reach about 15% of total BA investment by 3013.

As with VC firms, most BAs search high growth ventures, and usually focus on industries such as software, hardware and internet related businesses, electronics, media, healthcare, energy and environment and other industrial applications. In this regard they do not differ significantly from VCs with whom they cooperate and who may also provide exit routes, especially in later stage financing rounds. The following table presents the relative position of different industries in VC investment in a selected number of European countries – France, Germany, Italy, Netherlands, Poland, Spain, Sweden and UK – in 2011.

Table II.4. Share of Business Angels' investment by sector – Data from EBAN survey on selected EU Member States (% of deals)

<table>
<tr><th>Industry</th><th>FR</th><th>GE</th><th>IT</th><th>NL</th><th>PL</th><th>SP</th><th>SW</th><th>UK</th></tr>
<tr><td>Information and Communication Technology</td><td>40</td><td>38.3</td><td>13</td><td>17.5</td><td>100</td><td>33</td><td>26</td><td>26</td></tr>
<tr><td>Mobile (incl. software and service applications)</td><td>7</td><td>11.1</td><td>5</td><td>10.3</td><td>0</td><td>2</td><td>13</td><td>1</td></tr>
<tr><td>Creative Industries</td><td>2</td><td>7.5</td><td>10</td><td>0.9</td><td>0</td><td>14</td><td>2</td><td>6</td></tr>
<tr><td>Health Care/Medical technology</td><td>8</td><td>5.5</td><td>10</td><td>16.2</td><td>0</td><td>3</td><td>31</td><td>11</td></tr>
<tr><td>Social and Sustainable Investments</td><td>4</td><td>n/a</td><td>0</td><td>12.3</td><td>0</td><td>1</td><td>0</td><td>0</td></tr>
<tr><td>Energy</td><td>8</td><td rowspan="2">11.3</td><td>0</td><td>4.5</td><td>0</td><td>3</td><td>4</td><td>3</td></tr>
<tr><td>Environment and Clean technologies</td><td>9</td><td>9</td><td>0</td><td>0</td><td>10</td><td>11</td><td>6</td></tr>
<tr><td>Retail and Distribution</td><td>0</td><td>4.6</td><td>8</td><td>12.3</td><td>0</td><td>3</td><td>0</td><td>1</td></tr>
<tr><td>Finance and Business Services</td><td>0</td><td>1.9</td><td>22</td><td>5.3</td><td>0</td><td>1</td><td>0</td><td></td></tr>
<tr><td>Logistics and transportation</td><td>0</td><td>n/a</td><td>0</td><td>n/a</td><td>0</td><td>3</td><td>0</td><td>0</td></tr>
<tr><td>Manufacturing</td><td>0</td><td>9</td><td>7</td><td>n/a</td><td>0</td><td>13</td><td>0</td><td>19</td></tr>
<tr><td>Other</td><td>9</td><td>7.7</td><td>8</td><td>n/a</td><td>0</td><td>4</td><td>0</td><td>3</td></tr>
</table>

Source: Centre for Strategy & Evaluation Services (2012).

Despite significant country specificities, information and communication technology industries, including mobile, are the most favoured activities by BAs from all 8 countries included in table II.4. By contrast, traditional activities that may offer lower growth prospects, such as manufacturing or logistics and retailing are less capable of attracting the interest of BAs. By not reproducing the current distribution of economic activities, entrepreneurs and BAs may be guessing the future type of demand, while showing a belief that the best pay-offs are in the activities they prefer.

Life sciences, the most favoured industry by VCs (EVCA, 2012), are capital intensive due to the long development stages that are required before a new drug can go to the marketplace, so BAs tend to invest less, by comparison with VCs and to invest in syndicates, with other BAs and with VCs.

II.6 EUROPEAN BUSINESS ANGELS DYNAMICS

The dynamics of BAs and BANs are relatively unknown. How are BANs organised, what is theirs size, at what company stage do they prefer to invest, how close to home are their investees, what is the importance of co-investment, which services do BANs deliver, who are their favoured partner organisations, how are BANs expenses covered, how have they evolved and are they organised in different countries are all questions that have not hitherto obtained an easy answer and even in the US are relatively unknown. The recent expansion of European BANs and their interaction and mutual support led to the collection of data that can answer these questions, at least partially. The EBAN (2010b) includes the results of a survey that obtained information on 219 out of 396 networks as mentioned previously.

This questionnaire, with some key data summarized in table II.5 allows for a more detailed profile of BANs and their activity.

Table II.5. Key Figures – EBAN Statistics Compendium

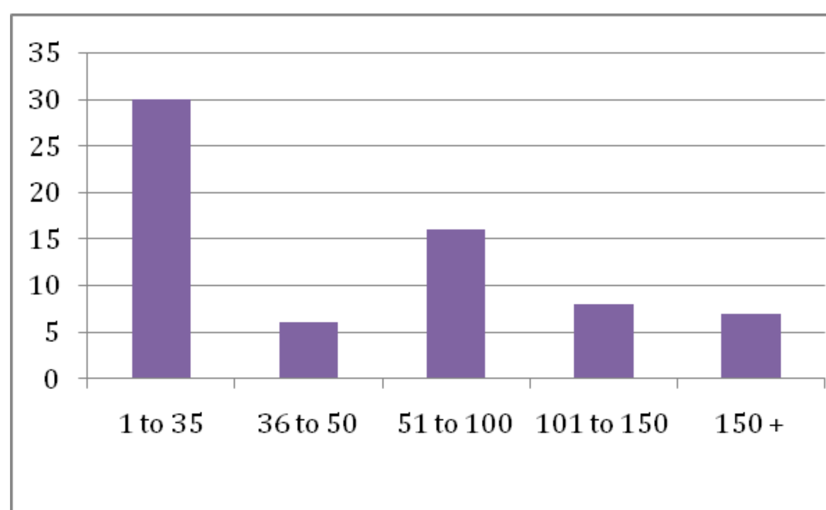
Key Figures	2009	nº of replies
Number of angels	14 785	186
Number of active angels (based on investments made, attendance rate at meetings, involvement in the network's processes etc.)	6 111 (42%)	186
Number of angels making an investment through the network in 2009	1 383	110
Number of women investors	620 (4%)	186
Number of deals done	1 385	208
Number of new companies financed	863	199
Total amount invested	275 882k€	194
Average amount of the deal	199 193€	-

Source: EBAN (2010b).

These data allow other calculations: in 2009 each member BA invested €18 660, on average, or €45 145 if only the 6 111 "active" angels are accounted or, finally, €199 481 if only the BAs who invested through the network are counted. It is also interesting to observe that only 863 firms were founded, out of 1 385 deals, showing that each firm obtained, on average, 1.6 rounds of financing.

The **size of BANs** varies considerably. Figure II.4 shows that although 30 of the 67 networks who answered this question had 35 members or less, 37 were larger, with 7 accommodating 150 or more BAs. As the number of BANs has been expanding, it is likely that some of the smaller networks may also be expanding. However, only a limited number of BANs expanded beyond 150 members, showing that coordination costs may out-weight eventual economies of scale that larger BANs might enjoy, after a certain size.

Figure II.4. Number of Investors per group (2010)



Source: EBAN (2010b).

Another interesting issue addressed by EBAN's questionnaire relates to the **stage of development of investee companies**. Confirming Osnabrugge's (2010) early finding that BAs tend to invest at earlier stages than VCs, respondents to this questionnaire stated that 86% of their investments were made to companies in pre-seed, seed or early stage. The following table compares BAs' answers with VCs according to the most recent data from EVCA. For VCs, the equivalent categories represent 40.7% of their total investments as restructuring and later stage investment attract most of VC's investment. The difference is even sharper for pre-seed and seed absorb a quarter of total BAs' investment contrasting with just 7.7% for VCs:

Table II.6. Stage of development of investee companies

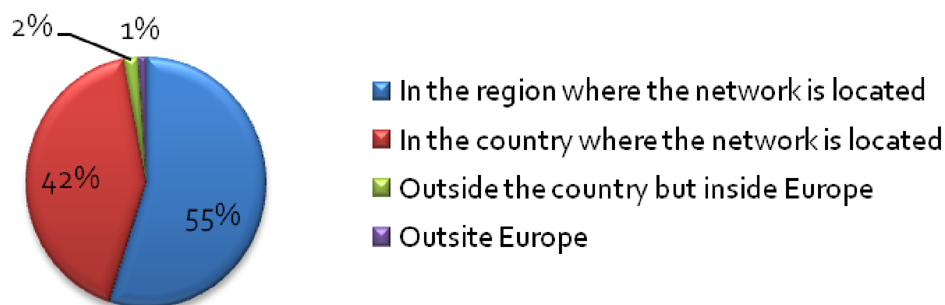
Stage of development of the investee companies	BAs	VCs
Pre-seed and seed	25%	7,7%
Start-up and early stage	61%	33%
Expansion, Growth capital and later stage	13%	38,8%
Buy-out	0,62%	15,3%
Other (Replacement capital, Rescue/turnaround)	0,38%	5,1%
Total	100%	100%

Source: EBAN (2010b), EVCA (2012) – wider categories were used as the classification was not coincident for both sources..

Location of the investee companies is another issue often addressed – are BAs focussed on proximity, choosing to invest in near ventures that they can monitor and mentor more efficiently? 183 networks replied to this question, relating to the geographic location of the companies having received finance through their

networks in 2009. The answer is largely positive, as can be seen in the next table. 55% have invested in their home region. Only about 3% of the total investment by these BAs is made outside of their home country:

Figure II.5. Location of the investee companies

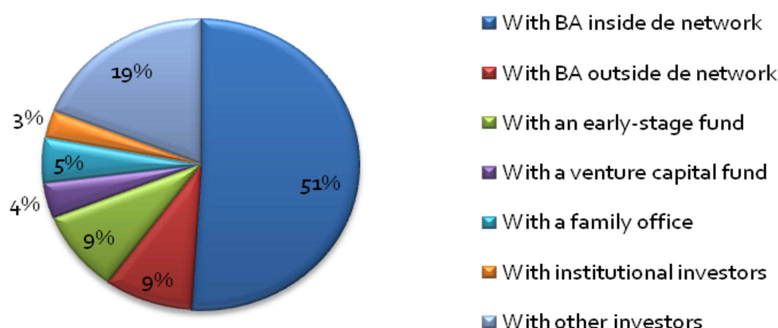


Source: EBAN (2010b).

This regional and national preference is likely to diminish in the future, as more international cooperation is being promoted within EBAN member networks facilitating larger industry specific expertise and cross border cooperation. As in other areas, BAs are following the example of the VC industry, traditionally also very location bounded. The Economist, June 2nd 2012, quotes the old saying of Sillicon Valley that VCs would not back a strat-up unless they could cycle to its office. This contrasts with the reported $3.4 billion of overseas investment made in 2011 by VCs in markets such as Brazil, Indonesia, Russia, South Africa and Turkey.

Another important question relates to the choice to share effort and risk with other BAs. **The co-investment** question was answered by only 69 BANs. The distribution of the weighted average of replies is the following regarding types of co-investment partners. BANs who acknowledge organising some type of co-investment report that cooperation among members of the same network is the most common, with 51% of answers. This result shows that familiarity within the BAN encourages co-investment. Other investors, other BAs and early stage funds are the next most important partners for co-investment.

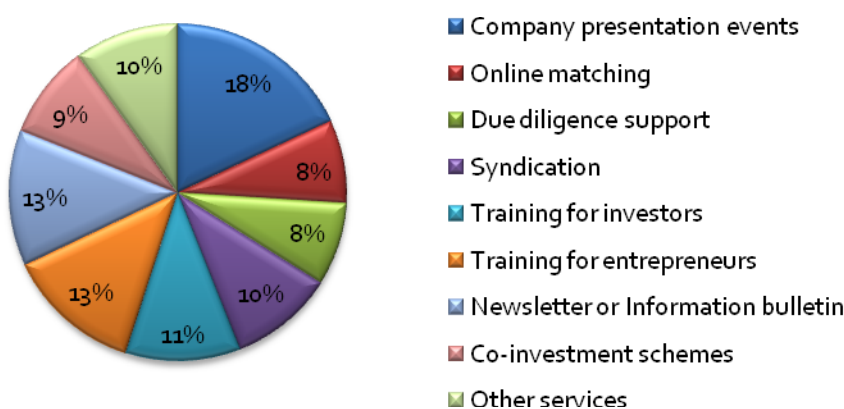
Figure II.6. Co-investment partners



Source: EBAN (2010b).

As the OECD (2011) observes, BANs play an important role in detecting and pre-screening business opportunities for their associates as well as helping entrepreneurs to streamline their business plans. However, what **services to the associates** do BANs really provide? 151 networks replied to this question with 75% running company presentation events, 57% providing newsletters or bulletins to their members and 54% providing training to investors. The most important services provided were more or less evenly distributed by the 151 responding BANs as presented in figure II.7:

Figure II.7. Services proposed by the business angel networks



Source: EBAN (2010b).

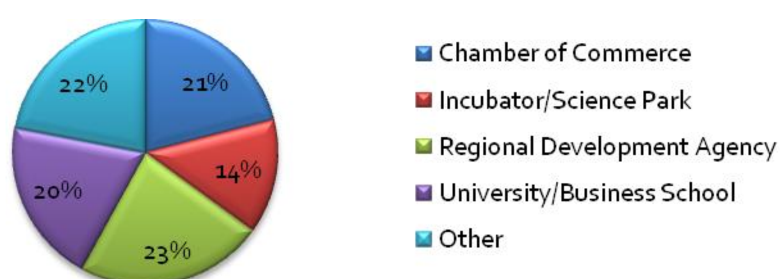
The process of **recruitment of entrepreneurs** was answered by 131 networks. The most common, cited by 75% was word of mouth, showing the importance of personal contacts, followed by events and information fairs (64%) and articles in the regional or national press (64%). The next figure presents the reported favoured modes:

Figure II.8. Recruitment of entrepreneurs

Source: EBAN (2010b).

BANs need to be part of an active eco-system that presents promising business opportunities. In order to generate deal-flow and have easier access to entrepreneurs, BANs cooperate actively with **partner organisations**. A total of nine different entities were mentioned by 119 respondents. The most important are included in the following figure:

Figure II.9. Partner organisations



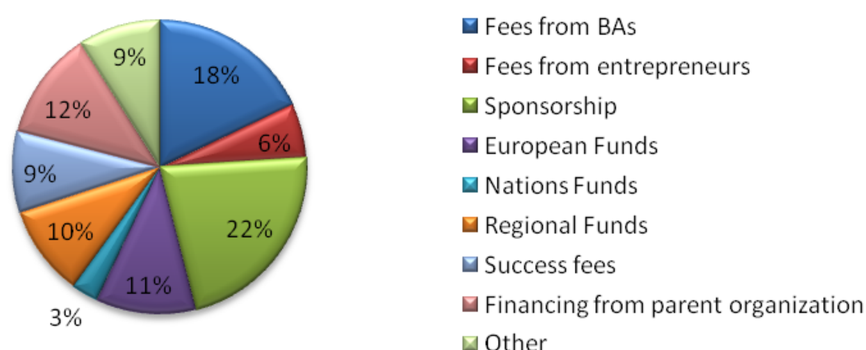
Source: EBAN (2010b).

Incubators, development agencies and universities are the most often cited partner organisations, confirming BAs' preference for high growth, technology based new ventures. Other mentioned partners were consulting firms, VCs, employers' associations, industry partners and business links.

Funding is a key issue for BANs who may be leaner or more supported by professional staff. To cover these costs, BANs may access a wide range of sources, from member fees, to entrepreneur fees. Public support, from

governments, the EU, municipalities or other public authorities may also play an important role. 46% of the 133 BANs who answered this question considered that public sources or other sponsors (including foundations and other entities) were the most important, as shown in figure II.10:

Figure II.10. Sources of funding



Source: EBAN (2010b).

BANs may access different types of **fee mechanisms**, that may be charged to BAN members or to entrepreneurs. Table II.7 shows the level of usage of different types of fees.

Table II.7. Fee mechanisms

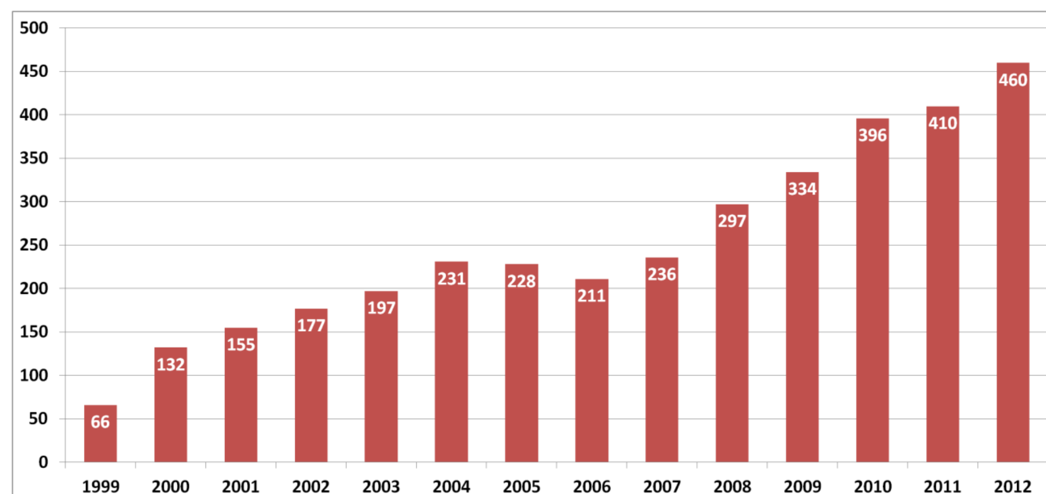
Fee mechanisms	Numbers of replies	Yes	No
Registration fees charged to entrepreneurs	180	11%	89%
Fees charged to entrepreneurs for presenting in front of investors	180	18%	82%
Success fees charged to entrepreneurs	180	26%	74%
Membership fees charged to business angels	–	11%	89%
Success fees charged to angels	177	10%	90%

Source: EBAN (2010b).

These data show that none of these types of fees is charged by a majority of BANs as they might discourage either associate members or entrepreneurs. Success fees charged to entrepreneurs who are successfully financed is the most common type of fees with 26% BANs acknowledging its practice.

The creation of a favourable environment and the associative efforts by existing BANs has led to a steady increase in the number of European BANs. Recent data show that in 2012, a total of 460 BANs were operational, against just 66 in 1999.

Figure II.11. Evolution of European BANs



Source: EBAN (2010b) Data for 2011 and 2012 was kindly supplied by Paulo Andrez from EBAN in June 2013.

The expansion of the number of active BANs has also led to the increase of BA investment in new ventures despite the adverse economic environment since 2008. The joint investment by BAs associated in BANs has already overtaken the VC led investment in pre-seed and seed (table II.6) as observed in the same survey.

Table II.8. BA versus Vc investment – Seed phase

	2007		2008		2009	
European Seed Industry	EBAN Statistics	EVCA Statistics	EBAN Statistics	EVCA Statistics	EBAN Statistics	EVCA Statistics
Number of deals	1111	699	1063	888	1385	615
Amount invested	184.202.562 €	184.693.000 €	218.696.626 €	310.131.000 €	275.882.967 €	150.613.000 €
Average amount of the deal	165.649 €	264.224 €	205.735 €	349.246 €	199.193 €	244.000 €

Source: EBAN (2010b).

The evolution between 2008 and 2009, a period of high intensity of the European financial crisis, shows that while VC investment fell 31% in number of deals and 51% in value, BA's increased the number and value of investments.

Recent data collection by EBAN shows that the number of BAs and investment kept expanding in the last two years. The following table summarizes these data:

Table II.9. Size and investment of visible and invisible European BAs

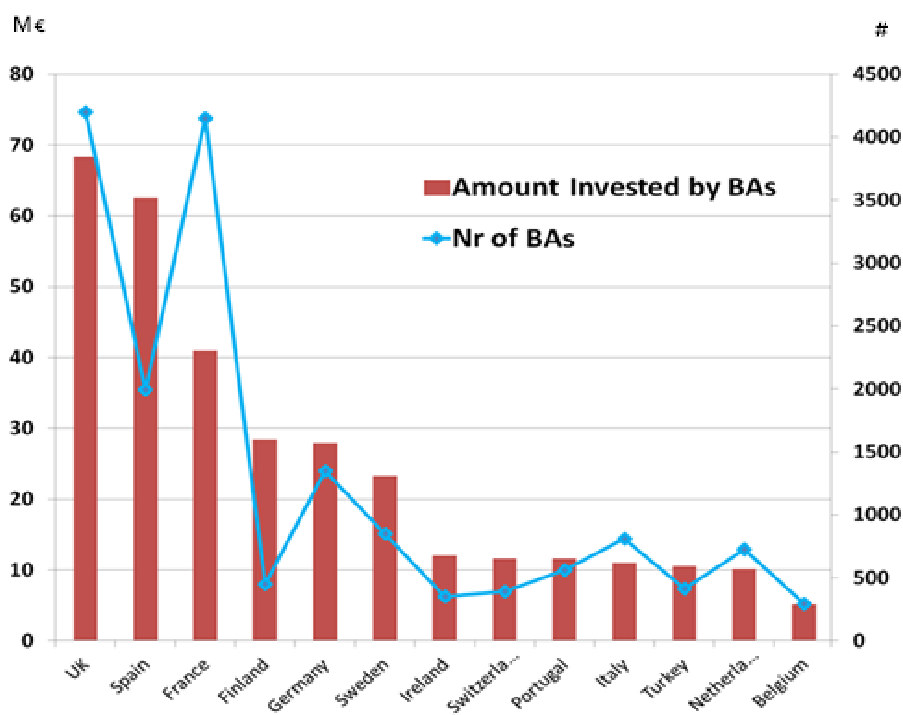
Visible Business Angels	Year	
	2011	2012
BAs associated to BANs	21730	26105
Number of BANs	410	460
Average # of BAs per BAN	53	57
Investment (€ Million)	427	509
Investment per BAN (€M)	1,04	1,11
Investment per BA (€)	19650	19498
Total Business Angels (estimate)		
Estimated % of visible BAs	9%	10%
Total number of BAs	241444	261050
Total investment by BAs (€M)	4754	5086

Source: EBAN (2010b) Data for 2011 and 2012 was supplied by EBAN in June 2013.

As in the US, it is considered that the “invisible” fraction of the business angel industry and its total investment is much larger than the one organised in BANs. Given the visibility and organisational benefits of cooperation, some autonomous BAs join existing networks or create new BANs with region or industry based common interests. However it is probable that many BAs start or remain operating autonomously. As pictured in table II.9, in 2012 European BAs could represent about 10 times the number of BAN members and provide about 10 times as much capital to new ventures, totalling 261050 BAs and €5 billion, approximately.

Finally, the next two figures show the pattern of BAN and BA activity per country. The three most active markets have been the UK, Spain and France. Regarding investment per BA, Spain and Finland show the highest levels of individual investment. About 2000 Spanish BAs, for instance, have invested approximately €62 million, which corresponds to an average investment of €31,000.

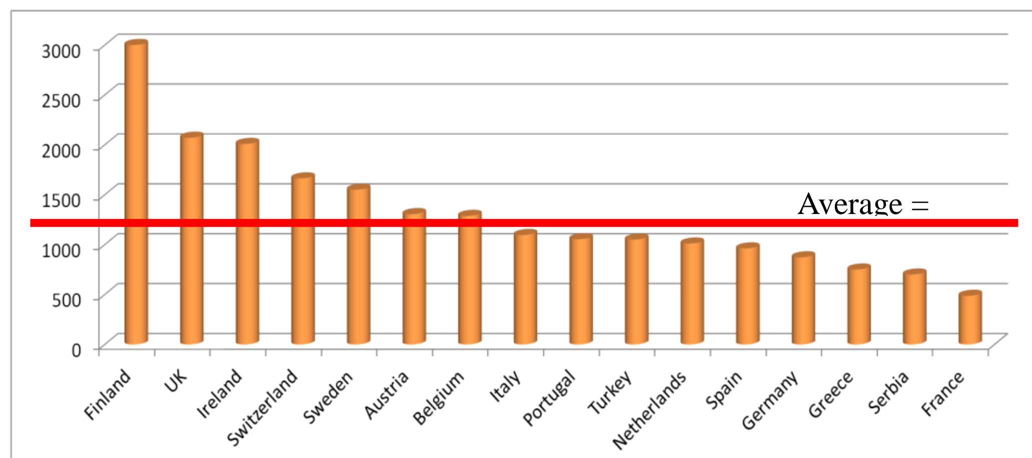
Figure II.12. Visible market per country, 2012 (M€)



Source: Data supplied by EBAN in June 2013.

Investment per BAN was largest in Finland. This may reflect the trend, in other countries, for the creation of a larger pool of smaller, more recent and more local BA networks.

Figure II.13. Average investment by BAN, 2012, (k€)



Source: Data supplied by EBAN in June 2013.

II.7 VALUATION AND NEGOTIATION

External equity providers tend to use very simple "adhoc" valuation procedures such as profit multiples based on the business plan projections prepared by the entrepreneur, although the precise figures are prone to intense negotiation between the entrepreneur and the investor. One of most popular tools for early stage valuation is the industry price/earnings (P/E) ratio which can be obtained from a financial data base such as Yahoo Finance. However, at a very early stage, usually at the development stage, there is very little data that can lead to any meaningful projection and valuations are even cruder and are only a "fiat" exercise that is carried out with the goal of defining a "post-money" equity sharing between the entrepreneur and the investor. For instance, if the BA is going to invest €200,000 to finance the prototype of a new type of solar panel and is willing to take a 20% stake in the new venture, this means that the post-money valuation is €1,000,000 and that the "pre-money" valuation, shared by the entrepreneur and other earlier investors is €800,000, so they are left with 80% of the venture's ownership.

One of the key differences between BAs and VCs, however, is the time consumed to reach a decision. Indeed, as previously shown in table II.1, the due diligence process carried out by VCs is longer and more costly than the BAs'. This difference is caused by two factors: (i) BAs tend to join the venture at an earlier stage when the entrepreneur's background is the most important hint at the venture's future performance and (ii) VCs need to gather information that can justify the investment decisions with their own shareholders.

However, this does not mean that BAs eliminate any level of due diligence. In a survey of UK BAs, Wiltbank (2009) found that those who had spent more than 20 hours in due diligence obtained significantly less failures than BAs who spent less time on due diligence. Familiarity is also a key factor as besides preferring to support ventures in industries they are familiar with, location also counts. Most angel investing was done within 250 km of the investor's home.

Despite the significant expansion of awareness about the offer of equity capital to sponsor new ventures, many aspiring entrepreneurs, especially those without track record, still consider that both VCs and BAs capital is ill suited for their ventures due to: (i) difficult access to interested investors; (ii) draconian requests if they finally could be persuaded to hear the "pitch" and decided to carry a due diligence. Although this feeling may be more frequent with VCs due to their more rigid model of evaluating and proposing the deal terms, BAs are also not entirely regarded as friendly and easy negotiators. By contrast, BAs regret the over optimism and lack of home work done by entrepreneurs before they start a negotiation. EBAN (2010, p. 7) summarises three main reasons for failure to obtain financial support from BAs:

- Poor and unrealistic business plan;
- Lack of knowledge of the diversity of financial resources and those suitable for their business;

-Lack of knowledge on how to successfully approach, and professionally present, business cases to potential investors with a proper understanding of the needs of investors.

II.8 EXIT AND PERFORMANCE

There is very little data on the actual performance of BA investment. Moreover, given the fast recent expansion of the supply of BA funds it will take a few more years to gather information that allows a reliable measurement of BA performance upon exit or harvesting. The next table presents data on the exit routes taken by VC sponsored exits, a reasonable proxy for BA investment, in 2012:

Table II.10. European venture capital exits in 2012

Divestment	Value (€ millions)	# of firms	Average divestment (€ millions)
Trade sale	1074,1	200	5,4
Public offering	340,4	69	4,9
Write-off	294,4	205	1,4
Repayment of silent partnerships	75,9	272	0,3
Repayment of principal loans	36,8	56	0,7
Sale to another VC Firm	262,2	55	4,8
Sale to financial institution	75,9	11	6,9
Sale to management	87,4	93	0,9
Other Means	55,2	30	1,8
Total	2300	991	2,3

Source: EVCA (2012), PEREP Analytics.

Trade sales, often to a larger firm, and IPOs are usually successful exits with positive returns, generally measured in “multiples” of the investment(s) made. Write-offs are associated to partial or total losses, while the other exit modes may be more mixed. The IPO market has been far less active after the stock market crash of 2000 that was severely felt by the tech firms listed in NASDAQ. Trade sales and sale to other VC firm have though become important alternatives for successful exits from both VC and BA investments.

Although little known on a systematic base, there is some evidence that BAs manage to obtain positive returns. Wiltbank (2009) studied 406 exits from angel financed investments, 70% of which took place between 2005 and 2008. He found

that, on average, exits took place 3.6 year after investment, yielding an average multiple of 2.2 and an internal rate of return (IRR) of 22%. Perhaps more insightful is to find that although 34% of those exits were total losses and 47% failed to yield any positive return, 23% of exits had an IRR above 50%. This means that diversification is advantageous, as BAs can not be entirely sure that they are making the right decision on a specific application – they may make a “bad” decision, rejecting a good project or an “ugly” one, supporting a venture that will fail. Wiltbank’s (2009) has also confirmed that experienced (serial) BAs, those with managerial experience and industry specific knowledge failed less. He found that BA mentoring contributes to the venture’s success but, less intuitively, that direct engagement in managerial positions does not. Perhaps this is due to the fact that some BAs took managerial positions in new firms that were already failing.

III – SUPPORT MECHANISMS

The importance of BA support to new ventures, including both financing at early stages and mentoring to often inexperienced entrepreneurs, has led governments from many parts of the world to design extensive support mechanisms. These can be classified in two groups – demand side mechanisms include a broad range of tools that foster innovation and technological development as well as an ecosystem favourable to the emergence and growth of new ventures; supply side mechanisms directly enhance the size and scope of angel financing.

III.1 DEMAND SIDE FACTORS

The availability of equity finance, both geographic and sectorial, depends on the development of the eco-system that surrounds this activity. On the demand side, investors must count on a pool of sophisticated entrepreneurs that submit potentially rewarding initiatives. Universities play a key role as is shown by the fabled Silicon Valley (near Stanford University) and Cambridge, Massachusetts (near Harvard and MIT). These are vibrant areas with a large number of start-ups, some highly visible such as Google and Facebook, that attract significant amounts of venture capital and angel investment. Lawyers, consultants, intellectual property (IP) experts, business media as well as incubators, accelerators and venture competitions are all part of a vibrant eco-system that builds upon locally bred skills and attracts entrepreneurs and investors.

Many countries are trying to emulate these experiments and create favourable eco-systems. Start-up Chile is a famous experiment backed by significant public funding that includes a grant to foreign entrepreneurs who decide to create a new venture in Chile.

Several European regions are competing for the title of European Silicon Valley. Berlin, Dublin and the region around Cambridge, UK, are just some of the European regions where entrepreneurial intensity and the capacity to replicate the favourable environment of those US poles are arguments to claim that cherished title. Proximity to technological universities and other elements of the eco-system is important, but the access to research grants is also crucial at this stage, especially for the more capital intensive ventures such as those in health and energy. Public funds coupled with capital provided by philanthropists would be a powerful source for much needed early stage financing. The availability of grants from private donors is much scarcer in Europe than in the US.

However, it is often acknowledged that the main cause for the relative backwardness of Europe, especially Continental Europe, as compared with the US lies in having a more bank dependent financial market. Beck (2007) emphasised

that the weakness of financial markets can be a significant drag on the entrepreneurial drive.

As listing in conventional capital markets is an expensive and heavily regulated process, smaller firms are less likely to meet their criteria and may have to postpone an eventual initial public offering. This conflicts with the time length that VCs and even BAs usually define for their support to the ventures they invest in. Five years after being launched, many new firms are still too small to be admitted in conventional capital markets. To bridge this gap, several capital markets have created a second tier, less regulated and cheaper, aimed at smaller and usually younger firms. The most successful is the Alternative Investment Market (AIM), a branch of the London Stock Exchange who is also present in Italy. Similarly, Euronext has launched Alternext (Belgium, France and Portugal); in Spain, the second tier stock market is Mercado Alternativo Bursatil; Entry Standard is the second market of the German Deutsche Borse. None of these exchanges has reached the size and influence with new ventures of the American NASDAQ, but there is a rising opportunity for successful domestic IPOs throughout Europe. Of course, the current economic crisis has reduced the number of new IPOs but they may take-off when the recovery starts.

Exit opportunities are a core stimulator for entrepreneurs and investors alike, as the prospect of an IPO exit, usually with high “multiples” on the initial investment, is a powerful incentive for taking the risk and the effort. Even if many exits are of the trade sale type, the buyers may also pay a higher price as they discount the future value of an IPO that can be carried out later. However, other financial factors are important to create a favourable environment for new ventures. These include access to bank credit and loan guarantees, as well as a dynamic offer of leasing, an important tool for early stage financing when firms still lack valuable assets to use as collateral with conventional lenders.

In summary, the support that may be provided by the state(s) to the demand side includes the preservation of a favourable climate for the flourishing of new ideas and projects (universities, protection of intellectual property, grants to research projects), access to capital markets and to debt financing (guarantees, regulation of the financial industries, preservation of a stable macro-environment).

III.2 SUPPLY SIDE FACTORS

The second type of support factors regards the financial capacity and skills of BAs. The high uncertainty associated with early stage investing creates a need for diversification that, given the indivisible nature of many investments, can not be achieved through an angel’s capital alone. He can compensate this acting in syndicate with other angels, but the overall capacity of angels requires further support from external sources, a reason why public funding is often asked for by BANs and provided by the European Commission or individual states.

Financial support and public/private co-investment

Lerner (2010) stresses that the provision of public funds must be preserved only while the detected market failure persists and should be made through market-based systems, namely private funds. Moreover, there should be a 50% cap to the public contribution. Exclusive public intervention without leveraging of private money may grow an unsustainable venture capital market (EVCA, 2010; OECD, 2011).

One often quoted case that illustrates the benefits of a temporary and carefully crafted mechanism to kick-start a market rather than providing a permanent flow of funds is the Yozma Fund in Israel. Israel enjoys one of the world's largest per capita investments by venture capitalists. The strength of Israel's entrepreneurial eco-system inspired the publication of "Start-up Nation", who contributed to the broad international recognition of the Yozma Fund experiment.

Box III.1 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 privatized 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*: OECD (2011);* Yozma Fund website: *www.yozma.com* and "Start up Nation" (Senor & Singer 2009).

Public/private co-investment funds are inspired by the Yozma Fund in two key areas – (i) they make available risk bearing public funds that private investors can manage and (ii) they accept an asymmetrical return in which public funds get a moderate return to create an incentive for private investors. Several EU member states have launched "co-investment funds" a bold attempt to enhance the financial capacity of angel or VC led funds. The typical procedure is to match public funds with those of private investors who are in charge of managing the funds created. The following table presents a list of the main co-investment funds launched in different EU countries. The Scottish Co-Investment Fund, a fairly large fund of 72 million pounds, inspired the design of more recent funds and was later evaluated

by the Scottish Enterprise Commission who found that 78% of the firms interviewed considered the fund vital for their survival (Harrison, 2009).

The European Commission complements national funds through the European Investment Fund whose arm to the seed and early stage market is called JEREMIE (joint European resources fir micro to medium enterprises). This initiative uses EU Structural Funds to support selected financial intermediaries, including business angel matching funds (www.eif.org/what_we_do/jeremie/index.htm).

Table III.1 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.
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.

Source: OECD (2011)

Although co-investment funds are a powerful tool at leveraging the impact of private funds there are several cautions that must be taken in consideration before committing scarce public resources. OECD (2011) carried out a series of interviews at the national level and concluded that (i) the cooperation, management and evaluation models of co-investment funds should be customised to each

country rather using a common blueprint; (ii) the success of these funds is highly dependent on the previous existence of an active network of business angels; (iii) joining efforts with venture capitalists may not be efficient, as VCs may be too distant from seed and early stage investment. The Danish experiment, launched in 2007 and discontinued in 2010 showed that the merger of Danish Business Angel Network with the Danish Venture Capital and Private Equity Association led the fund to an excessive focus on venture capital and buy-out firms while too few investments were made by the angel co-investment fund, Partner Capital.

Technopartner from the Netherlands and the Portuguese co-investment fund associated to the EU support program Compete have become the model for public/private co-investment with a strong incentive for BAs as they obtain 80% of the income generated until the BA's capital is recovered and after the public partner recovers its full investment. Between these two intervals, revenues from exits are shared evenly. **Appendix I** presents a description of the Portuguese model. The Portuguese model (EBAN 2013) is summarised next:

- It is a loan from Compete to the VEs (Investment companies where BAs are shareholders), but a loan with a venture capital "behaviour". Doesn't allow re-investments.
- Loan Period: 10 years.
- Investment period : 3 years
- There are no interests and capital guaranteed for Compete
- BAs have no personal liability to pay back the amount of the loan
- Minimum 3 business Angels per VE
- Maximum loan per VE: 65% of the VE Investment needs with a maximum of €500,000 per VE, so the VE Investment capacity that maximizes the COMPETE financing: €500,000 / 0,65 = 769.230 EUR (approx. 770.000 EUR)
- BAs must bring into the BAIVs 270.000 EUR. BAs can't charge management fees.

EBAN (2013) observes that this model has generated a significant level of BA activity. Since the foundation in 2005 until January 2013 Technopartners have accumulated an investment capacity over €250 million and made over 150 deals. The Compete model led to the creation of 54 investment vehicles endowed with €42 million, which will represent more than 70 Million EUR investment in start ups.

Besides the scarcity of funds available to BAs, another concern is that angel investing remains too local. Cross border investment could help bridge the gap between local supply and demand of early stage funds while allowing the BAs to have a more clear focus on their field of expertise. One of the most praised experiments to solve this problem is the launching of Seraphim Fund, an early-stage venture capital fund that invests between GBP 0.5 million and GBP 2 million

into high-growth early-stage UK businesses that is also looking to address two other critical issues facing many companies: people and international expansion. The Fund was created through a collaboration of leading business angel networks. This provides the Fund access to a unique network of more than 1 000 business angels, consisting of successful and influential business leaders from across both the United Kingdom and United States. In every company in which the fund invests, one of these business angels joins the board. In May 2011, Seraphim won the EBAN Early Stage Fund of the Year award (www.seraphimcapital.co.uk).

Tax benefits

Besides financial support to investment funds, governments have been providing fiscal relief to BAs that may have significant impact, mainly through reductions of the corporate, personal income and capital gains tax rates. Although most countries have implemented at least some reductions along these types of taxes, the levels of relief vary from country to country. The next table presents a synthesis of the European Tax System for a selected number of countries that is based on a comparison of European countries provided by Eurostat.

Table III.2. European Tax System (2013)

Country	Marginal Corporate Tax Rate (2013)	Marginal Personal Tax Rate (2013)	Capital gains tax base to GDP (2011)*
France	36.1%	50.2%	23%
Germany	29.8%	47.5%	28%
Ireland	12.5%	41%	46.7%
Italy	27.5%	43%	29.7%
Poland	19%	32%	40.4%
Portugal	31,5%	53%	22.5%
Spain	30%	52%	28.3%
UK	23%	45%	28.7%
EU 27 (average)	23%	38.7%	–

Source: adapted from Eurostat (2013).
* The Implicit Tax Rate on capital is the ratio between taxes on capital and aggregate capital and savings income.

Tax relief is particularly effective in countries where the highest tax rates are larger – being wealthy individuals, BAs are usually affected by the top marginal rate. Currently, France, Spain and Portugal have the highest (above 50%) personal tax rates that affect mostly income from wages and other work compensation. The capital gains tax affects income from interests and dividends earned on capital investments. Eurostat data show that these are higher in Ireland and Poland.

A reduction of the personal tax rate can create an incentive for BA investment in a new venture. However, any investment has to be compared with its future return, so relief on the capital gains tax can also be a powerful incentive for angel investing. Although less directly, the corporate tax rate is also influential for the decision to invest on a new venture as lower corporate taxes create a more favourable business environment, enhancing the expected return for both entrepreneurs and other investors. For instance, lower Irish corporate tax rates have led to higher investment by both domestic and foreign firms.

In 2008, EBAN carried out a cross-European comparison of fiscal relief policies for BAs in a selected number of countries that is resumed in the next table.

Table III.3. Fiscal Incentives

Country	Income tax rate	Capital gains
France	Tax reduction of **25%** of the total amount invested	Tax exemption can vary from 25 to **75%**
Germany	Tax relief focussed on capital gains	Exemption for holdings under 1% of investee. Only 5% of the capital gain is liable at a tax rate of nearly **30%**
Italy	Tax relief focussed on capital gains	49.72% exemption for individuals and 95% for investing corporations
UK	Income tax relief of **30%** that can go up to **50%** for investment in seed capital	Exemption of capital gains tax from investments made in EIS companies

Source: adapted from EBAN (2008) and CSES(2012).

Although it has gone through changes, according to EBAN, the original French model supported BAs through income tax and capital gains relief. CSES (2012, p. 59) summarises the French support mechanisms as follows:

> The Avantage Madelin provides a tax credit of 25% (and a maximum of €40 000) for any investment in an SME provided the equity is kept for more than five years. In 2007, the loi TEPA (Loi en faveur du travail, de l'emploi et du pouvoir d'achat) was adopted, providing a 75% tax break to tax-payers subjected to the Solidarity tax on wealth (ISF – Impôt sur la fortune) for any investment in SMEs, up to a maximum of €50,000. This break was reduced to 50% in 2010. SMEs financed cannot have over €1.5 million of such equity in their companies.

In **Germany**, tax relief is based on capital gains (CSES, 2012). Capital gains for holdings under 1% of the investee company are tax free, for a holding period of more than one year. If the BA invests through a corporation, 95% of the capital gain is exempt from the corporate income tax. The remaining 5% share is liable at a tax rate of approximately 30%. By contrast with other EU countries, Germany has no wealth tax, so BAs can not benefit from property-related tax shields arising from their investments.

As in Germany, **Italian** tax relief is based on capital gains tax reduction. Regarding BAs investing through companies, the income is exempt from any tax. In this case,

5% of the income is included in the taxable amount for corporation tax purposes. CSES (2012, p. 84) registers some important specifications of the Italian tax relief model applying to Italian residents:

1. Direct Investment by a private individual

   Dividends and other capital gains from non-qualified participations are subject to a final withholding/substitute tax of 12.5%. Qualified participations are tax exempt for 50.28% of the investment. The remaining 49.72% are included in the taxable income of the individual. Since 2008, dividends and other capital gains are exempt if the following conditions are met: (i) holding period of at least three years; (ii) companies of the referred participations must be less than seven years old; (iii) investee companies must have realised “productive” investments; (iv) capital gains must be reinvested into “start-up” companies within two years since the gain accrued.

2. Investment through a public/ private limited company

   Dividends are exempt from withholding tax, substitute tax or other deduction at source. 5% of such dividends are included in the taxable income of the companies (tax rate of 27.5%). Capital Gains could be partially exempt (95%) from corporation tax according to the "participation exemption" regime.

These mechanisms vary in size and complexity, from country to country. BAs do often complain of lack of fiscal harmonization which is also a barrier to cross-border investment. EU countries taxation on personal income and capital gains varies significantly. Benefits to BAs are in the form of lower rates or lower base for tax collection.

There is one important program that has been a source of inspiration in many EU countries which is the Enterprise Investment Scheme (EIS) from UK, OECD (2011). Investors in companies with gross assets worth less than 7 million pounds benefit from:

(i) An income tax relief on 30% of the amount invested, with the compromise to hold the shares for a period larger than 3 years. If the shares are sold earlier the saved income tax falls due;

(ii) Exemption of capital gains tax from investments made in EIS companies;

(iii) Share loss relief if the value of shares held in an EIS company subsequently drops;

(iv) Roll capital gains. For instance, if an investor has invested a capital gain obtained from selling a property in an EIS company he can defer the payment of the tax until he exits from this new investment.

In the case of seed capital Seed Enterprise Investment Scheme (SEIS) applies. It keeps all advantages designed for EIS, while the income tax relief rises to 50% of the amount invested.

EIS (and SEIS) includes other benefits, such as inheritance relief, if investors have held their shares for a minimum of two years prior to the date of their death. The EIS scheme is a carefully drafted program that has been evaluated, showing that it has had a significant impact. Wiltbank (2009) reports that 80% of investors surveyed had used the EIS scheme and 24% told that they would not have invested if the EIS scheme was not in place.

EIS is a comprehensive and generous model that has been the target of continuous improvements and remains the main reference throughout Europe. **Appendix II** presents a recent summary provided by CSES (2012).

Other countries have adopted parts of this program but usually have avoided complete replication. Ireland's business enhancement scheme (BES), for instance, provides a tax incentive on the initial investment, but no protection on any potential upside later (OECD, 2011).

Tax incentives are not fully consensual. Critics consider that they may bring benefits to wealthy individuals who may be pure investors instead of more effective BAs who provide expertise and contacts in addition to capital (Mason & Harrison, 1988). Supporters of the English model usually point to the development of the eco-system that favourable taxation brings and, therefore, the potential that current reductions in tax collection are compensated by further economic growth and, therefore, tax revenues in the future.

However, it can be argued that tax exemptions to BAs can translate into significant benefits for Government revenues, without even a significant time lag. **Appendix III** presents a study (Mazars, 2011) commissioned by FNABA showing that tax exemptions requested by Portuguese BAs would translate into higher tax revenues even in the case of unsuccessful investments while yielding much greater income if successful businesses are created in the process. The scenario researched by Mazars was based on the upper end – 30% personal tax relief of personal income tax – defined under the EIS model. Even without measuring indirect impacts such as reduction of unemployment compensation or tax income provided by the new venture suppliers, the enhanced revenues from personal income tax, social security contributions and corporate income tax are either sufficient to compensate for the loss revenue from the BAs' tax relief or largely exceed that value, making the government budget a net winner in all possible scenarios, even the in the case of the new venture's total failure.

Support to BA networks

An autonomous BA would be poorly positioned to access a reasonable pool of potential entrepreneurs, to track projects that meet his specific interests and expertise and to generate a significant amount of promising deal flow. Only a very reputed BA, with an impressive list of successful exits and regular press coverage, could expect to get a large and stable flow of applications, allowing for the finding of successful matches between the entrepreneur's vision and the BA's preferences and skills.

Networking and cooperation are fundamental for matching supply and demand in an activity as hard to value as early stage investment. However, time and money are required to keep up with an intense networking activity whose return is indirect and uncertain. BAs undertake a regular interaction with the whole entrepreneurial eco-system they belong to, much beyond listening to pitches from entrepreneurs. European BAs need to be in contact with other actors including governments, the European Commission, regional and local administrations, universities, research centres, incubators, accelerators, family offices, VCs, other BAs, banks, lawyers, consultants, intellectual property experts and the entrepreneurs.

Another important dimension that is better channelled through associations is training and education. Few activities will require more “lifelong learning” than angel investing as innovation is the core target of its activity. Even basic tools of more universal use require constant updating. The Angel Capital Education Foundation (ACEF) associated to the Kaufman Foundation offers regular short seminars and workshops that include topics such as:

-Angel investing overview;

-Starting an Angel Organisation

-Doing the Deal: Term Sheet

-Due Diligence

-Valuation and Portfolio Strategy

-Post-Investment Relationship: Entrepreneurs and Angels

Source: www.angelcapitaleducation.org

Finally, BA networks are fundamental on a more central dimension – investment cooperation and syndication. With the exception of very wealthy BAs, the build-up of a diversified portfolio requires co-investment and syndication. EBAN (2010) underlines the need to leverage the resources available to angel syndicates, the development of public-private partnerships and the cooperation between BANs and early stage venture capital firms, with the scope of enhancing resources for both initial financing and second round financing (series B) where a financial gap is still significantly wide.

Public support to BAN activities can thus take three forms: (i) sponsorship of activities and events such as conferences, seminars, venture competitions and other activities aimed at developing the learning and training of BAs and other members of the eco-system; (ii) provide financial support to universities and research centres as well as proof of concept funds; and (iii) support the creation of co-investment funds through public-private partnerships.

Several studies attempted at measuring the impact of direct government support to BANs (CSES, 2012). Collewaert et al (2010) analysed the impact of subsidies provided by the Flemish Government to BANs. Associated BAs invested in 55 companies who added €73.2 million in value from the year of BA investment onwards. The study measured an estimated €85.38 in added value per Euro of government subsidy. Moreover, companies supported by BAN members paid

€547k in taxes in the five year period starting at the year of the BA investment, a revenue that slightly exceeded the total government grants to BANs.

There is a general consensus that information asymmetries and positive externalities from equity financing and BA financing in particular, justify public support that may be channelled through leveraging the BAs' resources, tax benefits or direct support to BA networks. The "smart capital" as angel funding is called is good for the economy. What is debated in different European forums, especially due to the current economic crisis, is how much effort should be made to help BAs do their crucial work and what modes are more efficient. Yet, when we look at the US where BAs are more numerous, capital endowed and skilled than in Europe, there is a third question that has to be raised – how can we bring philanthropists to come to the fore and help the squeezed public budgets to support this nascent and crucial industry mature and fulfil its mission?

Legal protection of BAs

Given the high failure rate of new ventures, one important issue concerns the liability of equity providers for debts eventually incurred by the investee company. The provider of equity, like a shareholder in a public corporation, is aware that his committed capital is at stake, but he would like to be exempt from further losses or any risk for his other assets.

BAs or other minority investors usually invest as "limited partners". This means that they don't have obligations beyond the invested capital. As the "Investopedia, 2013" defines, in the case of a limited partnership, only one of the partners will be the general partner and have unlimited liability – this person will also be in charge of management and the day-to-day operations of the business. The other partners will have limited liability as long as they do not take an active role in managing the business, so their personal assets will not be at risk.

As long as the BA does not take managerial responsibilities in the investee company and this takes the limited partnership statute, the BA can not bear losses beyond the capital committed to the new venture.

Separation of ownership and control has been most developed in the Anglo-Saxon countries. Not by coincidence, the public corporation, with many small share-holders and no management duties, was an early US invention in the beginning of the 20th century. Separation of ownership and control and limited liability for non controlling partners were also fundamental for the emergence of the venture capital industry, after WWII and the consolidation of a vibrant, less formal business angel activity. However, the limits to "limited liability" are challenged by facts that put victims of corporate acts against firms that may have limited resources to meet their obligations. US courts tend to decide in favour of the "limited liability" rights as has been illustrated by the famous Walkovsky versus Carlton case (Milton, 2007), illustrated in **appendix IV**. When Walkovsky was walking in New York, he was run down by a cab owned by a company in which Carlton was a shareholder, who had the minimum required insurance of $10,000, a clearly insufficient amount to

compensate the plaintiff. Carlton and his associates owned other small cab companies. The court decided that decided in favour of Carlton, arguing that "the corporation and its shareholders had fully met their obligations to potential tort creditors".

The "Limited Partnership Act 1907, ch. 24" of the UK stipulates that:

> §5 "Every limited partnership must be registered as such ... or in default thereof it shall be deemed to be a general partnership, and every limited partner shall be deemed to be a general partner." and
>
> §6 "A limited partner shall not take part in the management of the partnership business, and shall not have power to bind the firm."

The legal systems of Continental Europe have also introduced limited liabilities arrangements, which facilitated the development of BAs, as they have legal mechanisms that protect them from potential debts incurred by investee companies. Investee firms can take the legal form of "limited liability companies" (Sociedad(e) de Responsbilidade Limitada, in Spain and Portugal), Société à Responsabilité Limitée, SARL, in France), (Gesellschaft mit Beschrankter Haftung, GmbH in Germany) or (Società a Responsabilità Limitata, in Italy) all provide legal protection for minority partners who do not share management responsibilities. Most legal regimes have also tried to facilitate the creation, property transfer and liquidation of companies. Reducing the requirement for notary registration of property transfer, except when real estate property is involved or reducing the minimum capital to create a new limited liability company are tools to facilitate new venture creation. Spain requires only €3,000 for registering a new company and Portugal has reduced this requirement to the symbolic value of €1. Given the high failure rate of new ventures, easy and swift liquidation procedures are crucial to facilitate early stage investment, even for limited partners.

IV – BUSINESS ANGELS IN BRAZIL

IV.1 RECENT HISTORY

Brazil has a strong entrepreneurial drive, with opportunity seekers taking over those that carry out an autonomous activity out of need, and a clear preference for creating a new business among university students. Anjos do Brasil (2013) summarises three significant evidences: (i) the 2009 GEM report found that opportunity seekers were estimated at 9.4% of the population aged between 18 and 64, against 5.4% for "need" entrepreneurs; (ii) the 2011 edition of GEM found that 17.5% of the adult population had a business initiated less than 3.5 years before; and (iii) a study from GUESS Brazil found that the most popular choice for university students, 5 years after graduation, was the launching of a new business with 27.1% of preferences against 12% for public service, 8.6% for academia/higher education and 8.1% for working in a large firm (over 250 employees).

In Brazil there are interesting success stories of angel led financing that contributed to the launch of well-known corporations. One often cited case from the US is the $100,000 capital that Andy Bechtalsheim granted to Larry Page and Sergy Brin's new venture. That support enabled the creation of Google. Bematech a company listed in Bovespa with a turnover of 350 million reais, was a small new venture in 1992 when two engineers from Curitiba-Paraná obtained the support of a local BA. BuscaPé a search engine to compare prices and products founded in 1999 with angel financial support of $500,000 was sold in 2009 for over $300 million.

However, these companies were sponsored by investors who might even ignore the designation of "investidor anjo" that has slowly become popular in Brazil. Only in this millennium have Brazilian BAs begun an organised activity. Currently, there are four BA associations in Brazil (GVcepe of Getulio Vargas Foundation, 2012): Bahia Anjos (BA), Floripa Angels (SC), Gávea Angels (RJ) and São Paulo Anjos (SP), the oldest, launched in 2002. GVcepe estimated that in 2008 these associations were integrated by 62 angels, with an estimated capital of US$9 million, and 19 support professionals. Between December 2008 and December 2009, the capital committed by these associations rose from $5.5 to $9.4 million. The typical value of an investment made by a Brazilian BA ranged from $50 to $50o thousand per company. In June 2008 only 4 invested companies were included in the Brazilian BAs' portfolio.

However, the "invisible" part of the BA market is estimated to be substantially larger. Anjos do Brasil (2013) estimated the total number of BAs to reach about 5,300 with R$450 million invested. This is considered small by comparison with the "potential" estimated by Anjos do Brasil (2013) – 50,000 BAs and R$5 billion in 11,000 firms per year. This forecast is not overly ambitious by comparison with the previous estimation of the current numbers and investment by European and US BAs. However, the comparison of the number and activity of BAs in Brazilian BANs shows that a quick expansion is required to reach that goal.

Cassio Spina (interview, January 31, 2013) observes that the early stage of BA cooperation in Brazil was not very successful, because the early associations were very formal and closed, lacking a widespread recognition by aspiring entrepreneurs.

According to Cassio Spina, a new cycle of BA was started in 2010. Small informal groups of 2 to 4 members, usually former entrepreneurs with one or more successful exits started supporting other entrepreneurs (especially opportunity seeking entrepreneurs, according to GEM classification). Cassio Spina is an example of those taking advantage of his former experience as entrepreneur, knowledge of the US and European models and networking experience, including institutions such as Finep. He carried out an extensive activity in conferences and seminars, talks to the media and launching Anjos do Brasil, in June 2011. This integrating association aims at:

1. Knowledge dissemination: through the publishing of materials, courses, conferences and helping the capacitation of both entrepreneurs and investors;
2. Creation of regional BA associations (akin to European BANs). Seven states are currently covered by this network who shares a common platform – accessible through (www.anjosdobrasil.net) that allows a common methodology for the screening of new venture proposals.
3. Institutional: dialogue with public entities to design policies that eliminate barriers and promote growth of the BA activity throughout Brazil.

However, the real impact of Brazilian BAs is much larger. In an interview to Estado de S. Paulo (Gazzoni, Oscar, & Fraga, 2012) Cassio Spina estimated a total of 5,300 Brazilian BAs with about 450 million reais invested in new ventures. He suggested that one reason for the difficulty in estimating the real number of BAs and the value of their investments is the fear that their safety could be at risk if the level of their wealth was known.

IV.2 ORGANISATION

Anjos do Brasil adopted the model of “open network” linking all existing BANs and accepting all volunteer BAs who wish to join the association. They support entrepreneurs through training, coaching, screening and routing to BAs who may be more prone to get interested in each project. All this activity is free, as the administrative costs are covered by member paid fees.

The average investment made by associated BAs is in the range of R$ 50,000 through R$ 100,000, while the total investment per new venture is usually in the R$ 250,000 through R$ 500,000 range. The screening stage checks a set of key factors such as capital required, market, and scalability. Selected proposals are then channelled to individual BAs who will carry out the evaluation, negotiation and due diligence. BAs are supported by Anjos do Brasil who makes available a set of standard procedures including the Term Sheet and the Due Diligence

questionnaire, available to both associated BAs and entrepreneurs through the site (www.anjosdobrasil.net).

The industries that have been covered follow the usual pattern of web, health, entertainment, energy, education plus some specific industries such as micro-breweries technology.

It is still hard to evaluate the performance of Brazilian BAs as there are very few cases of exits. Cassio Spina acknowledges that, despite recent efforts to attract smaller firms, BOVESPA still makes requirements that can be met only by large firms, with a turnover above R$250 billion, so IPOs are still largely beyond reach for smaller firms. Moreover, venture capital funds do not usually take positions from other investors.

IV.3 SUPPORT MECHANISMS

The current legal Framework is not focussed on the needs of BAs. Anjos do Brasil have summarized a series of requests that include three main items:

- Legal protection from invested firms' liabilities;
- Tax benefits (income and capital gains, including the carry on of eventual losses) and equivalence to other types of investments that already benefit from a specific legal framework under the Brazilian norms, such as investment funds.
- Improvement of the eco-system that facilitates exits and brings liquidity to BAs from BOVESPA, venture capital firms and large corporations.

IV.4 VENTURE CAPITAL INFRASTRUCTURE

The Brazilian venture capital industry is also fairly recent. Instituto Inovação (2008) observes that the industry became effective only by the late 90's, after the Brazilian currency real became stable. In 2004, 21 VC funds were operating in Brazil. By 2007, a total of 89 VCs managed 153 funds which had a portfolio of 404 companies. However, it is important to note that these instruments included later stage or private equity activities.

The following figure presents a list of the main VC players in the Brazil, for different investment stages, confirming a wide number of actors, both private and government led. However, the financial capacity is still smaller at the earlier stages of development and seed capital. Two reasons may help explain that the financing gap is more pronounced at the early stages: the IPO exit is available only for relatively large companies due to the requirements of the stock exchange Bovespa; trade sales to large corporations is still relatively less frequent than in other markets.

Figure IV.1. Main Brazilian Players

Development	Seed capital	Venture capital	Private Equity
• Finep • CNPq • Government Institutions for research support (Fapesp, Faperj, Fapemig, etc).	• Gávea Angels • Confrapar • Semeia • Eccelera • Intel Capital (Intel) • Inovar Semente (Finep) • Fundo Novarum (JB Partners) • Fundo Criatec (BNDES)	• Axxon Group • CRP • DGF • Draxxer • Eccelera • Fir Capital • Jesse Irving • Seligman • Rio Bravo • Votorantim novos negócios • BNDESPar	• Fir Capital • Investidor Profissional • Pátria banco de negócios • Angra Partners • GP investimentos • Fama investimentos • Pactual • Rio bravo • BNDESPar

Source: Instituto Inovação (2008)

Instituto Inovação (2008) provides a list of the main Brazilian players considering 4 stages:

-Development – public support research – grants, support to laboratories, etc.

-Seed capital – financing at an early stage with great technological risk (resources for the proof of concept and launching of the new business). Support provided by business angels and structured investment funds.

-Venture Capital – financing at an early and growth stage, with mainly commercial risk (operational firms, with large growth potential).

-Private equity – financing of expansion, consolidation and restructuring.

A better assessment of the Brazilian VC market can be made from data already gathered for VC firms. The following table presents the industry distribution of new ventures supported by Brazilian VCs between 2005 and 2008:

Table IV.1 – Number of Investments (2005-2008) – sample of 394 investments

Sector	Number of Investments 2005-2008
Agribusiness	8%
Biotechnology	1%
Civil Construction/Real State	18%
Communications	9%
Education	3%
Energy and Oil	11%
Entertainment/Tourism	1%
Financial Services	3%
Food and Beverage	3%
Infrastructure	2%
IT and Electronics	14%
Miscellaneous Industries	15%
Miscellaneous Services	1%
Pharmaceuticals/Medicine/Beauty	3%
Raw Materials	1%
Retail	5%
Transport Services and Logistics	3%
Total	100%

Source: GVcepe of Getulio Vargas Foundation (2012)

Civil construction/real estate and energy and oil have obtained a significant support from VC capital showing that these industries provide interesting opportunities at the current stage of the Brazilian economy and that alternative sources of financing may still be scarce. The pattern of VC investment in 2009 shows some significant differences, with civil construction/real estate falling sharply (table IV.2). These significant variations may be due to differences in activity in the different industries, but the most likely explanation deals with the size of big investments, led by large firms, that may attract a large pool of VC capital. As seen in the European case, BA investment tends to be led to smaller and more numerous projects, being more stable through time, even in the context of strong variations of the economic cycle.

Table IV.2 – Value of Investments (2009) – sample of 78 investments (82%) made by 37 fund managers (26% of total)

Sector	Value of Investments 2009
Agribusiness	3%
Civil Construction/Real State	1%
Education	5%
Energy and Oil	54%
Entertainment/Tourism	9%
Extractive Industries	6%
Financial Services	10%
Food and Beverage	1%
Infrastructure	1%
IT and Electronics	1%
Other Industries	1%
Other Services	1%
Pharmaceuticals/Medicine/Beauty	1%
Retail	1%
Transport Services and Logistics	5%
Total	100%

Source: GVcepe of Getulio Vargas Foundation (2012)

The large weight of energy and oil reflects the importance of this industry in the Brazilian economy. Finally, it is important to observe that most investments are at a late stage, with seed and start-up meaning only 21% of the total number of investments made by Brazilian VCs up to 2009:

Table IV.3 – Distribution by stage of 436 portfolio companies

Distribution by stage	2009
PE – Growth	36,5%
VC – Early	20,9%
Start-up	13,1%
Seed	7,6%
PE - Later Stage	6,2%
PIPE	6,2%
VC-Later stage	5,0%
Mezzanine	2,1%
Greenfield	1,6%
Distressed	0,2%
Total	100%

Source: GVcepe of Getulio Vargas Foundation (2012)

Both the investment stage and industry pattern of Brazilian VCs show that a large gap, with early stage and high growth industries remains open. This is both an opportunity and a challenge for BAs. There is a large void to be filled, but exits may take longer while this field is not occupied. A shift of focus by local VCs could be complemented by corporate venturing by large Brazilian corporations, the intervention of funds of funds or the joining of foreign investors – VCs ans BAs.

V – CONCLUSIONS AND RECOMMENDATIONS

The European experience has now shown that a joint effort by governments and individuals with financial and knowledge resources can strongly enhance the availability of angel financing and help in catching up with the demand by a rising breed of technology based entrepreneurs. This evolution is also reducing the gap with the more consolidated financial infrastructure developed in the US. Support to BANs, public/private co-investment and tax relief are the three most used instruments to create a favourable environment to the rising activity by European BAs.

Brazil is a strong economy with two powerful strengths: (i) a set of large, modern corporations that are global competitors in industries that range from aviation to oil extraction or from mining to civil construction and support a strong domestic capital market (Bovespa); (ii) an entrepreneurial attitude that is common to large parts of the population. However, there still is a void in the middle between these two groups that needs to be filled – Brazil needs to create more technological firms, to take away more firms from the informal sector and to allow the consolidation that will lead to the enlargement of the group of sophisticated firms at the top.

It is surprising that there are not more and more active domestic BAs taking advantage of these opportunities and that foreign BAs are not rushing more to invest in Brazil. Indeed, despite the acknowledgement of the great opportunities, the efforts to create BA networks in Brazil and some public recognition and support, the number of BAs and BANs operating in Brazil is still relatively small and their impact on the economy still modest.

This shows a situation of “market failure” that justifies some level of public intervention leading to the elimination of the gaps that are limiting the expansion of BA activity in Brazil. This support should seek an efficiency goal – to obtain a quick expansion of BA activity with a minimum long term effort from public funds.

The development of BA support to new ventures in Brazil can be strongly enhanced through the adoption of policies in the following areas:

- **Direct support to BANs**

  The European experience shows that better BA organisation can bring significant benefits in:

  - Reducing the costs of screening business opportunities;
  - Increasing the access to deal flow and facilitate the angels’ specialisation;
  - Increasing syndication and reducing risk;
  - Providing better services to associates and entrepreneurs.

  Public financial support reduces the need to charge fees to associates, entrepreneurs or both. This is important especially for small BANs that must

bear some fixed costs associated with organisation and communication. One important dimension of the BA activity deals with location – there is a clear preference for closely located entrepreneurs. Brazil needs a large network of BANs to cover its vast territory and support the numerous knowledge producing centres – research centres and universities.

- **Fiscal benefits to BAs**

  Personal tax relief is a powerful incentive to attract private capital to socially relevant causes. High risk associated to the pre-seed and seed financing justify the adoption of tax exemptions that are targeted to active BAs, who provide both capital and mentoring to aspiring entrepreneurs. While passive investors may easily build a diversified portfolio, BAs commit resources and knowledge to new projects that they nurture in order to help them succeed in the competitive market place.

  The most common type of tax relief in Europe takes the form of capital gains tax exemption, partial or total. Some countries have gone further, allowing personal income tax relief that may go up to 50% in the case of SEIS in the UK. As shown by Mazars (2011), the lost revenue by the state is quickly recovered even in the most unsuccessful cases.

  Truly committed BAs are stable – they keep their shares for at least three years and reinvest after successful exits. Allowing them to register losses in their personal income is another positive incentive, as are reliefs on inheritance tax and roll capital gains, for instance by eliminating the capital gains tax on the value of property that is reinvested in a new venture.

  The tax benefits can also be provided through a vehicle of the type of Venture Capital Trusts (VCTs) which pools capital from a number of investors and supports only small unquoted companies (CSES, 2012). Investors to VCTs enjoy the same tax benefits as if they directly invested in small firms.

  These are powerful incentives that lead more wealthy and skilled individuals to share their savings and expertise with entrepreneurs. This could have a significant impact in accelerating the number and activity of Brazilian BAs. However, it is important that positive discrimination applies: active BAs should provide evidence of their experience and support to new ventures as well as the general activities of BANs in order to be eligible to benefits that encourage their activities.

- **Public/private co- investment**

  Scarcity of available capital often affects BAs who may not be capable, even acting in syndicates, of supporting the demand of some capital intensive new ventures such as biotech firms. One efficient tool to deal with this problem is the co-investment of public funds. However, as the BAs don't enjoy easy diversification capabilities, it may be necessary to reward them more generously. Asymmetric sharing of the type designed by Technopartners and Compete, as shown in appendix I, provide financial support and a strong incentive to BA participation, without an excessive drain of public resources.

This arrangement is particularly appropriate for high tech start-ups that may require strong and long lasting capital investment such as in biotech and energy companies. Brazil might choose to create public/private co-investment funds targeting industries regarded as strategic and benefitting from competencies in which Brazil already excels or regards as strategic for the future.

- **Legal protection**

  The legal framework for the provision of capital to a start-up firm may be an obstacle if the investor can be made responsible for any torts of the investee firm. A clear limited liability status needs to be guaranteed following the experience in EU and throughout most legal regimes in the world. Anjos do Brasil (2013) has been drawing attention to the need to provide legal protection in the case of investors who take a minority stake (<=49%) and no managerial position in the investee firm.

  Easy bankruptcy procedures are important because legal protection is also important for entrepreneurs. A study on business closure by Stokes & Blackburn (2002) found that over 60% of entrepreneurs who had closed a business later opened a new business of their own.

- **Indirect support**

  Positive measures to support Business Angels are a necessary but not sufficient condition for accelerating the supply of funds for technological new ventures. All favourable conditions for doing business will translate into benefits for both demand and supply of BA support and assistance. Infrastructures, taxation (corporate and other), research grants, support to incubators and accelerators, protection of intellectual property are all important factors as they contribute to the development of the broad eco-system that favours entrepreneurship and its financing.

  There is however a key factor that leads the action of both entrepreneurs and external equity providers such as BAs and VCs – exit conditions. Brazil needs to broaden the exit opportunities.

  First of all, the most glamorous mode, Initial Public Offering in the stock market can give high visibility to success stories and create a favourable climate for further activity. For that goal it is necessary that the stock market creates easy and cheap conditions for access by smaller, younger and less sophisticated firms than those that can aspire admission to the Bovespa's "Novo Mercado" as inspired by AIM or Alternext.

  A second exit route that can play an important role in Brazil deals with corporate venturing – large firms may acquire start-ups that provide technology and new business opportunities to the parent firm. Large software and pharmaceutical companies in the EU and the US have been acquiring many promising new ventures providing interesting returns (multiples) for both entrepreneurs and their investors.

A third exit route, with more government intervention is with the development of funds of funds so that intervention in company restructuring can be made easier.

Finally, in an increasingly global environment, the creation of favourable conditions for Brazilian entrepreneurs and BAs should also be able to attract both types of economic actors from abroad. Foreign capital, ingenuity and knowledge can be attracted, once favourable conditions are present. The Brazilian Silicon Valley(s) of the future will be nurtured as the great potential of the economy is let free by the combined intervention of both domestic and foreign entrepreneurs and investors.

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GLOSSARY

A

Articles of incorporation – Basic legal declarations contained in the corporate charter.

B

Balanced fund – A venture capital fund focused on both early-stage and development, with no particular concentration on either.

Board rights – e.g. investors have the right to appoint one or more members of the board.

Bridge financing – Temporary financing needed to keep the venture afloat until the next offering.

Business Angels – Wealthy individuals who invest in early-stage ventures in exchange for the excitement of launching a business and a share in any financial rewards.

Business Plan – written document that describes the proposed product or service opportunity, current resources, and financial projections.

Buyout – Financing provided to acquire a company. It may use a significant amount of borrowed money to meet the cost of acquisition.

Buyout fund – A fund whose strategy is to acquire other businesses.

C

"Captive funds" – Refers to funds that are 100% owned by the parent organisation, while "independent funds" relates to semi-captive funds (those in which the parent owns less than 100%) as well as wholly independent funds.

Carried interest – Portion of profit paid to the professional venture capitalist as incentive compensation.

Cash burn – Cash a venture expends on its operating and financing expenses and its investments in assets.

Closely held corporations – Corporations whose stock is not publicly traded.

Common pool problem – Exists because individual creditors have the incentive to foreclose on the venture even though it is worth more as a going concern.

Confidential disclosure agreements – Documents used to protect an idea or other forms of intellectual property when disclosure must be made to another individual or organisation.

Copyrights – Intellectual property rights to writings in printed and electronically stored forms.

Corporate investor – Corporations that produce products (manufacturing companies) or deliver non-financial services.

D

Deal flow – Flow of business plans and term sheets involved in the venture capital investing process.

Development stage – Period involving the progression from an idea to a promising business opportunity.

Direct public offerings – Security offerings made directly to a large numbers of investors.

Discounted cash flow (DCF) – Valuation approach involving discounting future cash flows for risk and delay.

Divestment by public offering – The sale or distribution of a company's shares to the public for the first time by listing the company on the stock exchange, also includes sale of quoted shares after a lock-up period.

Divestment by write-off – The total or partial write-down of a portfolio company's value to zero or a symbolic amount (sale for a nominal amount) with the consequent exit from the company or reduction of the shares owned. The value of the investment is eliminated and the return to investors is equal or close to -100%.

Dividend rights – e.g. investors get a preferential, cumulative and/or deferred dividend.

Drag along – e.g. a shareholder, who proposes to transfer a given percentage of all the shares in the company, has the right to force the other shareholders to sell on the same terms.

Due diligence – The process of ascertaining, to the extent possible, an issuing firm's financial condition and investment intent.

E

Early-stage fund – A venture capital fund focused on investing in companies in the early stages of their lives.

Endowment – An institution that is bestowed money (and possibly other assets) via a donation with the stipulation to invest it and use the gains for specific objectives so that the principal remains intact.

Entrepreneur – Individual who thinks, reasons, and acts to convert ideas into commercial opportunities and to create value.

Entrepreneurial finance – Application and adaptation of financial tools and techniques to the planning, funding, operations, and valuation of an entrepreneurial venture.

Expansion – Financing provided for the growth and expansion of an operating company, which may or may not be breaking even or trading profitably. Capital may be used to finance increased production capacity, market or product development, and/or to provide additional working capital.

F

Family office – An office that provides services such as investment management and other services (accounting, tax and financial advice etc.) to one or several families.

Financial bootstrapping – Minimizing the need for financial capital and financing unique ways of financing a new venture.

Financial distress – When cash is insufficient to meet current debt obligations.

First-round financing – Equity funds provided during the survival stage to cover the cash shortfall when expenses and investments exceed revenues.

Foundations – A non-profit organisation through which private wealth is contributed and distributed for public purpose (most often charitable purposes).

Fund of funds – A private equity fund that primarily takes equity positions in other funds.

G

Generalist fund – A fund with either a stated focus of investing in all stages of private equity investment, or with a broad area of investment activity.

Good (or involuntary) and bad (or voluntary) leaver provisions: e.g. if a shareholder wants to exit because of illness or retirement (a 'good leaver'), he can keep his shares or sell to the other shareholders at (market) value; however, if he wants to exit because of a non-'good leaver' reason, then he must sell, at a lower value.

Government agencies – Country, regional, governmental and European agencies or institutions for innovation and development (including structures such as the EBRD or EIF).

Growth – A type of private equity investment, most often a minority investment but not necessarily, in relatively mature companies that are looking for capital to expand or restructure operations, enter new markets.

Growth fund – Funds whose strategy is to invest in or acquire relatively mature companies that are looking for capital to expand or restructure operations.

H

Harvesting – Process of exiting privately held business venture to unlock the owners' investment value.

Holdout problem – Exists when one or more of the creditors refuse to agree to the reorganisation terms because of the potential for a larger individual recovery.

I

Initial Public Offering (IPO) – A corporation's first sale of common stock to the investing public.

Internal Rate of Return (IRR) – Compound rate of return that equates the present value of the cash inflows received with the initial investment.

Investment Risk Premium (IRP) – Additional return that investors can expect to earn when investing in a risky publicly traded common stock.

IPO under-pricing – A reference to a syndicate's offering price when it is less than the market price immediately following the offering.

L

Later-stage fund – A venture capital fund focused on investing in later-stage companies in need of expansion capital.

Later-stage venture – Financing provided for the expansion of an operating company, which may or may not be breaking even or trading profitably. Later-stage venture tends to finance companies already backed by VCs.

Lead Investor – Venture investor taking the lead for a group (syndicate) of other venture investors.

Leverage buyout (LBO) – Purchase price of a firm is finance largely with debt financial capital.

Limited partnership – Limits certain partners' liabilities to the amount of their equity capital contribution.

M

Management buyout – Special type of an LBO where the firm's top management continues to run the firm and has a substantial equity position in the reorganised firm.

Mezzanine fund – A fund that provides (generally subordinated) debt to facilitate the financing of buyouts, frequently alongside a right to some of the equity upside.

Multiple liquidations – mechanisms by which, on any liquidation or exit event, the private equity investor receives an amount equal to a given multiple of his investment.

N

Nominal interest rate – Observed or stated interest rate.

O

Other asset manager – Financial institutions (other than bank, endowment, family office, foundation, insurance company or pension fund) managing a pool of capital by investing it across asset classes with the purpose to generate financial returns.

Other Early-Stage – Financing to companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales. They will not yet be generating a profit.

Over-the-counter (OTC) market – network of brokers and dealers that interact electronically without having a formal location.

P

Patents – Intellectual property rights granted for inventions that are useful, novel, and nonobvious.

Post-money Valuation – Pre-money valuation of a venture plus money injected by new investors.

Pre-emptive rights – The rights for existing owners to buy sufficient shares to preserve their ownership share.

Preferred book – Equity claim senior to common stock and providing preference on dividends and liquidation proceeds.

Pre-money valuation – Present value of a venture prior to a new money investment.

R

Real options – Real or nonfinancial options available to managers as the venture progresses through its life cycle.

Repayment of principal loans – If a private equity firm provided loans or purchased preference shares in the company at the time of the investment, then their repayment according to the amortisation schedule represents a decrease of the financial claim of the firm into the company, and hence a divestment.

Repayment of silent partnership – A silent partnership belongs to the so-called mezzanine financing instruments. It is similar to a long-term bank loan but, in contrast to a loan, a silent partnership is subject to a subordination clause, so that in the event of insolvency all other creditors are paid before the silent partner. The company has to repay the partnership and has to pay interest and possibly a profit-related compensation. The subordination clause gives the capital the status of equity despite its loan character.

Replacement capital – The purchase of a minority stake of existing shares in a company from another private equity firm or from another shareholder or shareholders.

Rescue/Turnaround – Financing made available to an existing business, which has experienced trading difficulties, with a view to re-establishing prosperity.

Royalty rights – e.g. investors earn a percentage of the revenues of the business.

S

Sale to another private equity house – See sale to financial institution.

Sale to financial institution – The sale of company shares to banks, insurance companies, pension funds, endowments, foundations and other asset managers other than private equity firms.

Seed – Financing provided to research, assess and develop an initial concept before a business has reached the start-up phase.

Seed financing – Funds needed to determine whether the idea can be converted into a viable business opportunity.

Special voting rights on restricted transactions – e.g. changes in the constitution, capital structure (including certain share transfers and issues), board or business of the investee company; transactions over a certain value; or proposed exits.

Staged financing – Financing provided in sequences of rounds rather than all at one time.

Start-up – Financing provided to companies for product development and initial marketing. Companies may be in the process of being set up or may have been in business for a short time, but have not sold their product commercially.

Start-up financing – Funds needed to take the venture from having established a viable business opportunity to initial production and sales.

Sovereign wealth funds – State-owned investment fund managing a pool of money derived from a country's reserves.

T

Tag along – e.g. no shareholder can transfer a given percentage of all the shares in the invested company, unless the other shareholders also have the opportunity to sell on the same terms.

Term sheet – Summary of the investment terms and conditions accompanying an investment.

Trade sale – The sale of company shares to industrial investors.

Trade secrets – Intellectual property rights in the form of inventions and information, not generally known to others that convey economic advantages to the holders.

Trademarks – Intellectual property rights that allow firms to differentiate their products and services through the use of unique marks.

U

Up and/or down ratchets – mechanisms by which the eventual equity allocations amongst classes of shareholders will go up or down depending on the future performance of the invested company or the rate of return achieved by the private equity investor.

V

Venture Leasing – Leasing contracts where one component of the return to the lessor is a type of ownership in the venture usually through warrants.

W

Warrants – Call options issued by a company granting the holder the right to buy common stock at a specific price for a specific period of time.

Sources:

EVCA (2012), EVCA Yearbook 2012 Activity Data on Fundraising, Investments and Divestments by Private Equity and Venture Capital Firms in Europe.

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APPENDIX

APPENDIX I

Co-investment funds – The Dutch and Portuguese Models

This appendix is closely based on an EBAN (2013) report on co-investment. Co-investment is a powerful tool that can leverage the private investment, valuation and mentoring provided by BAs. Joint design by governments and BANs led to an interesting model that involves asymmetric sharing between BAs and the supporting public entity (PE). The main agreement consists in defining three stages, according to the pay-back obtained through successive exits:

- First stage, until the BAs obtain their capital back – 80% for BAs, 20% for PE;
- Second stage, until the PE obtains its capital back – 50% for each;
- Third stage, after the PE obtains its capital back – 80% for BAs, 20% for PE.

The Dutch model started in 2005. In January 2013 there are 36 Angel Syndicates with a maximum investment capacity of €8 million each. Total investment capacity from the Angel Syndicates exceeds €250 million and more than 150 deals were done since 2005.

A more recent model was developed in Portugal. Public support, provided by European and Portuguese funds is managed by a specific entity called Compete. These funds can not exceed €500,000 per vehicle associating a group of BAs and can not exceed 65% of each investment, meaning that the BAs must provide at least 35%. They are also precluded from charging management fees.

The allocated capital can be invested in the next 3 years and has to be paid back within 10 years, if the investment is successful. Revenues are shared between BAs and Compete as with the Dutch model. In early 2013 54 Investment Vehicles were created with €42 million, which will represent more than 70 million euros potential investment in start-ups.

The following picture shows the revenue of both parties for an investment of €770,000 – 500,000 from Compete and 270,000 from the BAs (about 35%). When exits allow a return of €337,500, as they are paid 80% of the total, BAs fully recover their investment, while Compete captures 20% or €67,500. After that threshold, the returns are distributed evenly, 50% for each, until Compete recovers its investment: that happens when the total return increases by €865,000 [(500,000 – 67,500) x 2], reaching €1,202,500. From then on, BAs receive 80% again and Compete 20%.

This model significantly encourages BA support to new ventures, preserving an appropriate incentive for searching and mentoring high growth business opportunities, without an excessive burden for the public sponsor. Indeed, the initial investment provided by Compete is recovered if exits allow a multiple of the initial investment of less than 2, a relatively modest return by BA standards, as seen in point II.8. Although this return does not compensate for Compete's cost of capital which may be more significant if the required length of time till the harvest is larger. However, if future tax and social security revenues are considered, the return enjoyed by public entities is much larger, as shown in **Appendix III**.

APPENDIX II

UK incentives for Business angels - EIS and SEIS

Enterprise Investment Scheme – EIS provides tax relief to individuals who invest in the shares of qualifying unquoted companies. Brief details of the scheme are shown below based on the scheme details issued by HM Revenue & Customs, the UK tax collection department. The scheme provides the following reliefs to individuals:

- Income tax relief at 30 per cent of the cost of the shares. Relief can be claimed up to a maximum of £500,000 invested in such shares, giving a maximum tax reduction in any one year of £150,000;
- Any gain is free from Capital Gains Tax provided the shares are held for 3 years or more, and deferral relief in certain circumstances;
- If the shares are disposed of at a loss, the loss, less any Income Tax relief given, can be set against income instead of being set off against any capital gains.

Companies which can use EIS:

- Must not be quoted on a recognised stock exchange at the time the shares are issued (alternative
- markets such as AIM are not recognised exchanges);
- Must not be controlled by another company;
- Must be a small company;
- Must have fewer than 50 full-time employees.

Companies are not allowed to raise more than £2 million in any 12 month period from the venture capital schemes, and there are restrictions on the type of trade that qualifies.

Venture Capital Trusts – A VCT is a company, broadly similar to an investment trust, which has been approved by HMRC and which invests in small unquoted companies. The VCT Scheme is designed to encourage investment in small unquoted companies. Individuals invest by holding shares in a VCT. The VCT invests in a spread of small unquoted companies, enabling investors to spread their risk, just as they do by holding shares in an ordinary investment trust company.

An approved VCT has a number of tax advantages:

- the VCT is itself exempt from CT on chargeable gains (and losses for chargeable gains purposes are not allowable losses);
- individual investors can claim income tax relief on subscriptions;
- individual investors are exempt from income tax on dividends;

- individual investors are exempt from Capital Gains Tax.

Seed Enterprise Investment Scheme – The UK government has planned an additional new relief, the Seed Enterprise Investment Scheme (SEIS). The new relief comes into effect for investments made on or after 6 April 2012. This relief is specifically targeted at Business Angels investing in very small startups.

The relief offers income tax relief at 50% on the amount subscribed for ordinary shares (although there are provisions to permit certain preferential dividend rights) up to a limit of £100,000. As with EIS, gains on the Seed EIS shares will be exempt, providing certain conditions are met. Additionally capital gains made in 2012/13 that are reinvested into seed EIS shares will themselves become exempt.

The target company can raise no more than £150,000 in total under Seed EIS. It must be a small company; one with less than 25 employees and assets less than £200,000 immediately before the share issue. Additionally it must have been incorporated in the two years before the share issue and be carrying on a new trade.

The UK government issued a consultation paper before finalising SEIS and published the responses. The main reasons for introducing an additional scheme are that:

- the gap between the risk of the business proposal and the risk the investor is willing to take is larger at this stage;
- that investments were moving away from seed stage companies; and,
- although EIS works well to encourage seed investment now, the planned changes to the amount companies can raise per year (to £10 million, subject to State aid approval) could make it more difficult for seed companies in future.

Evaluation of EIS and VCT

An evaluation of the EIS and VCT schemes was carried out in 2007 by the Institute of Employment Studies. This focused on the performance of companies, rather than on the supply of capital. The study showed that, as far as companies were concerned, the conclusions were that “Overall, these results indicate that EIS and VCT investments have a positive effect on capacity building in recipient companies. However, in material terms, these effects remain at present very small. There is some additional limited evidence of a profit enhancing effect. However, we also note that both schemes appear to be associated with differentials in performance depending on the size, age and sector of the recipient company.”

Around 10,000 individuals invested through EIS in 2008-09, the last year for which figures are available and around 6,300 through VCTs.

Source:

Centre for Strategy & Evaluation Services. (2012). Evaluation of EU Member States’ Business Angel Markets and Policies. Retrieved from http://ec.europa.eu/enterprise/dg/files/ba-rep_en.pdf

APPENDIX III

Study on the impact on the State Fiscal Revenue of tax incentive of 30% granted to Business Angels' investments

I. Introduction

Currently, the Portuguese tax law includes a tax reduction of IRS (Personal Income Tax) that corresponds to the possibility of deduction from the tax bill, up to 15% of its gross value, of an amount corresponding to 20% of the investments made by a Business Angel in companies with growth potential, under certain conditions (paragraph 6 and following of the current article 32 of the Tax Benefits Code, future paragraph 5 and following of article 32-A of the Tax Benefits Code).

The present study arises within this context and having as an inspiration the United Kingdom parallel case, considering that it has increased the same tax incentive to Business Angels from 20% to 30% in April this year and, in 2012, it is planned that it will increase the relevant maximum amount for each investor in a given year from £ 500,000 to £ 1,000,000.

The present study shows that the referred tax incentive is not merely a decrease in revenue or increase in tax expense for the State Fiscal Accounts. Rather, it is a recovery engine for the economy with the guarantee of a quick return of the tax incentive granted with tax revenue increase in a few months. It is a risk free investment for the State: the expected rates of return are high, the payback occurs in the first months of activity of the company incorporated with the Business Angel's investment.

Because we are certain that it is an excellent recovery engine for the economy, and because we know that the State is starving for additional Fiscal Revenue, we propose an increase of the tax incentive from 20% to 30%, in order to show the State's intention to stimulate the creation of new businesses and the creation of new jobs that will generate additional Fiscal Revenue.

II. Assumptions

For the purposes of preparation of the present study we have taken into consideration the following assumptions:

- We have considered that 2% points of VAT incurred would not be deductible. This is typical in all businesses in Portugal. Other VAT output or input is neutral;
- Bank financing has not been considered (which would improve the Fiscal Revenue with a bigger investment);

- It was considered that the BA would invest half of the money needed (in practice BAs tend to invest less than 50%). If we considered less than 50%, it would improve Fiscal Revenue;
- Capital gains on disposal by the BA have not been considered. If they were considered, it would improve the Fiscal Revenue with 10.75% or 21.5% CGT;
- Indirect impacts, like taxes on profits of suppliers, less unemployment subsidies, etc. were not considered. If considered it would improve the Fiscal Revenue;
- It has been considered that the Tax Break is refunded in June of the year after the investment is made by the Business Angel;
- It has been considered that the BA would be able to deduct the total amount of tax deduction. In case there is a ceiling in terms of amounts (e.g. € 50.000), Fiscal Revenue improves;
- Additional legal emoluments, due to new shareholders, change of Articles, etc. were not considered;
- Fiscal Revenue that could arise from property taxes was not considered;
- A low average effective IRS (Personal Income Tax) rate of 10% was considered;
- An average Social Security charge of only 30% (20% cost of the employer and 10% contribution of the employee) was considered (actual rates applicable are higher: 34,75% employee + employer and 29,6% management + company);
- In case the company stops the activity after one year, it was considered that VAT incurred would not be refunded.

III. Study

For purposes of the present study it was considered that the start-up would require an investment of € 100.000 and that the company “consumes” the total investment. The study is valid for any other investment amount, since, apart from the fixed costs (that are residual) of incorporation and annual compliance, the remaining costs are directly related to the investments and with the activity of the start-up. I.e., the investment amount is not going to affect neither the State’s payback, nor the “return” of the “investment” to the Fiscal Revenue.

Scenario A

Scenario A is the most pessimistic scenario in which the start-up "consumes" all the investment in the first year of activity and cannot produce and sell, closing the business in the first year:

Start-up funded with the help of a Business Angel under Tax Break Scheme	Investment	1st year	2nd year	3rd year	4th year	5th year	Total
Investment	-100.000						
Revenues		-					
Management Staff Costs		50.000					
Other Staff Costs		30.000					
Other costs		20.000					
EBT		100.000	-	-	-	-	100.000

Under this scenario and despite the "failure", granting of the tax incentive is beneficial for Fiscal Revenue, given that, in the first year of activity, the start-up up results in the collection of the following taxes and other charges:

Revenue arising for State from the Start-up	Investment	1st year	2nd year	3rd year	4th year	5th year	Total
IRS - Personal Income Tax (10%)		6.667	-	-	-	-	6.667
Social Security Contributions (30%)		20.000					20.000
VAT (20%)		4.000	-	-	-	-	4.000
IRC - Corporate Income Tax (26,5%)				-	-	-	-
Other legal emoluments	500	85	-	-	-	-	585
Total State Revenues	500	30.752	-	-	-	-	31.252

Scenario B

The scenario B is what we can call the expected most common scenario, given that the start-up “consumes” all the investment but starts producing and after five years is selling € 500.000 per annum (cruise mode).

Start-up funded with the help of a Business Angel under Tax Break Scheme	Investment	1st year	2nd year	3rd year	4th year	5th year	Total
Investment	-100.000						
Revenues		-	100.000	150.000	300.000	500.000	
Management Staff Costs		50.000	50.000	50.000	75.000	75.000	
Other Staff Costs		30.000	30.000	50.000	75.000	125.000	
Other costs		10.000	20.000	25.000	35.000	60.000	
EBT		90.000	-	25.000	15.000	240.000	290.000

Under this scenario, the State Revenue will be as follows:

Revenue arising for State from the Start-up	Investment	1st year	2nd year	3rd year	4th year	5th year	Total
IRS - Personal Income Tax (10%)		6.667	6.667	8.333	12.500	16.667	50.834
Social Security Contributions (30%)		20.000	20.000	25.000	37.500	50.000	152.500
VAT (20%)		200	400	500	700	1.200	3.000
IRC - Corporate Income Tax (26,5%)				1.000	12.250	63.600	76.850
Other legal emoluments	500	85	85	85	85	85	925
Total State Revenues	500	26.952	27.152	34.918	63.035	131.552	284.109

Scenario C

The scenario C is an optimistic scenario that allows us to understand that if the business goes better than expected, Fiscal Revenues boost!

Start-up funded with the help of a Business Angel under Tax Break Scheme	Investment	1st year	2nd year	3rd year	4th year	5th year	Total
Investment	-100.000						
Revenues		100.000	300.000	600.000	1.000.000	2.000.000	
Management Staff Costs		50.000	75.000	100.000	150.000	200.000	
Other Staff Costs		30.000	90.000	180.000	300.000	600.000	
Other costs		20.000	60.000	120.000	200.000	500.000	
EBT			75.000	200.000	350.000	700.000	1.325.000

Under this scenario, the Fiscal Revenue will be as follows:

Revenue arising for State from the Start-up	Investment	1st year	2nd year	3rd year	4th year	5th year	Total
IRS - Personal Income Tax (10%)		6.667	13.750	23.333	37.500	66.667	147.917
Social Security Contributions (30%)		20.000	41.250	70.000	112.500	200.000	443.750
VAT (20%)		400	1.200	2.400	4.000	10.000	18.000
IRC - Corporate Income Tax (26,55%)			19.875	53.000	92.750	185.500	351.125
Other legal emoluments	500	85	85	85	85	85	925
Total State Revenues	500	27.152	76.160	148.818	246.835	462.252	961.717

IV. Conclusion

The table below is a summary of the conclusions reached and allows us to understand that the Fiscal payback occurs in the first months of activity of the start-up, regardless of the scenario considered.

Return for the State in terms of Revenues	Scenario A	Scenario B	Scenario C
Revenue from taxes 1st Year	31.252	27.452	27.652
Revenue from Taxes 5 Years	31.252	284.108	961.717
Taxes deducted if 30%	15.000	15.000	15.000
State Payback if 30% (Years)	-0,02	0,05	0,04
Return for the State in 5 Years, if 30% TB	108%	1794%	6311%
Compound Annual Return for the State if 30% TB	18%	92%	152%

Note that the tax incentive is only granted in the middle of the year following the investment; in practice, the Fiscal Revenues are collected from the start up before granting tax relief/refund to the Business Angel. Consequently, in any case, there is no disbursement of funds by the State in granting the incentive.

On the other hand, the expected rate of return for the State is extremely high and even if the start-up closes in the first year of activity, the State will have a yield greater than 100%, in the scenario of granting a tax incentive of 30%.

From the above, it is evident that this is a tax incentive that promotes the investment and assures, even in the worst case scenario, the return of the granted incentive through the taxes and other charges due by the start up.

It could be argued that investments could always occur, even without the tax incentive, particularly if they have high rates of return. However, in the current environment of high uncertainty, volatility and risk aversion, the lack of motivating incentives will hardly encourage Business Angels to take such risk. Combining the financing difficulties, lack of capital for high risk investment and lack of guarantees from the promoters, many projects that could be good initiatives will not get out of the paper.

Source:

Mazars (2011), Study on the impact on the State Fiscal Revenue of tax incentive of 30% granted to Business Angels' investments, Study commissioned by FNABA.

APPENDIX IV

Limited Partnerships

The Walkovszky Case

A well-known case in which this issue arose is Walkovszky v. Carlton. The plaintiff, Walkovszky, was a pedestrian run down by a New York City taxi cab. The cab was owned by a corporation called Seon Cab Corporation that owned it and another cab. Carlton was a shareholder of Seon. He and his associates also owned nine other corporations each of which also owned but two cabs. Together these ten corporations were operated as a single business. Seon's principal asset apparently was a $10,000 insurance policy, which was the minimum liability coverage required by New York law.

Walkovszky sued Seon and the nine other corporations on the theory that together they constituted a single "enterprise entity" and therefore ought to be treated as such for liability purposes. This form of veil-piercing claim, which denies the separate entity status of the several corporations sharing common ownership, even if successful, probably would not have yielded adequate recovery. Walkovszky therefore also pursued a different veil piercing theory, seeking to hold Carlton and Seon's other shareholders personally liable. In this regard, he alleged undercapitalization and also that Carlton "organised, managed, dominated and controlled" this single fractured economic entity.

The New York Court of Appeals affirmed the trial court's dismissal of the complaint for failure to state a claim. The court emphasized the lack of allegations that Carlton and the other shareholders were "actually doing business in their individual capacities, shuttling their personal funds in and out of the corporations 'without regard to formality and to suit their immediate convenience.'" In addition, the court also stressed the fact that Seon had complied with the legislatively imposed insurance requirement:

> The corporate form may not be disregarded merely because the assets of the corporation, together with the mandatory insurance coverage of the vehicle which struck the plaintiff, are insufficient to assure him the recovery sought . . . . [I]f the insurance coverage required by statute "is inadequate for the protection of the public, the remedy lies not with the courts but with the Legislature."

In this court's view, Seon's controlling shareholder did not act irresponsibly, even though he had operated the corporation with assets clearly insufficient to meet tort claims that were virtually certain to occur. The fact that the corporation had complied with the state's minimum insurance requirement was taken to indicate that the corporation and its shareholders had fully met their obligations to potential tort creditors. To impose additional liability on the shareholders was thought to amount to a usurpation of the legislature's power to define financial responsibility in this context.

Source:

Millon, D. (2007). Piercing the Corporate Veil, Financial Responsibility, and the Limits of Limited Liability. Emory Law Journal, 56(5), 1305–1382.

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