An Analysis of Investment Decision Factors
by Australian Business Angels
and Venture Capital Investors

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An analysis of investment decision factors by Australian business angels and venture capital investors

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A thesis submitted in fulfillment of the requirements of the degree of Doctor of Philosophy

The University of Newcastle

Faculty of Business and Law

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Statement of Original Authorship

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Signed: ……………………………………

Date: ………………………………………
I am grateful for the support and assistance I have received from many people, in particular my wife Linda who has given me the encouragement and motivation to remain focused on the task in hand. My daughters Mandy and Sally have been patient and interested in my progress at all times. I am also grateful for the continuing input and encouragement of a number of good friends.

The academic staff members of the University of Newcastle, Ourimbah Campus, have given me wise counseling and support. I take this opportunity to thank my supervisors Emeritus Professor Frank Clarke and Professor Bob Catley for their generous contribution to the project in terms of sound academic mentoring and invaluable suggestions as to form and content. Thanks also to Fiona Neville, Dr. Alison Basden, Dr. Jacqueline Flint and fellow doctoral students.

A number of people participated in this study as members of focus groups. Their collective wisdom helped structure the survey which was subsequently distributed through the Australian Private Equity & Venture Capital Journal. I am grateful to those who responded. The editor of the Journal, Adrian Herbert, was extremely generous with his knowledge of the private investment marketplace and remained willing at all times to assist with the publication of the survey. I owe him a particular debt.

This research has allowed me to access participants in the private marketplace and to understand the aspirations and challenges of those entrepreneurs, business angels and venture capitalists who operate in this space. They are creating a stronger and smarter society through innovation and through the funding of enterprises in the private investment marketplace.
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Abstract

Decisions taken by business angels and venture capitalists whether to invest in the private marketplace within Australia and the interrelations among such decisions depend upon the relative importance of different factors. The private marketplace operates distinctly and separately from the public marketplace in Australia. It comprises business angels, who invest monetary or business expertise at the seed or early stage of a venture and professional investors, venture capitalists, who generally invest at a later stage in more formal circumstances.

Whereas emerging themes coursing through the literature identify four broad groupings of factors: access to deals, equity / control, entrepreneur / management and investor input that may be relevant to the investment decision, none appears more dominant than the other.

The relative importance of different factors and the interrelations among decisions taken by business angels and venture capital investors to invest or not invest have, up to now, remained unidentified.

Here, a 2009 investigation of 21 business angels and 9 venture capitalists within Australia has revealed an association between the four factors stated and the decision to invest, with one factor being the quality of the entrepreneur / management team being the most important. The findings also suggest that a financial assessment of the proposed venture is core to the decision making of both business angels and venture capitalists and is not given greater importance by venture capitalists over business angels. These confirmed qualitative data were derived from two focus groups, one comprising business persons and the other of business angel investors and venture capitalists, pre-testing and refining a questionnaire put to those business angels and
venture capitalists and from the responses to the open ended questions included at the end of the questionnaire. Quantitative data were collected from the responses of business angels and venture capitalists to the survey of readers of a leading private marketplace journal within Australia.

These findings facilitate directed research into investment in Australia’s private marketplace within a prescribed framework of the hierarchy of factors, previously more a matter of normative conjecture than drawing on sound evidence.
Chapter 1

Financing in the private marketplace

No man can tell what the future may bring forth, and small opportunities are often the beginning of great enterprises

Demosthenes (385–322 BC) Ad Leiptinum 162


Financing start-up enterprises has important implications for a national economy by virtue of the significance of new business for employment growth, competition, innovation and export potential (Mason 2002). New and small firms have an acknowledged important role in the creation of technical and economic innovations (Reynolds and White 1997). Sohl (2003, p. 43) has noted that “the history of business in the USA is the history of equity financing”, whilst Anson (2002, p.379) has observed that “the successful investing of private equity firms throughout most of the 1990s has attracted significant investor capital into the private equity markets”. Of particular interest in this context is the role of capital and of the founder/entrepreneur in start-up and early stage ventures. Yet the interrelationships between such matters and their synergistic outcomes have been greatly ignored in the business literature. That omission is the focus of the current research study.
1.1 Investment decisions by business angels and venture capitalists

Investment in the private marketplace is the setting of this study. Capital, funding and the founder or entrepreneur; business angels and venture capital investors; and the factors impacting their investment decision, underpin the themes this study exposes and pursues.

The term “capital” evokes different connotations. *Human capital* encompasses the personal attributes, the skills and experience, an entrepreneur brings to the venture, whereas *financial capital* denotes monetary means with which it is pursued. The two may be substitutable without detriment to the venture (Chandler and Hanks 1998). Usually capital is used to refer to financial capital, or the capital provided by the party initiating the enterprise, almost inevitably the founder or entrepreneur (Banfe 1991; Bodde 2004), who then seeks funds from a network of family and friends, “emotional investors” (Sherman 2005, p.8). Family and friends also provide affective, educative and network resources (Steir 2003). These investors are variously motivated to invest “out of love” or because of a particular relationship and may offer flexibility and concessions for the founder in terms of the funds advanced and in relation to the percentage of shareholding claimed (Sherman 2005). In due course, the founder or entrepreneur will seek funds from private marketplace investors.

Financing start-up ventures requires (i) ‘initial capital’ to generate the start-up and maintain its momentum until the business can begin to fund itself, and (ii) ‘working capital’ derived from profits or other sources to drive the enterprise until ‘expansion capital’ is needed to drive the growth phase(s). In this context, working capital ordinarily includes the cash reserves and assets readily convertible into cash and is used to pay current obligations such as rent and wages. Fixed capital refers to durable assets
with a continuing, often long-term connection to the business, - real estate, fixtures and fittings, necessary infrastructure items and movables such as machinery and furniture.

The requirements of working and fixed capital can vary from time to time (Baumback 1988), with the enterprise often requiring funding through the investment of capital.

Two types of investment of capital, external funding and internal funding, generally fund new ventures (Ronstadt 1985). *External funding* can comprise equity funding and debt funding, each of which has costs and benefits bearing on the decision. Indeed, most companies raise capital in a manner consistent with finance theory and, in the case of debt and equity, relative costs will affect the choice of financial strategies (Carter and Van Auken 2005). Whilst both equity and debt funding can be used to finance either fixed or current assets, the two should not be perceived as mutually exclusive. With debt it generally follows that the monies borrowed should generate the means of repaying the debt, with short-term funding usually repaid from current assets and long-term funding from earnings of the firm (Baumback 1988).

*Internal funding* carries an assumption that using its assets and turnover the enterprise can earn income entailing internal cash generation. Internal funding is generally considered more appropriate for an established enterprise. In addressing primarily the funding of new ventures, this study focuses on raising capital through external funding, although the owner of an enterprise may require a combination of external and internal funding (Ronstadt 1985; Chandler and Hanks 1998).
1.2 The private marketplace and investors

The private marketplace encompasses the informal marketplace, where business angels operate, and the formal marketplace, where venture capitalists are located (Sohl 1999). Informal and formal markets are known collectively as the private marketplace or private equity, and are distinct from the public marketplace. Private investment is usually distinguished from investment in public companies by referring to it as private equity investment (Moskowitz and Vissing-Jorgensen 2002; Marks et al. 2006). Moskowitz and Vissing-Jorgensen (2002) refer to the private company space as being “non-publicly traded equity”, and use the term “private equity” to differentiate it from publicly traded equity. Consistent with that, Connolly and Tan (2002, p.1) refer to private equity as “investment outside of capital markets” and the manner in which it is variously categorized as start-up financing, expansion financing, turn-around financing and management buy-out (Connolly and Tan 2002; Edey 2007), initially by business angels and subsequently by venture capitalists.

Investment in the private marketplace is generally referred to as private equity investment conducted through and in private companies. Anson (2002, p.261) describes private equity as a generic term that encompasses venture capital, leveraged buy-outs, mezzanine financing and distressed debt financing. Venture capital in this description includes the financing of start-up companies.

1.2.1 Private marketplace investment capital

The private marketplace is where the parties responsible for undertaking start-up and early stage ventures seek sources of investment capital initially from business angels
and in due course from venture capitalists for growth, diversification and general expansion. These parties are referred to as founders or, more generally, entrepreneurs. Both terms are used in this study. An awareness of the role and motivation of the entrepreneur in establishing such enterprises may assist with an understanding of why only some entrepreneurs attract capital to their cause. In the final stages companies may be looking for finance to float on a public exchange (Bruno and Tyebjee 1985).

‘Business angel capital’ refers to capital provided by business angels from their own resources, invested directly in the private marketplace; ‘venture capital’ refers to funds raised by venture capitalists from investor clients and invested by venture capitalists as financial intermediaries in that marketplace (Berger and Udell 1998).

1.2.2 Investors in the private marketplace

Business angels and venture capitalists are the primary occupants of the private marketplace engaged in private equity activity.

(i) Business angels

The investors at the early stages of growth of the enterprise beyond the founder’s personal network are generally referred to as business angels, or simply angel investors or bands of angels (Sherman 2005), or seed capitalists or business angel investors (Benjamin and Margulis 2005). Business angels are “private equity investors who invest both capital and business expertise in early stage companies” (Payne and Macarty 2002, p.331) and “non-institutional equity investors who are neither part of the regular management team nor related to any members of the management team in the investee business” (Hindle and Lee 2002, p. 170). In contrast, venture capital investors usually
offer funds at a later, more expansionary, stage of an enterprise’s development and on a more formal, professional basis than business angels (English 1986; Kotler et al. 2004). Business angels, also known as ‘informal investors’, may consider the financial return as only one of the elements of the investment, whereas venture capitalists known as formal investors analyse their investments on a purely formal basis (Aernoudt 1999). The early stage support by a business angel may lead to an approach to or an approach from a venture capitalist seeking to provide formal support. Table 1.1 (in Appendix A to this Chapter) summarises the definitions and interpretations of business angels by previous researchers. The term “business angel” is adopted in this research. It is discussed in greater depth further and in Chapter 2.

(ii) Venture capitalists

In contrast, venture capitalists invest when the enterprise is at a mature stage of growth and seeking expansion, often with a view to a public listing. Benjamin and Margulis (2005, p. 98) refer to venture capitalists as “money managers”. They are “not passive investors” (Anson 2002, p. 266; Appendix A, Table 1.2). The term “venture capitalist” is used in this research. Chapter 2 defines and discusses venture capitalists. Venture capitalists and the business angels need to ensure that the business structure provides security for the funds invested and the appropriate degree of control and resulting financial benefits (Benjamin and Margulis 2005). Table 1.2 (in the Appendix A to this Chapter) summarises the definitions and interpretations of venture capitalist by previous researchers.

(iii) Factors that may be relevant to the investment decision

This research investigates how business angels and venture capitalists determine and evaluate the factors relevant in making their investment decisions and the interrelations
amongst such decisions. Particular factors have been revealed in the course of this investigation to be of major concern in the sourcing of the right type and stage of the deal, securing legal rights once the deal is located, ensuring that the parties to the deal are compatible and that management is capable and also assessing financial issues such as the valuation, the return on investment and investment-exit strategies. Whilst the financial aspects of the investment are undoubtedly important for venture capitalists (Sherman 2005), there is a view that some business angels (consistent with community or social responsibility objectives) are motivated by other than purely financial returns: altruism, fostering local economies, assisting family and relatives start up activities, coaching new entrepreneurs, becoming active (as perhaps a kind of ‘hobby’) in retirement and the experiencing of the highs and lows of the investment challenge; playing a role in the entrepreneurial process and in passing on skills and experience to new entrepreneurs (Kotler et al. 2004). Benjamin and Margulis (2005, p. 132) have suggested that there are “a plethora of non-financial returns sought” including the creation of jobs, developing advances in medicine and technology, contributing to urban revitalization, encouraging ventures by minority groups and obtaining satisfaction from assisting other entrepreneurs.

Clearly, there is a need by venture founders to source and obtain start-up funds, and a need for the continuing presence and support of investors in the private marketplace willing to back ventures with appropriate safeguards and financial benefits. Business angels and venture capitalists are seen to offer different levels of involvement and support. In that setting, flexibility in management and decision-making is traded off against exposure to individual liability for business losses and the likely scarcity of capital. Thus this research investigates the private marketplace to glean a better understanding of the factors that may determine these investment decisions.
1.3 Motivations for the study

Whereas numerous scholars have documented the rise of substantial enterprises from the ideas and inventions of entrepreneurs (Battelle 2005; Maynard 2005), little discussion or research has been directed toward understanding the funding of entrepreneurs through private investment by business angels or venture capitalists. Arguably, this investment is under-researched (Paul et al. 2007). Freear et al. (2002, pp.282-283) contend that a systematic collection of data about (business) angel practices would give the insights necessary to create more effective (business) angel capital markets for the benefit of investors and entrepreneurs alike. Private investors have been called “the spawning grounds for their venture capital counterparts” (Sohl 1999, p.106), whilst Berger and Udell (1998, p.627) have noted that the “interconnectedness of small firm finance” results in the angel contract leading to venture capital funding which in turn can lead to a public share offering and listing. Few scholarly studies have investigated venture capitalists’ strategies when dealing with the pressure to access lower risk investments accompanied by improved rates of return that add value to new venture development (Gupta and Sapienza 1992). Accordingly, this research pursues these issues as outlined in Table 1.3, with a view to a richer understanding of the investment decision making processes undertaken by business angels and venture capitalists, a greater awareness of the private marketplace in Australia and the development of a model for evaluating decision making factors.

The private marketplace is “largely misunderstood, inefficient and under-researched” (Sohl 1999, p. 117) and a greater understanding of the interaction between business angels and entrepreneurs remains largely untouched, prior research having “largely ignored the vital role of business angels” (Prasad et al. 2000, p. 176). Moskowitz and
Vissing-Jørgensen (2002, pp.745-755) have noted that “the private equity market has received relatively little academic attention” and that “venture capital pertains to a very specific type of investment in private equity that may not provide much insight into the typical entrepreneur’s investment decision and returns”. Bodde (2004, p.126) refers to business angels as being “animated by considerations that reach beyond the purely financial”, often with an intrinsic interest in a specific industry (Umesh et al. 2007). These non-financial motivations can lead to successful entrepreneurs becoming angel investors and supporting start-up enterprises (Bodde 2004). Researchers tend to investigate venture capital investment which is said to be more likely to be available for established enterprises with a proven history of successful growth (Bhide 2000; Lesonsky 2007). Barrow (1993) proposes that venture capital fund managers are looking only for winners and are thus focusing on enterprises projecting high capital growth. This research addresses these omissions and shortcomings.

1.4 The factors underlying private marketplace investments

The overall research question for this study is:

*What is the relative importance of different factors and what are the interrelations among decisions taken by business angels and venture capitalists to invest or not invest in the private marketplace within Australia?*

Chapters 2 and 3 of the study reveal discussion in the literature hinting at certain relevant factors in the investment decision making processes employed by business angels and venture capitalists in Australia’s private marketplace. The chapters also consider the interrelationship of such factors in the decision-making. These factors fall
into four broad themes as outlined in Table 1.4, each with a different focus providing a framework upon which the study was based. These emerging themes are: (i) *access to deals*, concerning location and type of the venture and stage of the deal (the physical issues); (ii) *equity/control*, focusing on the ownership structure and control issues between entrepreneur and investor (the legal relationship); (iii) *entrepreneur/management*, focusing on the abilities of the entrepreneur and management team (the managerial relationship) and (iv) *investor input*, the investor focus on the merits and details of the deal (the financial assessment).

Eight hypotheses are developed and pursued to test specific relationships amongst variables arising out of these themes in the investment decision making process with a ninth hypothesis developed in order to test the relative weight placed upon the financial assessment of the venture by business angels and venture capitalists.

### 1.5 Research methodology

McGrath, Martin and Kulka (1982) note that the research process can be viewed as a series of interlocking choices rather than a set of problems to be solved, with the process seen as a series of dilemmas to be avoided along the journey to a conclusion. Choices have to be made as to the formulation of the research problem, the design and implementation of the study and analysis of the results. This research focuses predominantly upon the quantitative data emerging from the survey and to a lesser extent from the qualitative data emerging from the focus groups. Analysis of the data allows for the testing of hypotheses and the drawing of conclusions from the study.
1.6 Thesis structure and summary

Here in Chapter 1 the background and justification for the research has been explained, with the primary research question to be pursued in a predominantly quantitative analysis with the qualitative analysis being conducted in the pilot study.

Chapters 2 undertake a review of the relevant literature concerning business angels and venture capitalists, identifies the types and characteristics of investors, defines the marketplace, discusses the nature of investment and investment structures in the marketplace and the funding of investments. Chapter 3 investigates the investment criteria and considers the context of and the making of investment decisions. From this analysis hypotheses are developed to test the relationship between factors that may be relevant to the investment decision and the subsequent making of same. Those factors can be grouped in broad classifications: access to deals; degree of equity / control; quality of the entrepreneur and management; and investor input factors.

Appropriate methods of research and analysis to be used in the study in order to test the hypotheses are identified and explained in Chapter 4, the research paradigm and the research design is specified, the data required are identified, their validity and reliability examined, and the mode of their collection explained. Analysis of those data, collected from the survey, is undertaken in Chapter 5 and the hypotheses are tested with the results analysed. Chapter 6 discusses the findings and outlines their implications thereby presenting the contribution of the research in the analysis of the relevant factors in the investment decisions and the interrelations amongst decisions taken by business angels and venture capitalists in the Australian private marketplace.
In summary, this initial discussion of the private marketplace describes the nature and availability of investment capital and the need by founders to source and obtain start-up funds and continuing support. Business angels and venture capitalists as the primary occupants in this space offer financial support in return for an interest in the venture in the form of debt or equity. The motivation for the study is discussed and the factors that may be relevant to an investment decision are considered and broadly identified leading into a review of the research methodology and analysis of the data.

**Appendix A**

**TABLE 1.1 Definitions and interpretations of business angels**

<table>
<thead>
<tr>
<th>Study</th>
<th>Definition/interpretation of business angel concept</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baeyens and Manigart (2005, p.512)</td>
<td>Enablers of growth</td>
</tr>
<tr>
<td>Benjamin and Margulis (2005, p.7)</td>
<td>Private wealthy informal venture capitalists who invest in high risk deals offered by entrepreneurs who they admire</td>
</tr>
<tr>
<td>Elitzur and Gavious (2003, p.710)</td>
<td>Wealthy individuals providing finance at very early stages</td>
</tr>
<tr>
<td>Gaston (1989, p.1)</td>
<td>Private individuals who supply risk capital dollars; directly diverse and dispersed group, often successful entrepreneurs</td>
</tr>
<tr>
<td>Goldstein (2002, p.143)</td>
<td>Generally wealthy people willing to put their money into new businesses</td>
</tr>
<tr>
<td>Payne and Macarty (2002, p.331)</td>
<td>Private equity investors who invest both capital and business expertise in early stage companies</td>
</tr>
<tr>
<td>Sherman (2005, p.71)</td>
<td>Investors in early stage businesses</td>
</tr>
<tr>
<td>Steir and Greenwood (2000, p.164)</td>
<td>Wealthy individuals who invest in small firms amounts typically too small for professional venture capitalists</td>
</tr>
<tr>
<td>Wessner (2002, p. 352)</td>
<td>Often successful business persons willing to finance</td>
</tr>
</tbody>
</table>

**TABLE 1.2 Definitions and interpretations of venture capitalists**

<table>
<thead>
<tr>
<th>Study</th>
<th>Definition/interpretation of venture capitalist concept</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anson (2002, p. 266)</td>
<td>Venture capitalists are not passive investors</td>
</tr>
<tr>
<td>Benjamin and Margulis (2005, p.98)</td>
<td>Money managers</td>
</tr>
<tr>
<td>English (1986, p. 63)</td>
<td>They “shy away” from start-up ventures</td>
</tr>
<tr>
<td>Kotler et al. (2004, p. 102)</td>
<td>They tend to have well-recognized reputations and a more professional approach than angel investors</td>
</tr>
<tr>
<td>Sherman (2005, p. 173)</td>
<td>They expect to have some controls, checks and balances built into the deal</td>
</tr>
</tbody>
</table>
## TABLE 1.3  Motivations for the research

<table>
<thead>
<tr>
<th>Item</th>
<th>Section</th>
<th>Page</th>
<th>Relevant issues concerning business angel investors and venture capitalists in the private marketplace</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2.4</td>
<td>p.37</td>
<td>Access to capital and the location of same is a concern for start-up and similar ventures.</td>
</tr>
<tr>
<td>2</td>
<td>2.4</td>
<td>p.37</td>
<td>Capital is not available from traditional sources.</td>
</tr>
<tr>
<td>3</td>
<td>2.5.1</td>
<td>p.44</td>
<td>How important is private company as investment vehicle?</td>
</tr>
<tr>
<td>4</td>
<td>2.5.1</td>
<td>p.45</td>
<td>What is the relevance of corporate structure for ownership and control issues?</td>
</tr>
<tr>
<td>5</td>
<td>2.5.4</td>
<td>p.46</td>
<td>A consideration of the control issues in family businesses and the difficulty in attracting professional managers, investors.</td>
</tr>
<tr>
<td>6</td>
<td>2.5.5</td>
<td>p.47</td>
<td>What concessions need to be made by the entrepreneur and investor to secure deal? Loss of equity v. loss of liquidity.</td>
</tr>
<tr>
<td>7</td>
<td>2.5.5</td>
<td>p.48</td>
<td>What steps should entrepreneur take to provide funding structure allowing investor security? Consideration of limited liability and apportioned share of venture.</td>
</tr>
<tr>
<td>8</td>
<td>3.1.1</td>
<td>p.61</td>
<td>The significance of the entrepreneur in attracting investors.</td>
</tr>
<tr>
<td>9</td>
<td>3.1.1</td>
<td>p.61</td>
<td>The characteristics, personality and experience of the entrepreneur as essential to attracting investors.</td>
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<tr>
<td>10</td>
<td>3.1.1</td>
<td>p.62</td>
<td>Understanding why only some entrepreneurs succeed.</td>
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Table 1.2 (continued)

<p>| | | | |</p>
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</table>

These issues reveal a pattern of emerging themes that may arise in Table 1.4
### TABLE 1.4   Emerging themes and classification from the research

<table>
<thead>
<tr>
<th>Item</th>
<th>Emerging themes</th>
<th>Classification</th>
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<tbody>
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<td>1</td>
<td>Access to capital, knowing where to look</td>
<td>Access to deals</td>
</tr>
<tr>
<td>2</td>
<td>Capital not available from traditional sources</td>
<td>Access to deals</td>
</tr>
<tr>
<td>3</td>
<td>Concessions in holdings entrepreneur/investor</td>
<td>Equity/control</td>
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<tr>
<td>4</td>
<td>Funding structure for liability/ apportion holding</td>
<td>Equity/control</td>
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<tr>
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<td>Use of private company as investment vehicle</td>
<td>Equity/control</td>
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<td>6</td>
<td>Equity and control issues and enterprise structure</td>
<td>Equity/control</td>
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<td>Family succession and need to attract investors</td>
<td>Equity/control</td>
</tr>
<tr>
<td>9</td>
<td>Role of entrepreneur in attracting investors</td>
<td>Entrepreneur/management</td>
</tr>
<tr>
<td>10</td>
<td>Reasons why not all entrepreneurs succeed</td>
<td>Entrepreneur/management</td>
</tr>
<tr>
<td>11</td>
<td>The relevance of personality of the entrepreneur</td>
<td>Entrepreneur/management</td>
</tr>
<tr>
<td>12</td>
<td>Management, business plan issues for deals</td>
<td>Entrepreneur/management</td>
</tr>
<tr>
<td>13</td>
<td>Dilution of holding in enterprise</td>
<td>Equity/control</td>
</tr>
<tr>
<td>14</td>
<td>Shift in management in growing enterprise</td>
<td>Entrepreneur/management</td>
</tr>
<tr>
<td>15</td>
<td>Entrepreneur requires competent capital</td>
<td>Entrepreneur/management</td>
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<tr>
<td>16</td>
<td>Networks and their importance</td>
<td>Investor input</td>
</tr>
<tr>
<td>17</td>
<td>Risks relating to marketplace and exiting deal</td>
<td>Investor input</td>
</tr>
<tr>
<td>18</td>
<td>Government funding and tax assistance</td>
<td>Investor input</td>
</tr>
<tr>
<td>19</td>
<td>Venture capitalists’ investment criteria, commonsense principles</td>
<td>Investor input</td>
</tr>
<tr>
<td>20</td>
<td>Non-financial factors for business angels</td>
<td>Investor input</td>
</tr>
<tr>
<td>21</td>
<td>Business angel investors have need to access deals</td>
<td>Investor input</td>
</tr>
<tr>
<td>22</td>
<td>Valuation of holding in enterprise</td>
<td>Equity/control</td>
</tr>
<tr>
<td>23</td>
<td>Relevance of being investor ready</td>
<td>Entrepreneur/management</td>
</tr>
<tr>
<td>24</td>
<td>Venture capitalist lack of market, financial data, “gut feel”analysis</td>
<td>Investor input</td>
</tr>
<tr>
<td>25</td>
<td>Venture capitalist need for due diligence</td>
<td>Investor input</td>
</tr>
<tr>
<td>26</td>
<td>Managerial capacity</td>
<td>Entrepreneur/management</td>
</tr>
<tr>
<td>27</td>
<td>Venture capitalist more research and experience than business angels</td>
<td>Investor input</td>
</tr>
<tr>
<td>28</td>
<td>Business angel softer investment factors than venture capitalist</td>
<td>Investor input</td>
</tr>
</tbody>
</table>
Chapter 2

Business angels and venture capitalists in the literature

“That I, considering everywhere
Her secret meaning in her deeds,
And finding that of fifty seeds
She often brings but one to bear”.

In Memoriam, Alfred, Lord Tennyson


An extensive literature exposes investors in public companies being removed from the day-to-day operations. This contrasts with the private marketplace investors in early- and later-stage private companies who may choose to become active early in the operation of the venture. Public companies maintain systems and follow procedures requiring a higher level of scrutiny and reporting than private companies and have funding needs that are generally beyond the resources of the early and later-stage investors. The financial returns for investors in public companies may take the form of dividend payments and share allotments, whereas private marketplace investors in private companies may forego a ready return on investment in anticipation of a share of profits on the future sale or public listing of the enterprise.

*Uncertainty* and *risk* are moderating influences on investment. The degree of uncertainty and level of risk inherent in a private company investment may be compensated by financial returns on investment beyond those achievable in the public
domain. The risk and returns associated with investment in public and private companies may determine the investment decision.

Public companies can provide the opportunity to invest in a passive capacity with the investor taking comfort in the security that is offered through the size of the company, the regulatory and reporting obligations with which it needs to comply, and the high level of public attention that the public company attracts from government, the media and the professional investment advisory community.

Private companies operate in the private marketplace without the level of scrutiny and reporting requirements of a public company. Thus an investor, either personally or through a trusted advisor, should undertake due diligence as to the risk and return of the enterprise. Issues may concern a lack of formal documentation in company records or financial reports, equity ownership, loan security requirements, control and management of the venture and the level of active involvement by the investor.

2.1 Types of investors

Whilst recognizing that some entrepreneurs through “founder’s capital” and their families and friends through “emotional capital” may indeed be the initial sources of funding of the enterprise, the emphasis in this research is external forms of funding by private equity investors - business angels and venture capitalists.

2.1.1 Business angels

Previous research has emphasized the difficulty of accessing private marketplace data, in particular business angel investment, because of the attendant level of privacy and
sometimes secrecy. Indeed, little research has been conducted on business angels because of the market’s disorganized, fragmented and anonymous nature, which makes it difficult to identify them and for them to locate acceptable deals (Coveney and Moore 1997). Transactions in private equities are not subject to public disclosure (Prowse 1998). Hindle and Wenban (1999) note the difficulty of identifying the participants, as there is no public reporting of the transactions. Similarly, identifying informal investors is difficult because of “their apparent preference for anonymity” (Reitan and Sorheim 2000, p.132). This point is also noted by Steier and Greenwood (1999) and Van Osnabrugge (2000). As Allen (2003, p. 436) has observed, “angel investors can’t be found in a phone book and they don’t advertise. In fact their intentions as investors are often well hidden until they decide to make themselves known”. Consequently, relatively little is known about the process by which entrepreneurs connect with these private investors. Mason (2002, p.1) has commented “that the business angel investment market [in the United Kingdom] is an invisible marketplace”.

Whilst locating wealthy individual investors is not easy, this can occur through matching services that introduce entrepreneurs to private investors (Kuriloff and Hemphill 1988). Bivell (2007) lists a business angel market within Australia of 24 business angel networks. The Australian Association of Angel Investors Ltd (AAAI) incorporated in 2007 represents Australian business angel networks, individual business angels and organizations supporting the growth of business angel investment in Australia (AAAI 2009). The 2008 National Angel Survey by AAAI noted that the number of angel groups had increased from three in 2006 to 10 by the end of 2008. Prowse (1998) considers that business angels tend to invest close to home so a national network may not be a more effective means of accessing these investors who are
heterogeneous in composition. Knowledge of the investment decision-making processes employed by business angels is still evolving (Prasad et al. 2000).

2.1.2 Venture capitalists

Sometimes the term “venture capitalist” is intended to include business angel investment and investors, though generally (and quite appropriately) there is a sharp distinction between the two groups. Occasionally this type of investor is referred to by other titles depending upon the type of investment and the stage at which that investment is made (Benjamin and Margulis 2005). Marks et al. (2006, p.3) have described the term “venture capitalist” as probably “one of the most misused financing terms (in) attempting to lump many perceived private investors and investment types into one category”. Venture capitalists generally invest in unlisted companies (Connolly and Tan 2002), most commonly through a corporate structure and not as individuals. Shares are issued as security for the investment (Mason 2002).

The role of the venture capital investor is important when the personal financial resources are exhausted and the entrepreneur needs alternative funding. Venture capitalists take an active role in the company as advisors or on the board. English (1986, p.63) has pointed out that venture capitalists usually “shy away” from start-up ventures and focus on businesses requiring expansion funds with a track record in management and growth. Some controls, checks and balances are structured into the deal and the governance of the company (Sherman 2005).

The term “venture capital” is not used uniformly throughout the investment community. Sometimes it refers to any external equity investment in a start-up or early-stage venture, including funding by angel investors (Berger and Udell 1998). Wiltbank et al. (2009, p.118) have suggested that the angel investor acts as “an informal venture
capitalist”. The terms “private equity” and “venture capital” can be interchangeable (Connolly and Tan 2004). Hindle and Rushworth (2002, p.17) have described investment in early stage enterprises as “entrepreneurial activity”. Bygrave (1994) has used the term “venture capital” to describe the financing as being seed and early-stage financing, start-up financing and first-stage financing, which covers all stages up to expansion financing at the point where the company is actually producing and looking for working capital. English (1986, pp.62-63) has referred to venture capital within Australia as “capital seeking higher than normal returns and taking higher than normal risks – that means it is expensive capital to the small business owner” . Figure 2.1 depicts where business angels and venture capitalists fit in the mix.

**FIGURE 2.1  Where angels (and venture capitalists) fit in the mix**

<table>
<thead>
<tr>
<th>Idea development</th>
<th>Seed</th>
<th>Start-up</th>
<th>Early and late expansion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders and family</td>
<td>Friends</td>
<td>Business angels</td>
<td>Venture capitalists</td>
</tr>
</tbody>
</table>

High risk  
Intuitive, emotional  
Informal  
Individual/independent  

Lower (but still high) risk  
Rigorous  
Formal  
Syndicated/pooled

*Source: Frederick et al. 2006, p. 396.*
2.2 Characteristics of different types of investors

This section discusses certain characteristics of private marketplace investors be they business angels or venture capitalist and the possible influence of those characteristics upon the investment decision.

2.2.1 Business angel characteristics

Business angels have been characterised in a number of ways: as “wealthy individuals willing to invest in high risk deals offered by entrepreneurs whom they admire and with whom they wish to be associated” (Benjamin and Margulis 2005, p.7); as people who “provide equity capital to companies without the intervention of a third party, such as a venture capital firm. To put it another way, angels invest directly, not through intermediaries” (Kotler et al. 2004, p.59); or as “private equity investors who invest both capital and business expertise in early stage companies” (Payne and Macarty 2002, p.331). Other descriptions include: “wealthy investors who invest in small firms in amounts that are typically too small to be of interest to professional venture capitalists” (Steier and Greenwood 2000, p.164); “high net worth individuals who make a limited number of investments, typically in early stage firms” (McKaskill 2006, p.9); “wealthy individuals who provide financing to the company in the very early stages” (Elitzur and Gavious 2003, p.710); “often successful business persons willing to finance start-ups” (Wessner (2002, p.352); and as “private individuals who supply risk capital dollars directly” without the intervention of a third party such as a broker (Gaston 1989, p. 1).

They access deals through networks and tend to invest more quickly than formal investors and with lower levels of due diligence. Business angels are said to distinguish between two types of informants: close associates with considerable investment
experience ties and mere acquaintances with weak ties through a referral. The reliance is generally upon the stronger association (Fiet 1995).

‘Angel investment’ is also known as “seed capital”. Usually it is provided by wealthy individuals for what may be high-risk deals or ventures (Freear et al. 1994). Angel capital thus involves a direct approach between the entrepreneur and the angel investor and, unlike most other categories of external funding it is not intermediated (Berger and Udell 1998). Entrepreneurs may have no proven success in managing such ventures.

Sherman (2005, p.71) has noted that “angel investors have become a critical source of seed capital at a time when venture capital funds are leaning toward latter-stage investments”. These angel investors are said to play a critical role in the finance chain by providing the majority of early stage finance, as much as 80 per cent of seed and start-up capital (Wessner 2002).

There is a funding gap in the investment marketplace as these early stage investors turn down a high proportion of proposals seeking expansion capital (Duxbury et al. 1996). Most people are said to be risk-averse and therefore require compensation for taking on perceived risk (Freear et al. 2002). Freear et al. (2002, p. 282) believe angel investors who invest at this stage are a breed apart and liken them to “wild flowers”. At the same time they acknowledge that “some (risk-takers) require less compensation than others (risk- avoiders)” (Freear et al. 2002, p.276).

An entrepreneur may need to establish a connection with a seed, start-up or early-stage investor and thereafter present a deal or proposition which leads to funding from that source (Baumback 1988). Seed capital can be expensive, often from the lender of last resort and, from the lender’s perspective entrepreneurial ventures can be risky with the lender foregoing investment in a safer or surer venture. Conversely, investors may be
seen as enablers of growth in allowing entrepreneurs to undertake projects and pursue opportunities which might otherwise not be funded (Baeyens and Manigart 2005).

In the United States, the home of the greatest number of business angels (in 1998 the number was estimated to be 1.5–2.5 million), they are better known technically as “accredited” investors with a net income of more than US$1 million and annual income exceeding US$200,000 in the most recent two years (Acs and Tarpley 1998). Four hundred thousand angel investors were active in the United States in 1999, investing US$30–40 billion per year in approximately 50,000 ventures (Sohl 1999). By 2002, a total of 250,000–300,00 active angel investors were investing up to US$20 billion in 30,000 ventures (Benjamin and Margulis 2005; Sherman 2005), representing over 80 per cent of the total start-up and seed capital investment in the US at that time (Sherman 2005). By 2005 the figure had increased to 400,000, with many more who were passive (Benjamin and Margulis 2005). With venture capitalists looking at investments in the United States from a minimum of about US$4 million, there was a broad window of opportunity for angel investors below that amount (Sherman 2005). Allen (2003, p.436) found that business angel investors normally invest between US$10,000 and US$500,000 in start-up and early-stage funding, tend to be well educated, may themselves be entrepreneurs and prefer to be actively involved. These investors lean towards manufacturing, energy and service businesses, and high-tech businesses and away from retail, and invest for a period of three to seven years, seeking returns of a multiple of 10 for a start-up and five for an early-stage investment.

Historically, U.S. business angel investment assisted more than 10 times the number of firms as their venture capital counterparts (Freear et al. 1994). The angel marketplace within the United States comprising small companies represents 47 per cent of all sales,
51 per cent of the private gross domestic product, 52 per cent of all business net worth, and 99 per cent of all U.S. companies (Benjamin and Margulis 2005). In 2001, approximately 60 per cent of the jobs created and 55 per cent of all innovation came through these small companies (Benjamin and Margulis 2005).

Benjamin and Margulis (2005, p.7) have categorised business angels as value-adding, deep pocketed, investor partners, families of investors, socially responsible, manager-investors, consortia, unaccredited investors and barter investors, in essence “private informal venture capitalists” investing in companies that would not qualify for later-stage venture capital because of the imposition of rigid criteria. The profile of a high network investor in this marketplace is a male, usually a self-made millionaire aged 46–65 years with a postgraduate degree, a minimum annual income of US$100,000 and often technical and previous management experience gained through having started up, operated or sold a successful business. Whereas investment opportunities are sourced primarily from friends and trusted associates, many investors would like more investment opportunities than the present informal referral system permits.

Within the United Kingdom business angels have been defined as “high net worth individuals (mostly self-made) who invest their own money in unlisted businesses” (Mason and Harrison 2002a, p.272.) They are said to be the main investors in entrepreneurial businesses at various early stages of the growth cycle, that is, at the seed, start-up and early-stage capital raisings. Illustrating the significance of government’s fiscal policies, Morris (1984, p.120) has observed that “private investors were nearly extinct, until changes in the tax rules encouraged people to make equity investments in small firms”. Mason (2002, p.1) has defined the business angel investment market as comprising “private individuals (business angels) who make
venture capital investments in some unquoted companies”. Business angels are part of the informal venture capital market, operating without geographical restrictions with a significant minority (24 per cent of participants in the study by Harrison et al. (2003)) making long-distance investments.

Research in Scandinavia confirms that business angels are extremely difficult to identify, preferring to remain anonymous. There are no directories or public records of individual investors (Landstrom 1993; Lumme et al. 1996; Muzyka et al. 1996; Landstrom 1998; Dahlqvist et al. 2000; Reitan and Sorheim 2000; Sorheim and Landstrom 2001; Saetre 2003; Maula et al. 2003). The business angel profile is similar to angels in other investor communities (Landstrom 1993; Landstrom 1998; Mannstrom and Landstrom 2006). Networks - friends and business associates - are their means of identifying new investment opportunities. Investors are likely male, aged 45–64 years, financially well-off, with approximately half holding a university degree. Nearly all have entrepreneurial experience and a high proportion have management experience (Landstrom 1998). Swedish angels have 11 per cent of their wealth in informal investments, and 63 per cent make such an investment through a family-owned company, the Swedish tax system providing a benefit for such investment. Norwegian informal investors have a similar profile: male, 35–55 years of age, highly educated, extensive work and management experience, financially secure with high incomes and net worth and making one to two investments a year (Sorheim and Landstrom 2001).

The study of active business angels in Finland by Lumme et al. (1996) confirmed that successful investors there spend more of their careers in management positions in large companies and place greater weight upon the fun and satisfaction gained from being involved in entrepreneurial ventures. These investors receive more investment
opportunities and take more precautions than unsuccessful or inexperienced investors in requiring more protective clauses in the funding contract (Parhankangas et al. 2005). The importance of prior entrepreneurial experience and competency, a function of age, suggests that a program bringing together young and committed aspiring entrepreneurs with older business founders may increase the rate of entrepreneurship (Rotefoss and Kolvereid 2005). A transition of experience and commercial know-how should occur.

Tashiro (1999) noted a basic similarity in the profiles of business angels in the East and the West. Japanese business angels are wealthy, well educated, with a management background and a preference to invest in high-tech businesses. There is also a level of altruism in their behaviour and less concern about purely monetary rewards. Japanese investors tend to be older than their western counterparts and with less investment experience (Tashiro 1999). A very low proportion has an engineering background, which is of consequence in the high tech ventures, in particular. Perhaps because of the relatively small geographical size of Japan, investors have no particular geographical issues in terms of the investment location and they have only a limited interest in networking, in sharp contrast with investors in the United States and the United Kingdom. Hindle and Lee’s (2002, p. 174) comparison of the characteristics of business angels notes that the sourcing of the angel connection is not through family ties with three-quarters of angel investors become aware of the credibility of the entrepreneur through the workplace.

Lesonsky (2007) categorises angel investors as ‘affiliated angels’ and ‘non-affiliated angels’, the former having contact with the entrepreneur or enterprise but not necessarily related to nor acquainted with the entrepreneur; and the latter without any connection with the entrepreneur or the business. It makes sense for the entrepreneur to
first seek an affiliated angel who is familiar with the entrepreneur and (or) the business and who may have a vested interest in the relationship.

Frederick, Kuratko and Hodgetts (2006) have suggested that angels can be classified into five basic groups:

- **Corporate angels**, who may have been previously active in the corporate world and who are now retrenched or retired.

- **Entrepreneurial angels**, who are generally individuals owning and operating successful businesses with income and wealth to invest, almost always within their areas of expertise. These investors require a seat on the board of the company structure but rarely assume managerial duties.

- **Enthusiast angels**, generally aged 65 and older, wealthy and interested in deals as a hobby, with no wish to be involved in management. They invest small amounts.

- **Micro-management angels**, who are wealthy and serious investors and who require representation on the company board. If the business is performing poorly they attempt to bring in management.

- **Professional angels**, who are in professions and like to invest in products and services with which they have experience. They rarely seek a seat on the board.

Table 2.1 summarises business angels’ characteristics from a number of studies.
TABLE 2.1  **Business angel characteristics**

<table>
<thead>
<tr>
<th>Study</th>
<th>Business angel characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bodde (2004, p. 126)</td>
<td>They are “animated by considerations that reach beyond the purely financial”</td>
</tr>
<tr>
<td>Freear et al. (2002, p. 276)</td>
<td>A breed apart, like “wild flowers”</td>
</tr>
<tr>
<td>Goldstein (2002, p. 143)</td>
<td>They still enjoy the challenge and can tolerate the risks of venture-type investment</td>
</tr>
<tr>
<td>Umesh et al. (2007)</td>
<td>Often have an intrinsic interest in a specific industry</td>
</tr>
</tbody>
</table>

2.2.2 Venture capitalist characteristics

Venture capitalists operate in venture capital firms and prefer varying degrees of industry diversity and geographic scope in their investments. Firms that specialize in early stage ventures prefer less industry diversity and a narrower geographic scope than those that invest in later stage ventures (Gupta and Sapienza 1992).

In the United States the emergence of venture capital firms began in California in 1958, with the late 1960s and early 1970s giving rise to the Silicon Valley complex. This growth accelerated in the late 1970s and early 1980s, with the emergence of venture capital “megafunds” in the form of venture capitalists pyramided partnership funds (Florida and Kenney 1988, p. 311) into the 1990s. New venture creation was seen to be “the sine qua non of future productivity gains” (Berger and Udell 1998, p. 614) with the rise of successes such as Microsoft, Genentech and Federal Express.

Zacharakis and Meyer (1998) note that, whilst venture capitalists are often considered expert in identifying and deciding when to invest, their judgements may be clouded by over-confidence and by a reluctance to cut their losses when an investment fails to prove successful. Venture capitalists do not appear to have a strong comprehension of the factors which influence their decision-making process, with obvious implications for
the success of the investment undertaken. They may suffer from information overload (e.g., business plan, outside consultants, due diligence) with the resulting “noise” created making it difficult to be fully aware of the intuitive decision taken. As a result, venture capitalists might well be encouraged to step back and re-evaluate their decision making process. Birmingham, Busenitz and Arthurs (2002) have suggested that venture capitalists may make errors in their judgements and that those venture capitalists who don’t take steps to counter their biases and information-processing errors are more likely to miss problems and negative signals and may continue to invest and escalate their commitment in a failing venture. When venture capitalists move in and out of a syndicate, they are less likely to engage in this escalation of commitment.

Venture capitalists’ overconfidence can impact negatively on the accuracy of decisions, whilst more information being available to make the informed decision may make the decision even more complex (Zacharakis and Shepherd 2001). Said to be “intuitive decision-makers” (Zacharakis and Shepherd 2001, p. 325) venture capitalists might be better informed by reducing over-confidence and using actuarial decision aids that decompose decisions into core components, such as cognitive maps - simplified visualization processes required to effectively understand venture risk, particularly for seed and early-stage ventures.

The pressing need in making a financial assessment is to reduce the level of ambiguity in the messages being received by the investor from the chaotic environment of the emerging enterprise, thereby helping the investor “to maintain a sense of orderly patterning in dynamic and complex business landscapes” (Moesel and Fiet 2001, p.187). Benjamin and Margulis (2005, p.246) have described a “prescreening” process that these investors undertake during the in-depth due diligence investigation. Designed
to weed out ventures that do not justify further interest, it entails a review of the business plan, the source of the deal, the advisers to the enterprise, any endorsements of the founders and the enterprise, whether there is any chemistry between the parties, and various strategic, risk and exit factors. The present study takes these insights into account in the construction of the questionnaire in Chapter 4.

Little research has attempted to validate the criteria used by venture capitalists to assess the potential viability and success of a new enterprise (Riquelme and Watson 2002). Applying “commonsense theories” validates the actual outcomes concerning the success of the enterprise. Venture capitalists’ beliefs as to the reasons for success in the venture can also be applied in the negative when a venture fails. For example, the characteristics of the entrepreneur such as staying power or determination may be seen as poor managerial skills or inadequate marketing of the product.

An assessment of whether the criteria have been successfully calibrated against actual outcomes suggests that a predictive model based on data is a better method of estimating the outcomes of new ventures than decisions based on the classifications of even experienced venture capitalists (Astebro 2003). This model was based upon data from over 500 new Canadian ventures, predicting the outcomes in 83 per cent of cases. Seasoned venture capitalists had an accuracy rate between 17 and 40 per cent. Humans have difficulty in processing large amounts of data in parallel and in distinguishing between valid and invalid variables and selection sample bias and data truncation. They can exhibit judgment biases and a tendency to be over-confident (Astebro 2003). The significance of a model such as that developed by Astebro (2003) is that it could be used to screen venture capital applicants with a considerable saving of time and less likelihood of error. However the limitations need to be taken into account. The
statistical model has been calibrated to screen only seed and early-stage investments. It
does not measure return on investment. Nor does it substitute for due diligence
investment review following the initial screening process. The characteristics of venture
capitalists are summarized in Table 2.2.

### TABLE 2.2  Venture capitalist characteristics

<table>
<thead>
<tr>
<th>Study</th>
<th>Venture capitalist characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Astebro (2003)</td>
<td>A predictor model may have better results than experienced venture capitalists</td>
</tr>
<tr>
<td>Barrow (1993)</td>
<td>Venture capital fund manager only looking for winners</td>
</tr>
<tr>
<td>Birmingham et al. (2002)</td>
<td>Venture capitalists may make errors in judgment and continue to invest unawares</td>
</tr>
<tr>
<td>Moesel and Fiet (2001)</td>
<td>Need to reduce the level of ambiguity and maintain a sense of orderly patterning</td>
</tr>
<tr>
<td>Riquelme and Watson (2002)</td>
<td>Little research on validating venture capitalist criteria in assessing potential of new venture</td>
</tr>
<tr>
<td>Zacharakis and Meyer (1998)</td>
<td>Judgment may be clouded by over confidence</td>
</tr>
<tr>
<td>Zacharakis and Shepherd (2001)</td>
<td>More information may make an informed decision even more complex</td>
</tr>
</tbody>
</table>

2.3  The investment marketplace

The Australian Bureau of Statistics states that the value of funds committed to venture
capital and later stage private equity within Australia was A$15.1 billion as at 30 June
2007. By 30 June 2008 the total was A$17.1 billion, an increase of 13 per cent over the
previous year (ABS 2009). These figures do not include seed and early-stage funding.
The Australian Government’s Austrade (2007) noted that by late 2006 the Australian
private equity and venture capital industry included 139 investment firms managing
A$17 billion, including 53 firms that were predominantly early-stage investors. The
Australian Stock Exchange as at 31 December 2008 had 2226 companies listed with a domestic market capitalization of A$1.29 trillion.

2.3.1 An understanding of the size of the Australian private marketplace

According to the International Monetary Fund, the Australia economy measured in 2008 by Gross Domestic Product was valued at US$1,010,699 million and ranked 14th in the world. As such, the Australian marketplace might be regarded as relatively insignificant in global terms. The U.S. economy in Gross Domestic Product terms was US$14,264,600 million, approximately 14 times larger than the Australian economy, whilst the U.K. economy Gross Domestic Product was approximately 2.6 times larger than the Australian economy. McNaughton and Bell (2004) consider that the critical factor in international expansion is the capacity of small Australian firms to sustain rapid growth with the limitations imposed by the relative small size of the Australian economy and the shortage of local markets. Traditionally this might have been an incremental process like “rings in the water” (Madsen and Servais 1997, p.561), whereas the internet provides a ready platform to transform a concept or idea into a multinational, multi-billion dollar enterprise such as Google (Batelle 2005). Such enterprises are referred to as “born globals” (Madsen and Servais 1997; McNaughton and Bell 2004).

(i) The business angel marketplace

The business angel marketplace is substantial, albeit largely misunderstood and inefficient, with research on angel investment acutely absent from the current knowledge base (Sohl 2003). In the United States and Scandinavia the angel capital
market is approximately 10 times larger than the venture capital market (Frederick et al. 2006). U.S. business angels fund 30–40 times more entrepreneurial firms than venture capitalists (Van Osnabruggge 2000). Jensen (2002, p.300) states that angel investment exceeds venture capital investment by a factor of two to 10 with angel investment being “the largest pool of risk capital in the United States” (Allen 2003, p.43).

The angel market in the United Kingdom is estimated to be four times larger than the formal venture capital market (Aernoudt 1999). There were around 20,000 business angels in the United Kingdom in 1998–1999 who invested £500 million in about 3,000 businesses (Mason and Harrison 2000, p.144). The “informal venture capital marketplace” accounts for eight times as many businesses raising finance from business angels as from institutional venture capital fund providers, although the actual amount invested by both groups is roughly equivalent. Mason and Harrison (2000) estimate that the amount of angel investment capital in the United Kingdom is roughly equivalent to that of venture capital placed through institutions in start-up and early-stage ventures. In 1999, the figures were £220 million in angel funds compared with venture capital of £288 million (Mason and Harrison 2000, p.144). However, these figures do not reflect the difference in activity between the two markets. The average investment in the business angel market is much smaller and the volume of deals is higher than in the venture capital market: One study noting 2,625 investments compared with 241 venture capital deals (Mason and Harrison 2000). Eight times more businesses raised capital from business angel investors than from institutional firms in the venture capital marketplace (Frederick et al. 2006). When informal investment for start-up and growing businesses is as much as one or two per cent of a nation’s GDP, it is a significant factor in that economy (Bygrave et al. 1994). Business angels are considered more attentive than venture capitalists to avoiding bad investments with limited ability to diversify, but
may be better able to select and evaluate deals and/or value add, thereby generating exceptional returns. However it should be borne in mind that there is nothing to stop a venture capitalist from entering this start-up space, particularly where the start-up has the desired quality and has significant potential. This is especially so if the venture is in high technology (Timmons and Bygrave 1986). In this respect Davila et al. (2003) claimed that the funding support of venture capitalists for a particular start-up enterprise provides a relevant signal as to the quality of the venture.

Angel funding is the largest source for seed and start-up businesses, in Australia and overseas (Golis 2002) and the nature, positioning and role of business angels is set out in Table 2.3 hereunder.

<table>
<thead>
<tr>
<th>Study</th>
<th>Types of angels</th>
<th>Involvement in enterprise</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allen (2003, p. 436)</td>
<td>Networked and quick to act</td>
<td>Lower levels of due diligence than venture capitalists</td>
</tr>
<tr>
<td>Benjamin and Margulis (2005, p.7)</td>
<td>Private informal venture capitalists</td>
<td>Value adding, active investors</td>
</tr>
<tr>
<td>Frederick et al. (2006)</td>
<td>Five types:</td>
<td>Previously active in corporate life</td>
</tr>
<tr>
<td></td>
<td>Corporate</td>
<td>Seat on board, not managerial</td>
</tr>
<tr>
<td></td>
<td>Entrepreneurial</td>
<td>No wish to be involved, a hobby</td>
</tr>
<tr>
<td></td>
<td>Enthusiast</td>
<td>Seat on board, can be involved</td>
</tr>
<tr>
<td></td>
<td>Micro-management</td>
<td>Rarely seek a seat on board</td>
</tr>
<tr>
<td>Harrison and Mason (2002, p. 272)</td>
<td>High net worth individuals</td>
<td>Invest in entrepreneurial businesses</td>
</tr>
<tr>
<td>Landstrom (1993)</td>
<td>Experienced entrepreneurs</td>
<td>Assist at board level and consult</td>
</tr>
<tr>
<td>Lesonsky (2007)</td>
<td>Affiliated</td>
<td>May have contact with entrepreneur</td>
</tr>
<tr>
<td></td>
<td>Non-affiliated</td>
<td></td>
</tr>
<tr>
<td>Landstrom (1993)</td>
<td>Networked</td>
<td>No contact</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Involved at board level or consults</td>
</tr>
</tbody>
</table>
(ii) The venture capital marketplace

Venture capitalists have recognized reputations and are more professional than angel investors (Kotler et al. 2004). Venture capitalists are more easily accessible and visible in their public profile and location, with a presence in the centres of commerce. In Australia, the Australian Private Equity & Venture Capital Association Ltd represents the venture capital industry’s participants and encourages investment (AVCAL 2008).

In late 2006, the more formalized private equity and venture capital industry was active and engaged, with a combined total of 139 investment firms managing A$17 billion in capital (Australia Government Invest Australia 2007). According to Anthill Magazine (2010) in 2008 Australian venture capital firms made 20 investments for an aggregate investment of A$57.8 million. By way of contrast, in 2001 venture capital firms made 122 investments for around A$610 million. In the financial year 2009, funds raised by venture capital firms fell by 19% from the previous year to A$263 million as a result of the global financial crisis. Total new venture capital commitments declined by two consecutive quarters in the first half of 2009 reflecting the difficult fundraising environment faced by the sector. All new commitments were for early stage or balanced venture capital funds with no commitments for seed investments (2009 Yearbook AVCAL) whilst the average venture capital investment round size fell from almost A$2 million in the financial year 2008 to A$1 million in the financial year 2009.

The United States venture capital marketplace in 2003 represented a total of US$60 billion in over 800 venture capital firms. In the United Kingdom the venture capital marketplace has been described as “institutional”, a highly concentrated marketplace in a geographical sense (Harrison et al 2003, p.116). Venture capitalists are more formally structured than business angels in their operations, business location and environment.
Venture capital is not a suitable funding vehicle for an undercapitalized company (Bhide 2000; Umesh et al. 2007). The reporting requirements imposed and the presence of a venture capitalist on the board of directors would be anathema to a fledging entrepreneur focused on the daily operation of the venture (Forsyth et al. 1991). The venture capital industry comprises two broad categories of funds: ‘captive funds’, which invest their own capital and ‘independent funds’ which manage other peoples’ money (Denny 2000). Corporate venture capital investments should not be grouped with business angel investments, with differing motivations, decision-making processes and types of investments (Mason and Harrison 1997). The venture capital marketplace lacks definition, with the entrepreneur having to deal with this vagueness in the “scattered, varied and confusing” venture capital marketplaces (Torrence 1986, p.248).

The U.K. venture capital market in 2000 was the largest in Europe with about half of all venture capital investment. It was second only in size to the United States (Denny 2000) and comparable as a percentage of gross domestic product. However, only five per cent of available capital was directed towards start-up and early stage investment (Denny 2000). Table 2.4 summarizes research into the venture capitalist marketplace.
### TABLE 2.4  The venture capitalist marketplace

<table>
<thead>
<tr>
<th>Study</th>
<th>Types of venture capitalists</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denny (2000)</td>
<td>Those who invest their own capital and independents who manage investors’ money</td>
</tr>
<tr>
<td>Forsyth et al. (1991)</td>
<td>Venture capitalists’ reporting requirements and presence on the board anathema to fledging entrepreneur</td>
</tr>
<tr>
<td>Gupta and Sapienza (1992)</td>
<td>Early stage venture capitalists prefer less industry diversity</td>
</tr>
<tr>
<td>Harrison et al. (2003)</td>
<td>Institutional, formally structured and located in business environment</td>
</tr>
<tr>
<td>Mason and Harrison (1997)</td>
<td>Corporate, not like business angels</td>
</tr>
</tbody>
</table>

#### 2.4  The nature of investment

Principles of investment decision-making indicate that more benefits (in the form of profits or cash flow) are preferred to less benefits, near-term benefits are preferred to more distant benefits, and safe investments are preferred to risky investments (Kotler et al. 2004). Whilst these principles may hold in general, it is also the case that start-up ventures receive funding through the investment of capital, despite not being able to demonstrate those metrics (Kotler et al. 2004). This raises the question of what factors might influence the decision to invest in a start-up venture which, by definition, has very recently started operating and has no demonstrable performance record. Anson (2002, p. 261) uses the term “venture capital” to describe the supply of equity financing to start-up ventures unable to attract funding from traditional sources, with venture capitalists investing in start-up ventures provided there is a reasonable rate of return. Kotler et al. (2004, p.21) speak of the “high level of risk” in start-up ventures. The nature of the decision to invest in start-up and early-stage ventures is central to this thesis and initially revolves around access to capital.
A start-up venture needs initial capital to generate the start-up and maintain momentum until the business can begin to fund itself. After this, the enterprise requires expansion capital to drive growth. The importance of investment capital is difficult to overestimate. Indeed, capital has been described somewhat romantically as “the lifeblood of a growing business” (Sherman 2005, p.3) and as “the coal that stokes the fires of entrepreneurship” (Benjamin and Margulis 2005, p.77). Ronstadt (1985, p.645) has observed that the “entire life cycle of a venture is punctuated by a recurring theme – the need to obtain capital at a reasonable price”. These comments suggest that one of the most difficult tasks the business decision-maker faces is where to look for capital (Ronstadt 1985). In simple terms, an investment of capital takes the form of cash or something that is convertible into cash (Kotler et al. 2004). The capital is a rubbery term, and what is meant by ‘capital’ deserves closer examination.

### 2.4.1 Sources of capital

Two widely used accounting classifications of capital are fixed capital and working capital. Fixed capital refers to assets that have a continuing and often long-term connection to a business (for example, real estate, fixtures and fittings), while working capital is usually thought to comprise cash reserves and assets readily convertible into cash for use in payment of current liabilities in day-to-day operations (for example, rent and wages). However, there are other ways of classifying capital and doing so in terms of how capital is ‘sourced’ helps understand the nature of investment, especially in start-up enterprises.

Founders of start-up enterprises are particularly concerned with funding their ventures. These founders are individuals who undertake substantial risks in order to establish a
business enterprise. As such, they are also defined as entrepreneurs. In the first instance, in order to fund their enterprises, entrepreneurs may need to rely upon their personal financial resources (Bhide 2000; Ekanem 2005). Bruno and Tyebjee (1985, p.65) describes this initial capital as the “seed money stage” of an enterprise, while Bodde (2004, p.116) refers to it as “founder’s capital”. Founder’s capital is the easiest and quickest source of funding, and utilizing the founder’s funds does not burden the enterprise as would debt or equity funding, requiring repayment and the capacity to refund it or surrendering a portion of equity in the business (Cohen 1990; Chandler and Hanks 1998). Whilst founder’s capital is provided only by the founder, seed funding can be provided from the founder or from external investors. Seed funding is useful in validating the concept of a business, for early product development, product feasibility studies and (or) preliminary market research (Bruno and Tyebjee 1985).

Capital-constrained entrepreneurs may take a more cautious approach by not establishing the enterprise until they have accumulated sufficient funds, whereas others may not seek external capital until a later intermediate stage of the enterprise’s growth (Schwienbacher 2007). This delayed form of “bootstrapping” capital sourcing is, in effect, an informal technique of solving financial problems and investment decisions by reliance upon previous knowledge and experience (Allen 2003; Harrison et al. 2004; Carter and Van Auken 2005; Ekanem 2005). Winborg and Landstrom (2000) consider bootstrap financing to be the method by which entrepreneurs meet the challenge of funding the venture without seeking long-term finance from lenders or new owners. Allen (2003, p.431) has noted that it involves “getting by on as few resources as possible”, and that such resources may include “savings, credit cards, mortgages, stock market accounts, and friends and family”.

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Where founder’s capital is unavailable and bootstrap financing is not viable, seed funding is sought from investors, in the first instance family, friends and supporters. Sohl (2003, p.36) has described these funding arrangements as being “poorly structured deals typically entered into without a great deal of due diligence”. The practice by entrepreneurs of borrowing from friends or relatives, whilst common in start-up enterprises, is generally frowned upon by experienced operators (Kuriloff and Hemphill 1988). Potential disadvantages are that the investor may have a short time span for investment and that personal relations between the investor and the founder may be affected by the financial arrangement (Harper 1991). Baumback (1988) sees such borrowing arrangements from friends and relatives as poor business practice. This investment is almost always equity capital.

In start-up financing the highest risk capital (and therefore the potentially highest return capital) appears in the balance sheet as equity (Roberts and Stevenson 1991). Given the higher risk profile of start-up enterprises, this finance is not usually available from traditional banking sources (Harper 1991; Roberts and Stevenson 1991; Cooper et al. 1994; Reiss 2000; Kotler et al. 2004). Invariably the entrepreneur must turn to business angel or venture capital investors. The natures of both are addressed in section 2.2.

Various business investment structures are available to support the different forms of investment and allow the investor both the security of limited liability and a clearly apportioned share of the enterprise. One overriding concern for business angels and venture capitalists is ensuring that their investment is in the appropriate business structure to protect and apportion the funds.
2.5 Business investment structures

Entrepreneurs and investors have a number of options regarding the business structure through which the enterprise can function and investment can be made. The investor, business angel or venture capitalist also seeks the appropriate investment vehicle structure.

2.5.1 Legal, corporate and financial considerations

These considerations can influence the appropriate choice of investment vehicle. The entrepreneur may initially wish to operate as a sole proprietor without the complications of forming and administering a separate legal entity, but may need to re-consider that decision when seeking capital from an investor.

(i) Sole proprietorships

This early pre-corporation business structure owned and operated by only one person has been described as the easiest, quickest and least expensive of the legal structures to create and to terminate; with little in the way of government regulation and with the dual benefits of sole control and rights of the sole-owner to the profits, but with the distinct disadvantage of the entrepreneur having unlimited legal liability for the conduct of the business (Cohen 1990). There can be difficulties in acquiring debt and (or) equity when there is only one individual to carry the burden and no effective means of offering up a share in the business to an investor. A benefit is a taxation loss offset against the founder’s other income in Australia and New Zealand (Frederick et al. 2006).

(ii) Partnerships

Partnerships generally comprise the association of two or more persons carrying on as co-owners of a business for profit. From an investment perspective there are advantages
for the entrepreneur seeking capital and for the investor; insofar as additional capital and resources can be brought into the enterprise by new partners and the enterprise can survive the absence of one of the partners. On the other hand, there are the obvious difficulties that may flow from the joint and several liabilities of the partners being binding on each partner, in the disposing of an interest in the partnership, or in offering a share of the enterprise as equity when seeking finance. Frederick et al. (2006) have noted the advantages of flexibility in obtaining capital, skills and in making quick decisions, whilst acknowledging the distinct disadvantages and valuation issues that may flow when a partner retires or sells an interest in the partnership and (or) the raising of capital by the remaining or incoming partners.

(iii) Corporate structures

In the private marketplace funds may be invested through and in a corporate structure which controls the enterprise. The notion of a corporate entity to solve group relations in religious and social communities was adopted by English law almost a millennium ago and nowadays is “the dominant modern form of business association” (Redmond 2000, p.2). Clough and Mulhern (2002, p.1) have referred to the twentieth century as “the century of the corporation” in many respects.

The company is “a legal invention” (McMahon 1971, p.3). Companies became possible by mere registration under the 1844 U.K. Companies Act following the report of the Gladstone Committee, as to the raising of capital in quanta beyond the capacity of the partnership structure (McMahon 1971). In Australia the two forms of company structure are denoted by the abbreviations Pty. Ltd. (proprietary limited) and Ltd. (limited) (Frederick et al. 2006). A proprietary limited company, generally referred to as a private company, cannot make an offer to the general public to purchase its shares, whereas a limited company, known as a public company, may do so by way of a
prospectus with a view to listing on a public stock exchange. This study focuses upon investment in unlisted private companies, as distinct from listed public companies. Throughout this thesis these companies are referred to as a “private company or companies” and not a “proprietary company or companies”.

At the heart of corporation law is the fundamental principle that a corporation is an entity separate from the shareholders of it, has a legal persona that enjoys perpetual succession and may sue or be sued in its own right. This principle applies in countries that have adopted the English legal system such as Australia (Frederick et al. 2006) and in other countries with similar laws such as the United States (Cohen 1990). An important outcome of the legal principle is that a company is fundamentally different from trusts and partnerships because of its separate legal identity (Lipton and Herzberg 2006), with a corporate veil insulating the members of the company from the company itself (Tomasic, Jackson and Woellner 2002). The personal liability of a founder is limited to the amount of investment in the corporate entity (Cohen 1990) which maintains the legal capacity and powers of an individual (Kobetsky et al. 2003).

This fundamental difference makes the corporate structure a suitable investment vehicle. Other advantages are the ability to raise capital through the corporate structure, listed or unlisted, by the issue of shares and equity in the enterprise and the permanence (the ‘perpetual succession’) of the corporate structure.

2.5.2 Investment in public (listed) and private (unlisted) companies

Within Australia there is a uniform corporate code enacted by the Commonwealth Government in 2001, which regulates the conduct of both public and private companies. In this study “public” and “private” are used to describe listed and unlisted companies.
(i) Investment in public companies in Australia

Public companies may be a preferred investment vehicle for those investors with no interest in or capacity for management participation, relieving them from the burden of monitoring fellow shareholders’ contribution (Redmond 2000).

In order for a public company to raise funds from the public, the Corporations Act 2001 (Cth) requires that an offer of their securities for issue needs disclosure to investors (Section 706), and this is usually via a prospectus issued by the company detailing the terms and conditions of its fund-raising exercise. Public companies also have continuous disclosure and reporting requirements (for example, those in the ASX Listing Rules) imposed upon them by the Australian Securities Exchange.

There can be risks for individual investors in investing in public companies as noted by Clarke et al. (2003) in relation to three decades of corporate collapse in Australia. The continuing exposure of sub-standard accounting practices, lack of proper corporate governance and occasionally blatant criminal practices have accounted for the failure of some well-known Australian public companies. However, investors can be comforted in part by the obligations increasingly imposed upon directors of public companies under the Corporation Act 2001(Cth) and the common law relating to negligence (Redmond 2000). Institutional investors tend to remain tactically conservative concentrating on low- to medium-risk investments. Institutional investment in private companies presents a different risk/reward paradigm, as discussed in the following section.
(ii) Investment in private companies in Australia

Private companies in Australia are not listed on a stock exchange and cannot, except under certain strict conditions, raise funds from the general public (Kobetsky et al. 2003; Kilmartin 2005). A detailed definition of a private company is contained in Section 45A (1) of the Corporations Act 2001. In more general terms, a private company is limited in the number of shares it can offer, has no more than 50 non-employee shareholders and is not permitted to do anything requiring disclosure to investors. The privacy attaching to transactions in private companies does mean that it is difficult to obtain data for research purposes.

By the use of the private company, the founder/entrepreneur and the private marketplace investor can structure private and confidential terms for the deal to allow for both equity and (or) debt funding, free of unwanted public scrutiny.

This flexibility of financing combines with the intrinsic certainty of a private company structure to facilitate investment of funds and creation of equity in a venture (Connolly and Tan 2002; Mason 2002). Thus the private company structure meets an entrepreneur’s capital needs, secures the investor’s capital, defines the critical issue of control and facilitates the risky step of commencing a business.

The founder/entrepreneur may wish to issue different classes of shares to investors with some not carrying sufficient voting rights to take control of the day-to-day operations of the enterprise, but allowing investor shareholders to exert a level of control when matters of policy and governance are considered at the company’s extraordinary and annual general meetings. The perceived risk profile of a private company can be
affected by the proprietor being involved in running the company and having some ownership of it (Baumback 1988).

The role of a proprietor may have particular impact on the risk-return and equity/control profile of a business when the private company is also a family business. For example, the issue of retaining family control can be important for older family businesses and may increase the level of risk perceived by a potential investor (Romano et al. 2000). Similarly, proprietors may have in place a succession plan conflicting with the degree of control preferred by an investor (Hoy and Verser 1994; Chau et al. 1999; Duneman and Barrett 2004). Mason and Harrison (1999) note the important overlap between venture capital and family business research. Venture capital can play a role in financing ownership transitions from generation to generation or when the business is sold to a third party.

Decisions to seek debt or equity, or a combination of both can involve a dynamic level of interplay between social, family and financial factors (Romano et al. 2000). Debt in the form of family loans is often a consideration for family businesses (Lesonsky 2007) and may be a source of financial stress (Worthington 2006). Equity is often seen as a more relevant source of funding for owners focused on achieving growth through increasing profit margins (Bruno and Tyebjee 1985; Allen 2003).

Within the family business structure, conflict between family members can impact the viability of the operating success and (or) long-term existence of the business. What is seen as good for the family may not necessarily be good for the business (Sharma et al. 1997). A desire to ensure continuing family involvement may lead to the practice of nepotism, with the result that the strategic planning of the business may be driven by family issues, allowing family members to be employed, rewarded and promoted in
circumstances that make it more difficult to attract professional managers or investors (Hoy and Verser 1994; Vinton 1998; Rowe and Hong 2000). Even the composition of the family may be an ownership issue where there are extended members of the family to be considered (Litz 1995; Ward and Dolan 1998; Chau et al. 1999).

Notwithstanding these concerns there can be definite advantages for an entrepreneur to access the “rich repository of resources: economic, affective, educative, connectivity” that a family can offer (Steier 2003, p.268). Family support may be a continuing process from start-up through to the transfer of ownership and management control upon retirement of the founder (Dyer and Handler 1994). The external investor in such private companies needs to consider whether to become actively involved in the operation where there is provision for such a role, or to remain at arm’s length.

2.5.3 Private external investment – active and passive

Some external investors in private companies prefer to have close involvement with the business, while others prefer some distance from its day-to-day operations. These active versus passive investment modes differ regarding how they manifest in investment form - the former to be equity investment and the latter being loans/debt. Investors may choose an active or passive role in the enterprise.

Entrepreneurs need funds to commence and maintain the enterprise and may need to offer security for such advance of funds in the form of debt or equity (Cohen 1990; Chandler and Hanks 1998). Part of the normal terms of the agreement between the founder or entrepreneur and investor is the price that the entrepreneur must pay to secure funding, namely, the percentage of the equity that must be given up. However,
the investor also sacrifices in particular the loss of liquidity of the funds advanced (often for a number of years), and a heightened risk of loss of capital (Bygrave 1994; Bodde 2004).

Equity funding has an advantage over debt funding in that the investor is accepting a stake in the business which is not subject to a strict repayment regime for interest and principal or subject to the entrepreneur providing collateral as security for the funding or establishing a good credit rating with the financial institution involved. Denny (2000) has suggested that the real issue for entrepreneurs is getting their ideas funded through equity and not through debt which may be unaffordable. Where the entrepreneurial productivity is low, professional support and a high level of productivity through an equity investor may be a considerable advantage for the entrepreneur over passive debt finance (de Bettignies and Brander 2007) or in taking short-term funding (Holmes 1988).

An entrepreneur may pass up the investment opportunity if it requires the issuance of further stock. Myers and Majluf (1984) have argued that such a course of conduct results in the misallocation of real capital investment and a reduction in the firm value, as the firm may be passing up valuable investment opportunities. Entrepreneurs who deliberately under-utilize equity and debt financing in order to avoid dilution of shareholding or cost of capital issues may not fully exploit the economic potential of the enterprise (Hutchinson 1995). The entrepreneur may also be deprived of the managerial input of a venture capitalist in the unlikely event that the venture capitalist is involved in an early-stage venture (de Bettignies and Brander 2007).

The experience and expertise of the entrepreneur or proprietor has a direct impact on how the business operates, manages its market environment and grows (Torrence 1986;
The greater the proprietors’ degree of ownership in businesses, the greater is the control and influence relative to any private investor. A proprietor who is able to access bank finance completely will be able to maintain full control of the venture but will not receive the benefit of the investor input and experience. Where the proprietor chooses investor capital then partial ownership of the enterprise and a degree of control will shift toward the investor. A significant shift in control may weaken the proprietor’s incentive to provide effort (de Bettignies and Brander 2007).

The funding of the venture through external investment brings with it the risk to the small firm of possible loss of identity or loss of control over the decision-making process (Street and Cameron 2007). Even if the investor is a minority stakeholder, contractual provisions in the terms of the contract may permit the investor to make management changes; covenants may also permit the investor to take control of the company if the business fails to meet certain milestones in growth and (or) income, or where changes are made by the entrepreneur to the business structure without the consent of the investor (Lesonsky 2007). The restraints imposed by a lender may also amount to a loss of control where there is a default of borrowing covenants by the borrower (English 1986). Where the entrepreneur and the investor share ownership control, new product development is more likely to be completed faster than for firms where control is not shared (Khavul 2001). However, this issue of control may be overstated. Lesonsky (2007, p.183) has suggested that in a typical high-growth company, the founder owns only 10 per cent of the enterprise by the time it lists on a public stock exchange. That is not necessarily a bad thing. Lesonsky (2007, p.183) notes that “ten per cent of $100 million is better than 100 per cent of nothing!”
In the early stages equity funding may not be the panacea, where the entrepreneur has strong views about sharing ownership and possibly control with a co-owner. An entrepreneur may resort to debt funding in an attempt to avoid these restrictions.

Commercial banks and finance companies are acknowledged as the major source of debt funding for small businesses (Churchill and Lewis 1986; Torrence 1986; Cohen 1990; Reynolds and White 1997; Allen 2003; Kotler et al. 2004; Frederick et al. 2006; Griffiths 2007). The Kauffman Firm Survey (2008) of new businesses in the United States indicated that 80–90 per cent of these firms’ start-up capital comprised equal parts owner equity and bank debt, whilst the 2009 Kauffman Firm Survey studying 2004 to 2007 in the United States revealed that external debt markets were contributing an increasing amount of capital to new businesses through bank products such as bank loans, credit cards and lines of credit. The banker considering an advance needs to take into account the Cs of credit - character, capital, capacity, collateral, circumstances and coverage (Ronstadt 1985). Banks, including trading banks (de Leeuw 1995), are a major source of credit financing for small businesses which are in turn an attractive source of profit for the banks (Churchill and Lewis 1986; Symonds, Wright and Ott 2007). Other sources include government-sponsored loan programs (Lerner 1998; Reiss 2000; Kotler et al. 2004); universities and private incubators (Sherman 2005); mezzanine debt, a combination of debt and equity funding (Anson 2002); government grant programmes and initiatives, and lease financing from a financial institution or from the supplier of the goods and services as a facility to enable the purchase of same (Holmes 1988). Later funding may come from suppliers, customers and even employees with accessible equity in properties that they can access (Lesonsky 2007). In the United States this is particularly so through employer investment in (401) k retirement funds. Other sources of funding include a business angel or venture capitalist, as discussed in section 2.4.
2.6 Funding investment in the Australian private marketplace

It seems likely that these factors underlie the continuing difficulty in Australia of obtaining equity capital for early-stage ventures, especially those lacking tangible “bricks and mortar assets” (Hindle and Rushworth 2004, p.23). Indeed, in 2005 start-up businesses were requiring more capital at a time when business angels were prepared to give less and there was also lack of effective government support for entrepreneurial activity (Hindle and O’Connor 2006a).

Hindle and O’Connor 2006c note that entrepreneurs without family assistance have considerable difficulty in securing angel funding with investors holding the balance of power. Whilst true entrepreneurial ventures are said to be increasingly rare, for many entrepreneurs independence is the main reason for starting and operating a small enterprise (Hindle and O’Connor 2006b). Within Australia, habitual, serial entrepreneurs as a group are more likely than other entrepreneurs to generate greater economic growth and wealth. They are more likely to operate another business and more inclined than novice entrepreneurs to expand their business (Schaper, Mankelow and Gibson 2007).

Whilst Australians are said to be a resourceful and entrepreneurial people with a distinctively Australian approach to innovation and invention (Blackall 1988; Encel 1988; Cochrane 2001; Barlow 2006), Ellyard (1998, p.86) has noted that Australia has “a poor and risk-adverse record in venture capital and a sorry record of investing in Australian creativity”.

The need for change has been evident in recent years. In Australia the targeting of small business for job creation and growth received government support (Reith 1999). Jones
(2006, p.5) has commented that the (Liberal Coalition) Government’s agenda for small business “ranges from lacklustre to negative” despite a coalition government presumably receiving support from the small business sector. In 2006, the Australian Labor Opposition promised, when elected to office, to deliver an innovation agenda that would turn Australian brilliance into successful ventures by kick-starting innovation, reforming R&D investment, developing university capacity and diversity, and rebuilding research institutions such as the CSIRO (Beazley 2006).

One positive note was the federal government’s increase in May 2007 of funding for the Building Entrepreneurship in Small Business (BESB) programme and an extension of the availability of grants with a focus upon the ongoing improvement of Australia’s small business operating skills, as announced in an Australian Government Industry Statement on 1 May 2007. Mid-sized private businesses within Australia continued to grow positively in 2006, with overall reports of 11.2 per cent average increase in profits and 14.9 per cent average growth in sales. However, there was little private equity and venture capital funding these ventures. PricewaterhouseCoopers reported that only 5.7 per cent of owners ranked these sources as an option for a capital raising in 2007 (PWC 2007). In 2008 PricewaterhouseCoopers reported that access to debt and its higher cost resulted in a serious decline in the ratio of debts to assets, with almost two-thirds of private businesses offering “bricks and mortar” security (frequently the owner’s family home) as security to obtain business finance (PWC 2008). Private equity and venture capital as a source of funding for private businesses continued to decline from 4.5 per cent in 2008 to 1.3 per cent in 2009 (PWC 2009), rising slightly to 3 per cent by 2010 (PWC 2010).
Encouragement and further development of such initiatives at the federal government level, particularly in light of Cutler’s Venturous Australia Report (2008) are pursued in Chapter 3.
Chapter 3

Business angels’ and venture capitalists’ investment criteria

The day I was hired I understood that the Company would go public because it had venture investors. The only question was timing.

Eric Schmidt, CEO Google


According to substantial literature addressing ‘entrepreneurial intent’, the need for achievement and autonomy emerge as imperatives, with networks being an important means of accessing deals and funds. At the early stages of the venture both equity and debt are common methods of acquiring funding, with both actual risk and perceived risk, major considerations for investors, especially in areas of high technology. There is a strong case that there is both a need and a place for government funding and assistance in the informal marketplace. Taxation concessions and policy initiatives have a role. Coupled to the earlier analysis of business angels’ and venture capitalists’ characteristics, an examination of investor decisions in the private marketplace is an immediate imperative.

Business angel investors and venture capitalists invest in a marketplace without the transparency and regulation of the public marketplace. These two groups of investors follow both similar and distinctly different investment practices in reaching an investment decision. Both groups are concerned with the quality of the management team behind the enterprise, yet they take a different approach to ex ante research, the
term of the investment, the degree of equity that each group seeks to acquire and control once funds are invested and the source of the funding of the enterprise.

3.1 The context of investment decisions

A consistent theme throughout the angel and venturer literature is that their respective decisions to invest in the private marketplace are “multi-factorial”. Invariably it involves a consideration of various decision making factors, but “little is known about the process by which private investor arrive at investment decisions” (Feeney et al. 1999, p.122). Eilon (1969) has suggested a decision process comprising eight stages: (1) information input; (2) analysis; (3) performance measures; (4) model; (5) strategies; (6) prediction of outcomes (on a set of alternatives); (7) choice criteria; and (8) terminating with resolution.

This research focuses on the factors that may influence the decision-making processes employed by private marketplace investors. Initially an investor may be attracted to either the deal or the investment opportunity, or may be influenced by the capacity and experience of the founder or entrepreneur. As the enterprise grows there may be other considerations. A decision-maker responsible for the investment choice will undertake a “personalistic” decision process that is a function of the decision-maker’s own predilections, beliefs, attitudes and value judgements, and the resulting decision may differ from how other decision-makers (also considered to be acting rationally) behave (Eilon 1969).

This investment decision by the investor should encompass due diligence processes, the “homework investors complete before a final decision is reached” (Bygrave 1994,
p.181) - checking on the history of the management team, reviewing and analyzing the performance of the industry and, in particular, the status of competitors, identifying strengths and weaknesses in the enterprise, before deciding whether or not to proceed with the investment. Due diligence is essentially a detailed evaluation of the business plan prepared and submitted by the party seeking finance and is a mutually beneficial and necessary process to be pursued by both investor and entrepreneur, concerned to evaluate the terms upon which the investment is being offered and the party offering the funds, particularly so if the investor wishes to take an active role in the venture. It is described by Bygrave (1984, p.181) as a “two way street”.

It is to the founder or entrepreneur that this enquiry now turns in order to gain insight into why business angels and venture capitalists choose to invest or not invest in such parties and the enterprises that they create.

3.1.1 The role of the entrepreneur in the investment process

The modern concept of entrepreneurship owes much to the ideas expressed by Carl Menger (1840–1921) and the movement started in Austria that concerned the “subjectivist perspective of economics”. In Menger’s view, economic change does not arise from circumstances but from an individual’s awareness and understanding of those circumstances. Joseph Schumpeter (1883–1950) perceived the entrepreneur to be an extraordinary individual who promotes the concept of innovative thinking (Cheah 1990). The role of the entrepreneur is that of a “change agent” (Holt 1992) and it is that “creativity, originality that is the essential focus of entrepreneurial studies” (Hughes
There may well be three theories of entrepreneurial behaviour – neoclassical, Austrian and behavioural (Endres and Woods 2006).

The model of “subjective enterprise” proposed by Menger has been fostered by entrepreneurs and prominent business schools within the United States. As noted by Hisrich (1988, pp.1-4), by the start of the 1990s there were more than 300 colleges and universities, including Harvard Business School, MIT, Stanford, the Wharton School and UC Berkeley, with studies in entrepreneurship. The move into entrepreneurship education accelerated in the 1990s with benefits to the U.S. economy through the growth of inventive and innovative businesses (Locke and Schone 2004).

The U.S. economy remains larger than the combined economies of Japan, Germany, Britain, France and Italy, with 66 per cent of all technological innovation coming from small, private companies and start-ups and 99 per cent of that total being financed by founders, family, friends and angels (Benjamin and Margulis 2005).

Arguably, into this mix must be factored the traditional entrepreneurial zeal of the American people that has helped create the world’s largest economy. Locke and Schone (2004, p.59) have commented that “Americans have always been entrepreneurial. It is not in their soul, but is almost an inevitable result when ambitious people are let loose on a rich, unexploited continent where the indigenous groups cannot stop their own conquest”.

When searching for a modern definition of entrepreneur Hindle and Rushworth (2002, p. 4) note:

a creator; one who turns a potential exchange into an actual exchange, one without whom the transaction may never occur. Similarly, in the case where the demand exists but the supply does not, the entrepreneur may actually create the supply as well as undertaking the exchange. In the
specific case of the exploitation of new technology, the entrepreneur may even have to create a market where none exists.

Consistent with Hindle and Rushworth (2002), entrepreneurship can be interpreted both as an initiating activity, a process where new products and techniques are introduced into the economy, and as imitative activity, where these innovations are interspersed throughout the economy.

Hindle and Rushworth (2002) acknowledge that a short definition of entrepreneurship will invariably create debates. Cheah (1990, p. 343) refers to the “yin and yang” effect of the two schools of thought, Schumpeterian, which involves changing an existing situation and Austrian, which involves change within an existing situation, whilst Gartner (1990) believes that various themes of entrepreneurship reflect different parts of the same phenomenon. In any case entrepreneurship is seen as the key to growth (Baumol 1986; Parker 2000), or as the creation of a new enterprise (Prabhu 1999) whilst the contribution may be in the form of productive activities such as innovation or unproductive such as rent seeking (Baumol 1990). Krueger et al. (2000, p.411) characterised entrepreneurship as “a way of thinking that emphasizes opportunities over threats”. MacMillan and Katz (1992) regard entrepreneurship as inherently idiosyncratic and entrepreneurs who adopt longer time frames and more flexibility are less likely to experience stress (Bluedorn and Martin 2008). Gartner et al. (1994) has identified a number of meta-themes in entrepreneurship based upon “the plurality, cognitive, temporal, motivational and diverse nature of entrepreneurship”. Entrepreneurs are thus perceived as participating in a complex plural and interactive network embracing all or most of the above concepts in complex interaction.
Krueger et al. (2000) see the decision-making process from an entrepreneur’s perspective as a form of planned behaviour, which they suggest could be better understood using a model of intentions. In contrast, Ackoff (1987) has considered the decision-making process from an ethical position. There, ethical-moral judgements are not based on the rules applying to the outcomes of the decisions, its products, but to the business ethics to be applied to the assessment of the deal. How entrepreneurs see themselves and the application of a moral imagination by the entrepreneur is critical to the ethical and entrepreneurial outcome (McVea 2009) with the experiential learning process appearing to be the key contributory factor (Ekanem and Smallbone 2007). Sociologists such as Reynolds (1991) have noted the complex, multi-faceted phenomena constituting entrepreneurial activities, suggesting that an adequate understanding of all aspects of entrepreneurship cannot be gleaned from any one discipline or conceptual scheme. Entrepreneurship may not be a single event and there is a need for a multifaceted approach to future studies of entrepreneurs and angels (Wright et al. 1999). Many support the proposition that the lower the opportunity for individuals, the more likely they are to undertake entrepreneurial activity (Amit et al. 1995). It may well be that these individuals are less capable than their former employed colleagues, leading to the high failure rate of new ventures. As such, entrepreneurship may be a difficult term to define (Schaper and Volery 2004).

Aldrich and Martinez (2001) take an ‘evolutionary perspective’ to their study, whilst others (Stopford and Baden-Fuller 1994; Barringer and Bluedorn 1999; Floyd and Wooldridge 1999; Sharma and Chrisman 1999; Antoncic and Hisrich 2001; Ferreira 2002; Garvin and Levesque 2006; Ramachandran et al. 2006) have investigated this core issue in entrepreneurial behaviour from a ‘corporate perspective’.
Corporate venturing is a significant form of venture capital that can be conceptualised as a specific type of strategic alliance whereby a smaller firm receives not only an injection of funding but also gains access to the resources of the investor. These resources may include managerial, manufacturing and marketing and distribution expertise (Mason and Harrison 1999). Theories focusing upon the existence and role of the firm and corporate strategy and growth need to consider the concept of entrepreneurship, as it is the key to the growth and survival of firms in a volatile environment (Casson 2005). Corporate entrepreneurship is considered risky. It is critical that corporations achieve the right balance in setting strategy, nurturing and operating the business and designing the organization (Garvin and Levesque 2006). According to Sykes (1986), if a venture requires development of new technology and if this is commenced at the research stage, then it carries a greater risk of failure.

Stopford and Baden-Fuller (1994, p.521) noted that the various types of corporate entrepreneurship comprise individual managers, business renewal, and Schumpeterian-style or industry leadership, that they share five “bundles” of attributes: proactiveness, aspirations beyond current capabilities, team orientation, capability to resolve dilemmas, and a learning capability of varying prominence during the corporate rise. Investors will be looking for these bundles of attributes when considering whether to invest, as they provide indicators of managerial orientations and organizational capabilities (Stopford and Baden-Fuller 1994). As the entrepreneur is most often regarded as an innovative and creative individual, ably positioned to lead an entity that emphasizes innovation (Ferreira 2002), the proactiveness of an organization will probably reflect the characteristics of the related entrepreneur and will be seen to be critical to the success of the venture. Lerner (1998) has studied corporate
entrepreneurship from an ‘angel investor perspective’, this with a view to encouraging investment in entrepreneurial firms.

As the social enterprise activities might primarily be either economic or non-economic, Chell (2007) argues that the notion of entrepreneurship might be modified to encompass the creation of social and economic values. In so doing he argued that the definition might then be applied to private entrepreneurial ventures as well as social enterprises. Certainly a number of capabilities found in social entrepreneurial leadership are also common amongst economic entrepreneurial leaders (Prabhu 1999; Fowler 2000; Thompson, Alvy and Lees 2000; Chell 2007).

Studies have considered the relationship between entrepreneurship and small business owner/managers (notably studies by: Bruderl et al. 1992; Holt 1992; Vinnell and Hamilton 1999), and between entrepreneurship and family businesses (especially by: Hoy and Verser 1994; Dyer and Handler 1994; Litz 1995; Sharma et al. 1997; Ward and Dolan 1998; Vinton 1998; Chua et al. 1999; Steir 2003; Dunemann and Barrett 2004). Entrepreneurship has also been studied from a ‘gender perspective’ (DeMartino and Barbato 2003; Arenius and Autio 2006; Leitch and Hill 2006; Becker-Blease and Sohl 2007; Coleman 2007); from a government perspective (Dana 1988; Evans 1996); a university perspective (Thorburn 2000; Yencken et al. 2002; Rutherford and Fulop 2006); a managerial perspective (Buesnitz and Barney 1997; Chung and Kim 1997; Salaman and Storey 2002); a ‘cultural perspective’ (Shane 1992; Knight 1995; Dana 2000; Haliassos and Hassapis 2002); a minorities perspective (Reynolds and White 1997); and a ‘corporate perspective’, where it can assume the role of an agent of change (Holt 1992) and is usually referred to as “intrapreneurship”. Thus Antoncic and Hisrich (2001, p.495) describe intrapreneurship as “entrepreneurship within existing
organizations”. Earlier MacMillan et al. (1985, p.119) suggested that five of the 10 most significant factors considered by the investor in deciding whether to invest relate to the experience or personality of the entrepreneur, noting that: “there is no question that irrespective of the horse (product), horse race (market), or odds (financial criteria), it is the jockey (entrepreneur) who fundamentally determines whether the venture capitalist will place a bet at all”.

The personal characteristics of entrepreneurs are said to be relevant not only to their success but also for the signals they send to potential investors concerning the value of their investment pitch. Guzik (1999) has suggested that the one quality that most entrepreneurs seem to possess in abundance is the desire to accomplish and that this quality alone - perhaps better expressed as drive or passion, self-motivation or enthusiasm - can compensate for entrepreneurial shortcomings in organizational skills, communicative talents and visionary gifts. Entrepreneurship should not be measured solely in financial terms. Monetary gain is not found to be the sole reason that drives entrepreneurs (Kuratko et al. 1997) the equation of success is more complex than a simple economic risk vs. return formula. Thus the significant characteristic to emerge is entrepreneurial motivation; it remains a critical determinant.

Earlier Gerber (1995, p.23) described the ‘entrepreneurial personality’ as turning “the most trivial condition into an exceptional opportunity. The Entrepreneur is the visionary in us. The dreamer. The energy behind every human activity. The imagination that sparks the fire of the future. The catalyst for change”. Thus in business, the entrepreneur is the primary, the lead innovator, strategist and creator of new methods and new markets (Gerber 1995), the “catalysts providing the spark for economic development”
and the fostering of an economic culture that promotes the entrepreneurial spirit and acts as a conductor for the spark (Berger 1991, p.14).

Entrepreneurs can possess personality flaws with competing traits; on the one hand, driven by the need for high achievement, autonomy, independence and a degree of risk-taking and, on the other, anxious, non-conformist and given to self-destructive behaviour (de Vries 1997). The impact of this personality on the continued success of the organizational enterprise can lead to “serious dysfunctional developments in the future in the case of continued growth of the enterprise” (de Vries 1997, p.53). The impact of the entrepreneurial personality upon the organizational development could indicate a need to understand how the process and the context (the strategy and the environment) interact in the development of entrepreneurial endeavours (Aldrich and Martinez 2001). Against that background Minniti and Bygrave (1999, p.41) suggest that only individuals with “superior alertness towards possible changes and who are able to cope with disequilibrium move to re-allocate resources and become entrepreneurs”.

Whilst acknowledging that almost every sound business proposal will likely secure funding, actually sourcing it can nonetheless be difficult for non-business owner/managers. And especially so from distant investors or in circumstances where there is no comprehensive business plan. In this regard Gaston (1989, p.219) has labelled funding failure as the “kiss of death”. Funding will be more difficult to obtain, it is suggested when involving deals in transportation/utilities or natural resources/mining industry, exotic investment instruments, deal liquidation via outsiders or co-investing with government economic agencies. Illustrative of the funding needs issue, none of the 18 entrepreneurs interviewed by Fried and Hirsch (1994) had the financial means to fully fund the enterprise from personal sources.
In general, entrepreneurs and small business owners look to informal sources of funding before approaching the venture capital market. The majority of the founders of the 100 companies on the 1989 *Inc.* 500 List used bootstrap financing, and an estimated 80 per cent plus of the *Inc.* 500 fastest-growing companies were financed solely by founders’ personal savings and other bootstrapping methods (Bygrave 1994).

Whilst finance is of central significance to the viability of small firms, with bootstrap financing methods being probably the most common financing characteristic of small firms world-wide, surprisingly little research has investigated this topic (Carter and Van Auken 2005). Bootstrapping is said to be the fundamental building block in new venture creation (Harrison et al. 2004).

Entrepreneurs often rely initially upon different forms of financial bootstrapping when external financing is either unavailable or too expensive (Winborg and Landstrom 2000). From the entrepreneur’s perspective the acquisition of venture capital may be viewed as either a scarce resource or as a commodity (Saetre 2003). Access to financial capital and the commitment that accompanies it has a substantial effect upon the performance of the new firm (Dahlqvist et al. 2000). Yet entrepreneurs need to exercise caution at this early stage of seeking funding with its pitfalls of inadequate protection for both parties to the deal (Schaper and Volery 2004). This is particularly so in ensuring repayment of the investment and valuing the contribution correctly. There can be a tendency for the entrepreneur through enthusiasm and optimism to overvalue the real worth of the early stage enterprise.

Dilution of the entrepreneur’s stake in the enterprise is a continuing issue for both entrepreneur and investor. The risk is highest in the initial phase. There, the entrepreneur seeking to attract an investor prepared to lose all, must be willing to part
with a proportion of the share capital which otherwise provides the investor, either as an income stream or upon exit as a form of capital gain, with a return, well in excess of bank interest. As a general rule, Kuriloff and Hemphill (1988) have found that entrepreneurs try to put up 50 per cent of the seed money, to show investors a level of commitment and to protect a degree of equity and control as the enterprise grows. If the start-up venture proves to be extremely successful the entrepreneur may assess that too much equity was sacrificed, whereas if the venture fails the investor might be blamed for turning off the funding (Banfe 1991).

But entrepreneurs assess risk differently from non-entrepreneurs. Entrepreneurs generally assess like investments more favourably (Norton and Moore 2006). Even between entrepreneurs this risk assessments may vary and those who commence their careers earlier in life are more likely to handle risk successfully than those who begin later (Ronstadt 1986), with the “more seasoned” entrepreneurs tending to experience longer careers as such.

For many entrepreneurs the initial motivation to start-up an enterprise – a desire for independence and a type of Hicksian *quiet life* – may suggest that the entrepreneur possesses a strongly risk-averse attitude (Hutchinson 1995). Such an attitude can lead to the underutilizing of the sources of equity and debt financing, resulting in a level of sub-optimal performance of the firm. A “Hicksian lifestyle” is depicted as one where (economic) demands are defined as derived from expenditure minimization subject to a utility constraint. Its depiction contrasts with a “Marshallian” approach, wherein demands are defined as derived from expenditure maximization subject to a budgetary constraint (Turnbull 1991). Entrepreneurs are said to recognize opportunities that can possibly be exploited and make strategic decisions, whilst considering competitive
advantages and disadvantages (Mitchell et al. 2004). Risk is said to play a central role, with entrepreneurs avoiding ventures with a high degree of variability in their patterns of anticipated outcomes. There is a need for sound market research before undertaking the venture and an avoidance of personal bias in the assessment of ventures, based upon a propensity to take risks (Forlani and Mullins 2000).

There is less risk of failure as the enterprise grows. One of the chief motives for increasing the size of the firm is to reduce the degree of risk through the operation of the law of large numbers (Arrow 1951). Banfe (1991, p.176) has noted that “risk is perceived as inverse with each step up the ladder”. The difficulty for the entrepreneur as the venture gains momentum is to balance the loss of a percentage of the shareholding with the increase in value of the percentage of the retained shareholding.

Holt (1992, p. 353) sees a need to share the success of the new venture with the entrepreneurial team that makes it happen. Here the suggestion is that an entrepreneur hiring “nine-to-fivers” will not receive the level of commitment that is brought to the venture by those who share in the vision and who emotionally “buy into” the venture concept. Eventually, if the venture is soundly based and well managed, there is a phase of rapid growth, during which there is also need for a shift in the decision-making processes. A previous strength of the enterprise, the informal decision making by the entrepreneur, can be a weakness as the venture grows, and there needs to be a transfer of responsibility within the organization (Gilmore and Kazanjian 1989). It is argued that inexperienced entrepreneurs should move towards a more balanced position before developing a clear preference for highly effectual strategies (Read et al. 2003).

In due course, an entrepreneur needs investors with the requisite expertise and contacts. Banfe (1991, p.124) has described a “market explosion” taking place, characterized by
mezzanine or second round (funding) rapid expansion with labour force multiplying and additional capital necessary. Negative cash flow may continue for one to two years and, as the venture becomes more successful, the entrepreneur is increasingly required to cede control of the enterprise to professional investors in order to see it grow (Bodde 2004).

As Saetre (2003, p.83) notes, it is reasonable for an entrepreneur to place greater weight upon an investment proposal coming from an investor with “competent capital”, including one or more attributes such as entrepreneurial experience, leadership and business experience, higher education and investor experience, and even more so when accompanied with “relevant capital” experience (relevant industry-based experience and networks). The acquisition of this relevant capital greatly increases the contribution of an active investor who may already bring to the enterprise the valuable assets of capital, competence and commitment. The more active the investor, the more likely the ability to exert a strong influence on the project direction (Sorheim and Landstrom 2001).

When considering the role of the entrepreneur in the fund raising process, Aldrich and Martinez (2001, p.44) state that organisational survival “does not depend on the strategic choices or environmental forces alone, but rather on the degree of fit between entrepreneurial efforts and environmental forces” with three elements which are essential for the nascent entrepreneur to succeed being, human capital (knowledge obtained through formal education, previous experience or informal training), financial capital (monies required to cover costs until profitable) and social capital (the development of social networks to obtain information, knowledge and other resources). Banfe (1991) proposes some ‘common truths’ which enhance an entrepreneur’s chances of being funded. These entail entrepreneurs accurately determining the finance needed
and assuming the role of a salesman in acquiring it, since investors invest in entrepreneurs, not companies.

Entrepreneurs can access capital through networks (and partnerships) which are a means of assessing deals and funds (Sohal et al. 1998). In certain situations the network may be a constellation of firms working together with a head firm that maintains the control of key matters, such as - product development and marketing strategy (Shepherd 1991). Entrepreneurs with better social skills often place less reliance upon accessing resources from established networks and are more willing and able to seek resources in the marketplace (Zhang et al. 2003). Entrepreneurs seeking capital should target potential investors with prior managerial experience and start-up skills, who, apart from being more likely to invest, are also more likely to inject mentoring skills (Wong and Ho 2007). The networks and resources of the entrepreneur, a penchant for innovation and the entrepreneurial orientation of the entrepreneur and the presence of cultural links may impact the resources and performance of the enterprise (Yang 1995; Begley and Tan 2001; Tan 2001; Zapalska and Edwards 2001).

West and Bamford (2005) confirm the importance of networking behaviour and the degree of start-up knowledge. Networks bridge different social groups and provide access to different network clusters. Highly trained entrepreneurs of larger and growth-focused enterprises have been found to link into broader networks (Donckels and Lambrecht 1997). Indeed, the development of a network by an entrepreneur can deliver three advantages; private information, access to the diverse skill sets and power (Uzzi and Dunlap 2005). Traditionally this capital was provided through locations of financial control from venture capital companies in cities such as New York and Chicago (Florida and Kenney 1988).
Two significant aspects of networks are that ‘social capital’, as it is sometimes known, is important in locating and securing external funding (Ostgaard and Birley 1996) and men make better use of their social networks to securing such funding than women (Leitch and Hill 2006). Human capital and financial capital are considered necessary for the success of the venture. Coleman (2007) has found that females place more importance on human (or social) capital when determining profitability, whereas financial capital is more significant for males. There is a need to ensure that female entrepreneurs have access to educational opportunities and management experience and to financial capital with programs focused on these issues.

Entrepreneurs must understand that the proposed funding relationship will require a continuing involvement with the investor who may desire to be active in the management of the enterprise. Investors may differ in their abilities and entrepreneurs must undertake due diligence on potential investors (Berg-Utby et al. 2007). During the technology boom in 2000, with the competition for deals and pressure to invest so as not to “miss the boat”, the time and effort devoted to due diligence decreased, sometimes being completed in less than 10 days (Sohl 2003) when it might normally have taken some months. Bygrave (1994, pp.181-182) has suggested that founders and entrepreneurs approach other entrepreneurs who have been funded by the target investors with a number of key questions as to whether the investor is trustworthy and predictable, fair and reasonable, funds the venture properly and is active and helpful. Entrepreneurship, though less consequential in the later phases of the business, should not be stifled in “managing” the organization. There is a continuous and collective shift in balance between (individual) entrepreneurship and management, as depicted in Figure 3.1.
Forsyth et al. (1991) note the need for continuous innovation if a small business is to be continuously successful. Management entrepreneurship need not be a contradiction in terms. The distinction between the manager and the entrepreneur is “critical and profound because it deals with the essence of man” (Locke and Schone 2004, p. 60).

### 3.1.2 Access to funding in the private marketplace

Entrepreneurs regard accessing private capital as one of their most difficult challenges (Bhide 2000; Kotler et al. 2004; Benjamin and Margulis 2005; Sherman 2005). Sherman (2005, p.65) notes that “raising capital at any stage of a company’s growth is challenging and requires creativity and tenacity but these hurdles are especially difficult to conquer at the earliest stages of an enterprise’s development”, and Gaston (1989, p.1) has observed that “the difficulty of finding risk capital is the number one barrier preventing good business ideas from becoming profitable enterprises, because most
entrepreneurs do not qualify for traditional funding”. Reinforcing this theme, Torrence (1986) has suggested that accessing venture capital depends upon the right circumstances, preferably not when the business is in trouble and that the right investment climate for investing in small companies takes into account an exit strategy, a compelling basis for market demand for the product or service, and provision for a quick turnaround of the venture if the enterprise is in loss mode. Further, the profit margin from the acquisition of an equity stake must justify the opportunity.

This lack of early-stage equity finance is said to be “a major constraint on the growth and development of small and medium sized enterprises” (Acs and Tarpley 1998, p.793). Small-business owners often find it difficult to obtain capital because “they are woefully ignorant of the need for a sound capital structure and how to obtain it” and also because “lenders are often uninformed or mis-informed about the peculiar capital needs of the small business owner and the excellent opportunities that many such businesses offer” (English 1986, p.63). Financial support can be difficult to obtain from institutional investors because of the inherently uncertain and high-risk nature of the enterprise (Van Osnabrugge 2000). The risks of investment in this marketplace still outweigh the rewards for business angels (Mason and Harrison 2002b).

From an investor’s perspective, the investment often requires an involvement in managing the enterprise and some direction and control of the day-to-day operations of the venture. An investment of equity in the longer term requires a return on the investment, often dividends, but also a return of capital in due course for which an exit strategy should be anticipated by both investor and entrepreneur (Frederick et al. 2006). As part of the equity funding package, the investor may accept a majority of the preferred stock (non-voting) in the company with a priority entitlement attached to the
preferential shares as to payment of dividends and (or) the repayment of capital. Thus the investor has, through the latter arm, an advantage over ordinary shareholders in the event of a distribution of the capital including liquidation (Redmond 2000). The investor may also seek to hold redeemable preference stock (shares) with the right to convert to ordinary stock or cash after a fixed period. The profit margin from the acquisition of an equity stake must also justify the opportunity.

An equity investor requires a return on the investment, generally dividends and a return of capital in due course, for which an exit strategy should be anticipated by both investor and entrepreneur (Frederick et al. 2006). Entrepreneurs who can be assumed to know more about the firm’s value than potential investors need to act prudently in accepting new shareholders, for where they possess inside information about the value of prospective investments there is the quandary of preferring the interests of existing shareholders to those of potential new equity shareholders.

3.1.3 Stages in the investment cycle

“Private investment” covers a wide range of investment activities from (business) angel investment (early-stage investment) to buy-out fund investing (Kunkel and Mukherjee 2004). Venture capital as part of the investment process follows the early stage investment by business angels and seed capitalists. In relation to the development of emerging technologies, there may be a gap between the two market places, in the funding space between US$250,000 and about US$2 million, where low returns and very high risk necessitate the application of public programmes to support the enterprise (Wessner 2003). Berger and Udell (1998) reported that, at that time, about half of U.S. small business financing came from equity and about half came from debt. Frequent
sources of equity are reported to be wealthy investors and syndicates with such venture capital, whilst debt sources include financial institutions, government agencies and trade credit. However, as Berger and Udell (1998) have noted, the largest source of financing was the enterprise owner – almost 35 per cent. We might expect Australian experience to be similar.

3.1.4 Investment risk factors

Risk is defined by Forlani and Mullins (2000, p. 309) as “reflecting the degree of uncertainty and potential loss associated with outcomes which may follow from a given behaviour or set of behaviours”. Decision-making under risk is a future-oriented activity that entails uncertainties (Lopes 1983) entailing choices between options that differ in expected value and of necessity require trade-offs (Lopes 1984).

Huntsman and Hoban (1980, p.44) have noted that “there is little formal knowledge about either the risk-reward trade-offs inherent in the commitment of capital to new, high risk ventures or the capital formation process that supports the development of such ventures.” Arguably, perceived risk has a critical role in human behaviour, particularly as it relates to the process of decision-making under pressure. Thus a heightening of perceived risk both increases the level of information sought and lowers the level of capital invested in the enterprise (Cho and Lee 2006). On the other hand, a propensity toward risk results in the investor being more likely to obtain professional advice and also investing more in riskier propositions. Carter and Van Auken (2005) have argued that there is a relation between investment, financing, risk and investment, and that risk may be an important factor in the selection of financing sources. In the
static theory of the firm there is a distinction between actions (decisions) and consequences (varying levels of monetary profit) (Arrow 1947).

There is a ‘risk premium’ attached to this stage of investment, necessitating compensation with a number of separate risks to be considered. Investing in new ventures involves “a high level of uncertainty as well as a high risk of failure” (Ruhnka and Young 1991, p.115). The first exposure to risk is that the start-up enterprise may fail to succeed. At the earliest stage, the start-up enterprise may have no more than a business plan and no income to substantiate the investment and attract investors.

Secondly, and this is a continuing problem for informal marketplace investments, there is the risk attaching to the lack of a public marketplace in which a business angel can exit the deal, other than selling to other early-stage investors. Enterprises with a rapid growth trajectory rarely have the necessary liquidity to pay dividends, and investors need to exit the investment to receive a return on investment through the sale of the shareholding privately or publicly through a stock market listing. But these are options generally occurring only when the enterprise has gathered sufficient momentum, income and professional management to support an approach to the general public for funds. Benjamin and Margulis (2005, p.240) have described venture and angel capital as “patient money” and the exit route as “the means by which an investor leaves an investment and through which he or she is able to realize returns”. Those authors proposed a number of alternative exit strategies: an initial public offering (I.P.O.), being the first fund-raising done from the general public; the sale of the investor’s stock back to the founders; a leveraged buy-out and recapitalization of the company; the sale of the company; a merger or acquisition with a public traded company in exchange for liquid stock; or the transfer of stock to other investors.
Both the entrepreneur and the venture capitalist might be seen to be engaging in opportunistic behaviour on the issue of exit strategy at the expense of the angel investor who has taken the initial risk and could be viewed as “free riders” (Elitzur and Gavious 2003, p.721) creating a moral hazard problem. How can the angel investor know in advance whether the entrepreneur and/or the venture capitalist will “take the money and run” at the earliest opportunity once the angel investor has committed? This dilemma needs resolving.

The entrepreneur requires in the first instance the financial support of the angel investor. Venture capitalists need to be motivated to shift from a position of not investing to a position of commitment. An entrepreneur incurring some costs in dealing with an angel investor is a start. It signals to the angel that the entrepreneur has chosen to exert a positive level of effort and is attempting to create a level of equilibrium in the relationship. Likewise, the venture capitalist can elect to exercise a level of governance and use stock options and staged financing as a signal of commitment (Elitzur and Gavious 2003). Such venture capital funding event can be an important signal to the market as to the quality of the start-up venture (Davila et al. 2003).

Third, there is the risk that the business angel is taking on a specific investment in a particular venture, contrary to a general principle of investing where the risk is spread across a number of ventures. This specific investment limits opportunities for an angel investor wishing to exit the deal at an early stage (Anson 2002).

Freear et al. (2002, pp. 276-277) have categorized risk as being related, first to time, on the basis that a longer period of exposure to an investment carries with it a greater level of risk and, second, to the nature of the business such as the ability of management, the financial state, and competitive and marketing factors. Together, these factors are
known as “alpha” or firm-specific risk, as distinct from “beta” risk – that more generally spread across a portfolio of investments. According to Benjamin and Margulis (2005, p.124), “nothing minimizes risk more than the business plan”. In the words of Banfe (1991, p.113), the business plan should contain “an element of excitement. Every business plan should come close to winning a blue ribbon at the Optimists’ Convention. It is not a historical document or a commercial for the founders”.

High technology is an area of investment characterized by high-risk and appropriability issues. It is unattractive to venture capitalists because of the technical uncertainties. Even business angels are wary of a high risk investment with uncertain returns in this “new economy” (Wessner 2002). Early-stage computing and IT ventures are said to be some of the riskiest investments that an investor might make (Umesh et al. 2007). As such, these investments are seen as too small or too high-risk for institutional funding with a slower graduation to profitability. In terms of the development of the marketing strategy of small and medium sized enterprises, Coviello and Munro (1995) consider that high-technology firms need to adopt a more entrepreneurial approach than the traditional paths followed by larger manufacturing firms. In relation to high technology funding, Sohl (2003) have noted the funding gap between capital and information was a problem during the market volatility, the market inefficiencies, of the 1990s and 2000, and thereafter. The first common market inefficiency is usually a ‘capital gap’ between the needs of early stage ventures and the suppliers of early stage capital. In most cases the cost of successfully commercializing a high technology innovation is at least 10 times the cost of the original research and is often overlooked by the entrepreneur (Sohl 2003). A second inefficiency is the ‘information gap’, where investors seek a level of anonymity whilst wanting to be kept aware of quality deal flow (Sohl 2003).
On the issue of investment risk, many high technology firms focus on a single product and have limited management skills in marketing and finance (Knight 1995). New ventures such as high technology and fast start internet companies often face a substantial imbalance in the make-up of the founding team, which commonly consists of scientists or young internet entrepreneurs with little market experience and no prior knowledge of the requirements needed to undertake a rapid and successful execution of the business plan (Allen 2003). In Australia, Thorburn (2000) has noted the need for the tacit knowledge of the researchers who move into spin-off firms, the means of technology transfer, whilst maintaining existing ties with the research institution.

Technology-based enterprises, which may have greater difficulty in accessing traditional sources of finance, rely more heavily on bootstrapping finance than non-technology firms (Van Auken 2005). A lack of familiarity by owners of small technology-based firms with the forms of capital used to fund growth is a major impediment to the proper pricing of equity and debt investment (Van Auken 2001). Governments could assist through the adoption of policies promoting investment through taxation benefits and (or) grants (Gimenez 2006).

3.1.5 The taxation environment

The history of taxation “can be traced back as far as the existence of government itself” (Cassidy 2004, p.2). Tax planning is a prominent component of the Australian fiscal landscape, and one of the most prevalent practices pursued by Australian taxpayers is negative gearing - “a tax planning arrangement in which a taxpayer borrows funds to acquire an income-earning asset, but the taxpayer’s interest expense exceeds the taxpayer’s [taxable] income from the asset. The taxpayer is allowed to deduct the net
loss each year from other assessable income” (Kobetsky et al 2003, p.388). However the deduction can not be claimed where the relevant borrowings are applied to private or domestic purposes (Woellner et al. 2003). This arrangement contrasts with the U.S. setting in which home mortgage payments are allowable deductions. Investors wishing to take advantage of this deduction may apply the borrowed monies (upon which interest is payable and tax deductible) to the purchase of an income-producing capital asset such as real estate acquired for income producing purposes, shares or a business. Business angels and venture capitalists are able to benefit from this taxation ruling in exactly the same manner as other investors provided, of course, that there is an ‘assessable income’ for taxation purposes against which the interest payment can be deducted. However, the promotion of small business capitalization through tax benefits has not delivered the anticipated results (Asea and Turnovsky 1998; Carpentier and Suret 2007). The provision of favourable taxation credits specifically directed towards start-up enterprises may have negative results in that the investors, having received the benefit from merely investing, may be less inclined to monitor their investments or be less selective in choosing the venture(s) in which they intend to invest.

As to the relevance of tax concessions schemes available for private investment, Connolly and Tan (2002) have concluded that the prospect of high returns to investors is the reason that they are attracted to private equity, as well as the potential diversification benefits. However, the returns on such funds formed since 1998 have been quite low, possibly due to the large proportion of investment in ICT (Information and Communication Technology) firms. Cutler (2008) makes a number of recommendations relating to taxation measures that may provide incentives to firms. These recommendations include replacing the existing R&D Tax Concession by a tax credit, 40 per cent for larger and 50 per cent for smaller firms, in order to raise the level
of business expenditure on research and development by providing a less complex and more predictable system, and expanding the range of eligible activities to include less technically risky activities. Such measures, if introduced, should clarify and simplify the grants process within Australia.

Other economies have different taxation environments. In the United States, one of the reasons for the expansion of the private market is said to be the use of tax incentives on a systematic basis to favour equity investments by the promotion of individual share ownership through tax advantages (capital gains and income differentials) granted and exploited by the 401(k) private pension schemes. In the case of university endowments the investments are non-taxable, and in the case of individuals the capital gains tax is generally phased out at 20 per cent. Canada has been looking at creating a more competitive taxation system with a view to encouraging venture capital investing whilst stimulating entrepreneurship by the reduction of corporate income tax rates, the elimination of the federal capital tax over five years and the reduction of taxes on small and medium businesses.

In the United Kingdom, fiscal and regulatory influences on the development of private sector venture capital have included tax transparency, capital gains tax, taxation and regulation of stock options, innovation and venture capitalists, and control over investors (Mason and Harrison 1999; Denny 2000). In The Netherlands, the rate of taxation can affect the decision as to the type of assets held with marginal tax rates inducing investors to choose assets carrying more risk (Hochguertel et al. 1997).

Researchers have noted differing views about the merits of taxation concessions and the relationship between taxes and risk-taking (Hochguetel et al. 1997; Asea and Turnovsky 1998). Taxation credits alone are insufficient to encourage angel investment, with the
motivation for investors being the tax break without the level of monitoring of the investment that would need to occur in a successful investment (Carpentier and Suret 2007). The taxation regime in Sweden has resulted in a lack of stimulation of private wealth accumulation, and Landstrom (1993) considers that the tax treatment of informal investments should be made no less advantageous than other forms of saving. Indeed, more recent macro-economic changes to the economy in Sweden have resulted in a new level of professionalism in the behaviour of angels and a maturing of the market (Mansson and Landstrom 2006). The growth of the internet industry and changes to the Swedish taxation system probably encouraged investors to invest at an early stage and in high-tech companies, notably in new technology-based firms with reductions in corporate and personal tax rates (Dahlstrand and Cetindamar 2000). Government funding policy can also play a role in the growth of the private marketplace.

3.1.6 Government funding and support

Within Australia, Cutler (2008) has highlighted the need for the urgent restoration of public funding levels for research in universities and government research agencies, there being a need in Australia to successfully adopt and adapt the 98 per cent of innovative ideas that are generated in the rest of the world. Commercialising the significant amount of intellectual property that Australian innovation produces, including information technology, health and biotechnology and communications technology, remains a challenge because of the limited size of Australian capital markets, the number and size of venture capital firms and the geographical position of Australia relative to the main centres of commercialization (Australian Government Austrade 2007).
Innovation, as a focus of Australian policy, came to prominence only in the 1980s (Cutler 2008). The Australian Government Austrade (2007) notes that the Australian government has supported private equity and venture capital with programs such as the venture capital limited partnerships, including early stage programs; innovation investment fund program assisting new venture capital managers at the early-stage of the market; a pre-seed fund program encouraging the private sector to fund the commercialization of research from tertiary and government agencies; ICT incubators program providing seed capital and incubation services to early stage ventures; and the renewable energy equity fund for renewable energy technologies. Cutler (2008) in his report to the Minister for Innovation, Industry, Science and Research, proposed changes related to the support of business innovation, including the extension and expansion of the enterprise connect program and the establishment of a new knowledge connections program. These measures were intended to grow business innovation services and facilitate new connections and clusters which are critical in ensuring that there is a competitive edge for knowledge-based economies. In relation to Australia’s economic growth, Cutler (2008, p.1) comments “that innovation pre-eminently determines our prosperity”. The last 20 to 30 years have seen changes in the architecture of the innovation system, the nature of innovation, especially the growth of internet-based businesses, the loss of support at the federal level for innovation in the face of the minerals boom and the extraordinary growth of economies such as India and China, and, to a lesser extent, Singapore and Korea. Clearly Australia lags without government building structures and introducing policies that support growth in innovation.

The United States has federal legislation intended to protect the survival of small firms under pressure when competing against the superior efficiency of large-scale production (Gilbert et al. 2004). The need to improve access to equity capital has led to government
bodies providing a network connecting small corporate offerings with accredited high net worth investors. Security and anonymity for angel investors are provided through a password-controlled access, and angel investment data can be collected for public policy purposes (Acs and Tarpley 1998). Individual states in the United States have also encouraged angel activity, some providing tax incentives, deductions and subsidies (Lipper and Sommer 2002). Funding start-up and early-stage ventures makes sense. An innovative culture, turning creativity into enterprise, fosters the growth of science and technology with resulting employment opportunities. Eventually the fruits of that success, in the form of financial returns and improved living conditions, benefit governments and individuals.

Chang, Shipp and Wang (2002), Wessner (2002) and Sohl (2003) have all emphasized the importance of the role of government in the United States in the private equity market. According to Krawczky and Wright (2004, p.36), the 2003 Tax Act following on from the Jobs and Growth Tax Relief Reconciliation Act of 2003 was intended “to jump-start the economy and generate investment in the stock of American companies”. Under the U.S. taxation regime, capital gains are assessed and taxed at differing rates depending upon the time for which the asset has been held by the taxpayer. Wessner (2002) has argued that public policy has a significant role to play in advancing and sustaining the development of the new information technology. Public programmes such as the Small Business Innovation Research Programme (SBIR) and the Advanced Technology Program (ATP) can fill the funding gap for approximately 20–25 per cent of early-stage funding and help transform promising new technologies from invention to innovation (Chang et al. 2002). These U.S. government funding initiatives for early-stage investment provide a direct and tangible benefit that flows through to the marketplace in terms of financing and developing the enterprise. The benefits that flow
from investment in R&D are available for others inside and outside the value chain and may also spill over into other companies (Chang et al. 2002). The Advanced Technology Programme (ATP) is an example of the way in which government can assist angel investment through the sharing of some of the risk in the development of high-risk technologies by offering direct financial support, providing a level of risk on the down-side of the deal, and implementing a system of peer review that assists the angel in the due diligence process (Sohl 2003).

The European Commission (2003) has noted that an equity culture can be developed and promoted through the implementation of public policies. Similarly, governments can create sympathetic investment environments and assist enterprises to innovate through skills development and through mechanisms encouraging collaboration and accessing capital (Stern 2006). Europe has adopted a number of policies aimed at promoting a more entrepreneurial culture, removing barriers between sovereign states, co-ordinating legislation and using tax incentives, which have resulted in an increase in the liquidity and efficiency of the marketplace. In the United Kingdom, the Venture Capital Trusts established in the United Kingdom in 1994/1995 to promote the supply of capital to small businesses, invested £160 million in 316 companies, of which 20 per cent were in the early stage (Denny 2000). In Norway, government agencies have entered this arena with a view to assisting entrepreneurs, and with a mixed reception (Saetre 2003) whilst in Belgium, an enquiry into the use of public sector finance as a means of supporting the angel network (Aernoudt et al. 2007) has confirmed that governments seek innovative ways to enhance business angel investment. In Italy government intervention aimed at identifying and targeting the specific needs of a local area, rather than a blanket application, can assist in stimulating the diffusion of entrepreneurship (Dubini 1988).
Serious government initiatives in India have aimed to create a culture of entrepreneurship in a society where social structure and cultural values have not generally fostered such an approach towards business. The establishment of the National Institute for Entrepreneurship and Small Business Development and the PHD Chamber of Commerce and Industry, and the focus upon creating entrepreneurial personalities amongst the youth through the Entrepreneurship Development Institute of India, have laid the foundations for confidence in the population and an availability of important resources with concomitant economic growth (Dana 2000).

Elsewhere governments have been pro-active in the pursuit of an entrepreneurial culture. The rise of the South Korean economy in the 1980s and 1990s provides a striking example of the influence of government policy in advancing an entrepreneurial culture - in this case with a high technology base. South Korea moved quickly in the 1990s to establish new industries utilizing microprocessor technology (Ellyard 1998). The government provided the necessary support in the form of specific-purpose credit funds and taxation breaks (Gilbert et al. 2004). In China traditional cultural and legal practices continue to play a part in entrepreneurial growth (Zelin 2009) and private entrepreneurs have adopted innovative practices whilst remaining aware of the transient nature of a favourable government policy and entrepreneurial environment (Tan 2001). Policymakers in China have a number of options that may enhance entrepreneurial development, such as the opening of new markets, simplifying laws and regulations, giving tax benefits and financial assistance and giving preferences to non-government businesses (Zapalska and Edwards 2001).

Hart and Lenihan (2006) have emphasized the importance of the relationship between private and public sector equity finance in stimulating the number of firms with viable
investment proposals to access government support, whilst Oakey (2003) argues that a better integration of public and private sector funding would be to the advantage of all funders, recipients and the marketplace.

Mason and Harrison (2002a) have proposed that business angel networks should become more pro-active and engage in a wider range of investor and entrepreneur education, which would significantly raise the quality and quantity of deal flow. These initiatives require funding and it clearly appears to be in the interest of government to develop a second tier of business angel networks focused on educating the marketplace and promoting the development of business angel networks. This particularly applies to the growing entrepreneurial technology marketplace, beyond the R&D phase (Berry 1998). Research from Scotland confirms the need for public policy initiatives to encourage the development of more locally based investor syndicates and the education of entrepreneurs to be “investor ready” (Paul et al. 2003).
3.2 The making of the investment decision

This is a core issue for this study. Before the business angels and venture capitalists become involved, the founder of the enterprise will invariably have looked to other sources for funding. Once bootstrap financing sources are exhausted the next participants may well be family, friends and supporters who can offer moral support and limited amounts of seed capital (Banfe 1991). The research addresses these issues in section 2.4.1 and no further reference is made to that source at this point in the study.

3.2.1 The business angel’s investment decision

The 2008 National Angel survey in Australia noted that over 67% of individual angel investors (and 88% of angel group investments) had invested at the seed or start-up stage of a business with a further 22% investing at the development stage. The main focus of investment was the information and communication technology sector with more than one third of the deals followed by the biotech sector with 20%. Angels spent an average of 34 hours per month on their investment activities.

(i) Access to deals

The geographic location of the investment can influence potential angel investors’ decisions. Aernoudt (1999a, p.188) refers to the Anglo-Saxons adage of the “one day drive by car” and speaks of business angels wishing to see and be seen by the enterprise. Aernoudt does note that a significant minority (24 per cent in the study undertaken) of investments were regarded as long-distance investments, suggesting that where investors are unable to identify potential opportunities locally they seek such
opportunities in long-distance investments. Some investors indicate that they would invest outside their home state if there was a trusted relationship with another party who could monitor the deal.

The investment criteria of business angels are an investment between US$25,000 and US$1,000,000 in transactions that generally match their technical expertise, preferably in participation with other financially sophisticated individuals and with 23 per cent preferring to invest “close to home” (Benjamin and Margulis 2005). These investors maintain “active” professional relationships with portfolio investments of one to four transactions per year and a holding term of eight years. Diversification and tax shelter income are not the most important objectives. Whilst the return on investment is rarely the only objective, the investor will be looking for a rate of return from 22.5 per cent to 50 per cent, with a minimum portfolio return of 20 per cent (Benjamin and Margulis 2005).

The criteria for angel investors in the United States seem to be a degree of excitement in investing in a product or idea that enjoys a proprietary advantage or exploits a unique technology that may result in significant barriers to competition, enjoys costs advantage and can be understood (is not too complex) (Benjamin and Margulis 2005). According to Sherman (2005) typical business angels invest approximately every two years, have a strong preference for manufacturing ventures, high technology in particular, and expect to liquidate the investment in five to 10 years. They seek compound annual rates of return on individual investments, ranging from more than 50 per cent from inventors to 20 per cent from established firms, and minimum portfolio returns of about 20 per cent. They often accept limitations on financial rewards or higher risks in exchange for non-financial rewards. Angels are “generally wealthy people willing to put their money into
new businesses. Some don’t have enough funds to get into a venture capital fund but still enjoy the challenge (and can tolerate the risks) of venture-type investment. Others want a hands-on approach to their investment decisions” (Goldstein 2002, p.143).

Freear et al. (1994) note that a complete business plan is a prerequisite for investors who may make an investment. However, business angel investors will invest in ventures even where the potential for high level sales has not been met. They take the view that they require their investment returns to meet their targeted multiples and personal expectations as a consideration over and above issues of liquidity and return on investment in the short term. There should be the possibility of new markets with potential for fast growth and share of the market and a return on investment of five to 10 times the initial outlay, with solid financials and assumptions spelt out. A study of business angels in the United States identified such investors as well educated, middle-aged and male, with considerable business experience and a preference to invest in the start-up and early stages of a venture close to where they live (Freear et al. 1994).

Sorheim and Landstrom (2001) consider that more than 40 per cent of informal investors would invest more if they had better access to investment opportunities, whilst Aenoudt (1999) has noted that business angels do not always know where to find investment opportunities and that there is a need for business angel networks. Whilst Reitan and Sorheim (2000, p.140) stated that “the potential for investments in unlisted companies is several times greater than the actual level of investment” and further that “66% of informal investors would increase their activity level if a forum was created to enable entrepreneurs and investors to meet”. They identified a shortage of “interesting” investments according to almost 40 per cent of investors and that more than 30 per cent
of non-investors would have invested in private companies if they had been aware of interesting opportunities.

Informal networks of business angels provide a major source of capital for entrepreneurs as business angels may value add, may be geographically dispersed, willing to consider smaller deals and be less expensive to engage. Disadvantages can be that business angels may have limited access to follow-on capital, be interventionist and not provide leverage to professional capital, resulting in the venture not being properly funded as it expands (Frederick et al. 2006).

Wiltbank (2005) has suggested that angel investors would be more successful in investing if they followed a venture capitalist approach, and invested in new ventures that are in later stages of development, conducted more due diligence and sought out broader-based investment opportunities where more investors are involved, participating after the first investment and leveraging their experience as an investor and an entrepreneur.

(ii) Equity / control

Harrison and Mason (1992) characterise informal U.K. investors as ad hoc investors, less sophisticated, professional, less likely to seriously evaluate and to commit to an investment and, if so, for a smaller amount, than their U.S. and Swedish counterparts. Landstrom’s (1993) study of U.S., U.K. and Swedish investors confirmed that all three groups look to hold their investment for five years or less. Whilst in the United States there seems to be an adequate exit strategy, this is not the case in Sweden. The availability of an exit route in the United States may reflect the more professional and sophisticated market, and also the smaller size of the Swedish risk capital market (Landstrom 1993). Furthermore, informal investors in each country have different
characteristics, probably attributable to differences in contextual factors such as the investment climate, entrepreneurial, fiscal and regulatory factors and the distribution of wealth. Landstrom (1998, p.323) has investigated the decision–making criteria by posing questions as to the nature of these criteria and the assessment of value placed upon the investment opportunity and upon the entrepreneur. Of particular interest are why Sweden’s informal investors value certain qualities in the investment opportunity and not others and whether the findings have relevance to this study. The outcomes of the study as outlined above in contrast with the United States and United Kingdom experience suggest that Landstrom’s (1993) study may have little or no broader application. Further, in the Swedish informal marketplace a particular relationship can develop between the informal investor and the entrepreneur, a kind of “resemblance focus” (Landstrom 1998, p.330) which means that the decision–making criteria will vary from investor to investor and will depend upon the dynamics that drive the particular relationship between investor and entrepreneur.

The valuation of the shareholding in the venture is a major consideration in the relationship between the entrepreneur and the investor in the investment decision-making process. *Valuation* “haunts every aspect of a venture; in its very scope, valuation becomes the entire process writ small. No deal gets very far without it; no deal can be torpedoed more quickly if it is off the mark”, note Benjamin and Margulis (2005, p.269). Valuation of an existing business McKaskill (2006, p.72) notes is “the greatest source of conflict between entrepreneurs and venture capitalists’ funds (and is) plagued by emotion, misunderstanding, entrenched position taking and ignorance.” The assessment of the relative contributions of the entrepreneur and the investor to the deal needs to start from an agreed point of reference, and that is almost invariably the financial criteria outlined in the business plan prepared by or on behalf of the
entrepreneur. As Pricer and Johnson (1997, p.24) have noted, “owners and investors need to know the market value of a small business in order to determine the ownership percentage that is appropriate for an equity investment”. Market value is important in the continuing development of the enterprise; for lenders assessing the risk; for owners wishing to exit; in the purchase of key person insurance; for settling disputes within the enterprise; for employee share plans; and for settling any litigious issues from an external claimant. Whilst no single valuation may be superior for estimating the selling price (or a share thereof) of a particular business, there can be a single valuation method which proves to be a reasonable predictor of the likely price to be paid (Pricer and Johnson 1997).

(iii) Entrepreneur / management

Angel investors want to see ability in management and a clear demand for the product or service. They view the overall business proposal and the entrepreneur as significant factors in the decision-making process (Feeney et al.1999).

Business angels in the U.K. place considerable weight upon the characteristics and experience of the entrepreneur when assessing the perceived riskiness of an investment opportunity (Harrison and Mason 2002). Serial investors prefer to invest with entrepreneurs who are personally known to at least one of the investors or to the party referring the deal to them, and where they have some direct experience of the area of investment (Kelly and Hay 1996). Mason and Harrison (2000, p. 293) consider that presentation skills such as structure and clarity may be critical to the success of the investment decision in the capital raising process with entrepreneurs needing to be “investment ready”. Trust between the parties and active involvement by investors are important determinants in the decision-making process (Kelly and Hay 2001).
An entrepreneur may have an advantage in approaching business angels rather than professional venture capital investors for funding, for many angel investors are not motivated solely by profit. This is particularly so if the business angel is a former or current entrepreneur who may have an affinity with the entrepreneur’s drive and vision, and be more interested and willing to provide greater assistance to the entrepreneur in a business which, because of its early-stage status and uncertain future, would not qualify for traditional sources of capital (Gaston 1989).

There is a subjective element to consider – the use of the heuristics of representativeness and overconfidence in the decision-making process by both novice and habitual angels. Heuristics are defined as “the cognitive short cuts decision makers use in order to simplify information processing” (Farrell and Howorth 2002, p.382) and can lead to sub-optimal decision making. If there is no advantage in securing habitual angels, entrepreneurs might be better advised to develop or cultivate novice angels as a source of investment funds, rather than attempting to locate habitual angels (Farrell and Howorth 2002).

United Kingdom business angels are said to be generally experienced investors, financially aware and confident in their own ability to evaluate the merits of a proposal who invest in an opportunistic, rather than a scientific, way (Mason and Harrison 1996). Their reasons for investing are primarily for the high capital appreciation. However, there are also non-financial reasons such as being involved in the entrepreneurial process and enjoying the experience.

The degree of significance of the business plan to different parties such as banks, venture capitalists and business angels, suggests that entrepreneurs would be wise to customize their plan according to the source of the funding. As business angels are
seeking a richer experience from their investment than their professional counterparts, such a plan when submitted to a business angel should have an extra dimension of excitement to capture the angels’ emotions (Mason and Stark 2004).

Most business angels require that the entrepreneur submit a business plan before they give the venture serious consideration (Kotler et al. 2004). Investors expect the entrepreneur to have given consideration to an investor’s needs and expand upon same in the business plan (Barros 1993). This plan should include the financial projections and financing sought and should incorporate a combination of presentation tools (Bode 2004) to persuade the investor as to the quality of the market opportunity in terms of future profitability and the soundness of the business model. Benjamin and Margulis (2005) consider that, in the wake of the dot com boom and bust, a strong business plan should be mandatory.

**Investor readiness** is a key issue. Whilst only at early stage of development or established but in a precarious market (Posadas 1998), an investment is not ‘investment ready’ if it is either unprepared or the investor is unwilling to take on an equity partner. A venture may have unrealistic growth assumptions, with investor returns not realizable in a reasonable period of time or it may have management and control issues. Clayton (1998) considers that entrepreneurs seeking angel investment should compile cash flow schedules, budgets, competitor analyses, lists of product or service details, and projected markets and opportunities.

(iv) Investor input

Numerous factors motivate why early-stage investors become involved in private equity investment in a marketplace which has a high chance of loss of capital (Benjamin and Margulis 2005). Reitan and Sorheim (2000) state that 63 per cent of informal investors
would increase their level of activity if the exit channels were better and 45 per cent
would do so if tax incentives were better.

Haar et al. (1988) claim that angel investors are enthusiastic and persistent, with claims
of higher investment returns than other investment strategies and a repeat investment
rate of more than 80 per cent. As there is no middle man in the deal, the investor can
directly influence the outcome of the investment, which can be a satisfying experience.
One very attractive advantage is said to be “the possibility of hitting a home run in this
arena” (Benjamin and Margulis 2005, p.121). Investors, particularly early-stage
investors such as seed capitalists or business angel investors, seek a long-term rate of
return in excess of that offered by the general stock market (Anson 2002).

Angel investment is not always based upon receiving a financial return (Sherman 2005).
It is often seen as a means of giving something back to the community, in the spirit of
fostering local economic growth, or as a means of providing a mentor role for younger
entrepreneurs. That is not to say that business angel investors are not diligent in the
manner in which they undertake a review process of their investments, but there may be
more informality in the process than applies to venture capital firms.

Lesonsky (2007) is of the view that business angels look to the same criteria as
professional venture capital investors when deciding whether to invest. These factors
are strong management, proprietary strength and the features of the product or service, a
window of opportunity in being first to market and acquiring a substantial share, market
potential, with franchise or expansion plans and a return on investment of 20 to 25 per
cent, or less depending upon the level of assessed risk.

The referral of an investment opportunity through a trusted network may be an
important consideration in the investment decision of the business angel. Freear et al.
(2002, p. 280) noted that “angels find out about investment opportunities through friends and business associates, and often operate in loosely joined networks” and when investing with other investors often have a respected lead investor. Networks are important for angels and for entrepreneurs as a means of becoming aware of deals (Donckels and Lambrecht 1997; Acs and Tarpley 1998; Steier and Greenwood 1999; Frederick et al. 2006) and many angel investors form syndicates in order to create larger pools of capital. Dubini and Aldrich (1991, p.305) described networks as “patterned relationships between individuals, groups and organizations”. An invitation to join a successful network has been described by Bodde (2004, p.126) as “the keys to the kingdom are your contacts” by providing a conduit for an investor into a business angel network and access to financial opportunities. Business networks are said to be constructed upon a series of fundamental paradoxes: they are driven by selfish motives yet survive through a selfless sharing of ideas and information (Yanagida 1992). Steir and Greenwood (1999, p. 165) regard the understanding of how angel networks are developed and managed as “a significant but imperfectly understood aspect of the entrepreneurial process”.

Unquestionably, the business angel marketplace has evolved since the late 1970s and early 1980s when an informal word-of-mouth network prevailed, with deal-making being done on an ad hoc basis preceded by a low level of due diligence (May 2002). Since the mid 1990s the marketplace has become more organized. Business founders and entrepreneurs have become aware of business angels through networks of work associates, lawyers or accountants, or business school academics. The success of these early contacts tends to be hit or miss. May (2002, p.337) cites the experience of C. Richard Kramlich, who commented “I was just plain lucky as an angel” when the
US$22,500 he (Kramlich) gave to a couple of Bay Area “geeks” named Steven Jobs and Steve Wozniak was parlayed by them into Apple Computer Company!

The rise of new technology has led to the formation of a number of formal networks across the United States (May 2002) with investors generally needing to satisfy the United States Securities and Exchange Commission requirements for accreditation, have a liquid net worth of at least $US1 million and (or) an annual income, for at least two years running, of $US200, 000 ($US300, 000 if married). With a more structured entity, a professional manager can access and follow-up investors.

Table 3.1 summarises the research as to investment considerations of business angels.
## TABLE 3.1  The business angel investment decision

<table>
<thead>
<tr>
<th>Study</th>
<th>Relevant considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allen (2003)</td>
<td>Normally invest in start-up and early stage, prefer manufacturing, energy and high tech for a period of three to seven years and seeking returns of multiple of 10 for start-up and five for early stage</td>
</tr>
<tr>
<td>Anson (2002)</td>
<td>Early stage investors seek a long term rate in excess of general stock market</td>
</tr>
<tr>
<td>Benjamin and Margulis (2005)</td>
<td>Generally invest in transactions that match technical expertise, with other sophisticated investors, and prefer to invest closer to home, with one to four transactions a year and a holding term of eight years and no middle man in deal</td>
</tr>
<tr>
<td>Feeney et al. (1999)</td>
<td>Look for ability in management, demand for product, view business proposal and entrepreneur as significant factors</td>
</tr>
<tr>
<td>Freear et al. (1994)</td>
<td>Prefer to invest in the early start-up stage and close to home</td>
</tr>
<tr>
<td>Kelly and Hay (1996)</td>
<td>Prefer to invest with entrepreneurs known to them or through trusted referral and investment where they have experience</td>
</tr>
<tr>
<td>Lesonsky (2007)</td>
<td>Angel investors not motivated solely by profit, look for strong management, proprietary strength, window of opportunity and returns of 20 to 25 percent, less if lower risk</td>
</tr>
<tr>
<td>Mason and Stark (2004)</td>
<td>Seeking a richer experience, plan should have degree of excitement to capture emotions of business angel</td>
</tr>
<tr>
<td>Sherman (2005)</td>
<td>Invest approximately every two years, strong preference for manufacturing and high tech, liquidate in five to 10 years, seek compound annual returns of 20 to 50 per cent, will accept limitations on same or higher risks in exchange for non-financial rewards</td>
</tr>
<tr>
<td>Wiltbank (2005)</td>
<td>Angel investors should follow venture capitalist approach for more success, invest at later stage, more due diligence and broader based opportunities</td>
</tr>
</tbody>
</table>
3.2.2 The business angel’s rejection of the deal

Several reasons underpin a business angel rejecting the deal (Mason and Harrison 1996). Gaston (1989) lists the top four deal rejection reasons ranked in order of importance by angels: inadequate growth potential; inadequate personal knowledge of the firm, its principals, and key personnel; management’s lack of experience or talent; and unrealistic values of the firm’s equity.

Business angel can reject an investment for a number of reasons (Wetzel 1983; Gaston 1989; Bygrave 1994; Benjamin and Margulis 2005): If the venture shows insufficient potential, or inadequate profit margins or risk return ratio; if mutual respect is lacking in the management team or the entrepreneur has weak credentials or no successful track record; if the venture is too technical or not easily understood; if the investor is uninterested in or unfamiliar with the proposed business, or sees no socio-economic value in it; if the venture has no well defined business plan; if there is no agreement on price or a lack of commitment by the principals of the venture; or if the investor has personal or family reasons for rejecting the investment. Harrison and Mason (1996) note that the reasons for not investing are most commonly associated with the quality of the management team and entrepreneur, marketing issues and unrealistic financial factors. Failure by the entrepreneur to produce a requested business plan may be a significant factor and an accumulation of factors rather than a single factor can lead to rejection of the proposal (Mason and Harrison 1996).

When screening proposals from entrepreneurs, business angels rely mainly on whether the individual is known to them or an associate and is trusted (Prowse 1998). Business angels are also concerned with growth potential, the pricing of the deal and the amount
of profit available to outside investors. The location of the venture, preferably close to home, may be an issue. Table 3.2 provides reasons for rejecting the deal.

### Table 3.2 Business angel reasons for rejecting the deal

<table>
<thead>
<tr>
<th>Study</th>
<th>Reasons for rejecting the deal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benjamin and Margulis (2005)</td>
<td>Insufficient business potential, profit margins not adequate, risk return ratio inadequate, lack of chemistry and entrepreneur credentials, too technical or difficult and no obvious value</td>
</tr>
<tr>
<td>Bygrave (1994)</td>
<td>Inadequate management and risk/reward ratios, unfamiliar or unattractive business and proposal</td>
</tr>
<tr>
<td>Gaston (1989)</td>
<td>Inadequate growth potential and personal knowledge of the entrepreneur and enterprise, lack of management skill and unrealistic value of share offered</td>
</tr>
<tr>
<td>Prowse (1998)</td>
<td>Reliance upon referral from trusted source and need to see growth potential and value in enterprise, with location close to home</td>
</tr>
<tr>
<td>Wetzel (1983)</td>
<td>Risk ratio return not right, inadequate management, no obvious value in business proposition</td>
</tr>
</tbody>
</table>

#### 3.2.3 The venture capitalist’s investment decision

A lack of quantifiable financial and market data can hinder the decision in relation to early-stage ventures and it can be primarily a subjective assessment. Quality of judgement is the key to success in venture capital management (Stevenson et al. 1987). Riquelme and Rickards (1992) suggest that two stages occur in a venture capitalist’s decision-making process: (i) Screening the entrepreneur’s experience and the product’s quality; and (ii) evaluating criteria such as product gross profit margin, patents and, particularly, management experience. The first stage is more judgmental than analytical. Feeney et al. (1999) divide the decision process into six stages: search, screening,
evaluation, due diligence, negotiation/closing and post-investment involvement. The first stage involves gaining access to the deal.

(i) Access to deals

The deal may be rejected because it does not fall within the investment portfolio of the venture capitalist (Tyebjee and Bruno 1984b). While business angels are seen to “invest earlier in the lifecycle of the business than venture capitalists” (Kotler et al. 2004, pp.26-27), there will be instances where venture capitalists invest in start-up and early-stage enterprises.

Evaluation criteria can include market attractiveness, product differentiation, managerial capabilities, environmental threat resistance and cash-out potential (Tyebjee and Bruno 1984a). Despite the long list of rational reasons behind the decision to invest, venture capitalists often rely on a sense of personal chemistry or “gut feel” (Hisrich and Jankowicz 1990), with just one or two factors resulting in what is essentially a subjective analysis of the venture. Whilst investment decisions can be grouped into three areas (management, unique opportunity and appropriate return) venture capitalists bring their own subjective approach to the investment (Hisrich and Jankowicz 1990). Venture capital firms present their services in different ways and there can be a degree of “shopping” by entrepreneurs for a suitable venture capital firm (Robinson 1987).

(ii) Equity / control

Venture capital firms may require representation on the board of the enterprise as a condition of the injection of funds and the taking of an equity stake in the business. This is more commonly an active role, especially if the venture capital investor believes that the firm needs support in management (Oates 1987; Barrow 1993). This
appointment to the board means that the entrepreneur has access to a “talented financial brain” of which use should be made (Barrow 1993, p.72).

Both entrepreneurial opportunities and the potential for risk can increase in a time of rapid change. Over-enthusiasm can lead to “capital market myopia” where the participants, including venture capitalists, ignore the logical implications of their investment (Sahlman and Stevenson 1985, p.7). Valuation risk occurs when the investor pays too much for the investment (Golis 2002). Values turn out to be unsustainable and businesses are overfunded. Ventures known as “the living dead” are those located in the critical middle ground of venture capital investments. Whilst being self-supporting, they fail to achieve the necessary profitability to provide returns or an exit strategy (Ruhnka and Young 1991, p.127; Ruhnka, Feldman and Dean 1992, p.137). Thus there can be no sale of such a venture or a public listing whereby the investors’ shares in the venture can be publicly sold (Kotler et al. 2004). To avoid such problems, venture capital investors can value the investment proposal in different ways. Traditionally they rely upon “gut feel” in deciding which ventures to back (MacMillan et al 1987, p.124). However, two major and identifiable criteria are predictors of venture success: The extent to which there is initial insulation of the venture from competition, and the degree of demonstrated market acceptance of the product. An alternative means of assessing the value is to measure the proportion of the entrepreneur’s initial wealth invested in the venture (Prasad et al. 2000). This assessment indicates both the project’s value and the entrepreneur’s commitment, so that investor and entrepreneur can objectively value the injection of further rounds of capital and be aware of the commitment of the entrepreneur and the value of the project. As the entrepreneur has an advantage over the investor through knowledge of
expected returns, outside investors need to assess the entrepreneur’s financial commitment to the enterprise and strike a valuation figure (Leland and Pyle 1977).

(iii) Entrepreneur / management

Venture capitalists give most importance to interviewing the management team and seeking attributes in managers such as personal integrity, prior successful job record (even if previously associated with losing ventures), a realistic attitude and ability to assess and deal with risk issues, good work ethic and flexibility, and leadership skills especially under pressure (Fried and Hirsch 1994). This due diligence may attract other venture capitalists to join in the investment (Jain 2001).

The relationships between entrepreneurs and venture capitalists who provide a more structured level of financing than the angel investors are noticeably different in the value-added benefits in terms of the degree of involvement, the formality of the relationship and the type of expertise (Erlich et al. 1994). The party from whom the entrepreneur receives funding is as important as the amount of capital obtained and may, if the match is right, create a synergy promoting the growth of the enterprise. The weighting of the various criteria used by entrepreneurs in choosing their venture capital investors can be a significant factor in the effective matching of resources to opportunities (Valliere and Peterson 2007). Entrepreneurs, especially novice entrepreneurs, need to be aware that some espoused criteria are not as reliable as they might have initially believed. Whilst valuation and the terms and conditions of the deal may be seen as primary criteria, with more experience entrepreneurs increasingly value the personal compatibility of the venture capitalist.

Three factors concerning the management team are critical to the investment decision: A strategic alignment, a long-term managerial commitment and focused strategies from
the early stages of development (Jain 2001). The venture capitalist needs to address the entrepreneur’s creativity as opposed to the motivation espoused (Khan 1987).

Building a strong management team is critical to the venture’s success (Drucker 1985; Ronstadt 1985; Bodde 2004) and the creation of the management team should commence early as such teams generally take at least three years to develop (Drucker 1985). Professional venture capitalists will choose to work with the management team by contributing their own experience and business knowledge to the enterprise (Schaper and Volery 2004). Indeed, “some venture capital firms will only inject funds into businesses run by proven management teams” (Oates 1987, p.77). Whilst market attractiveness is seen as critical, the significant factor in the actual evaluation of an enterprise’s performance is the managerial capability of the venture (Timmons and Gumpert 1984; Robinson 1987; Rah et al. 1994). According to Holt (1992, p.350), “the success of an enterprise is more often determined by the individuals who lead it forward than by its products or services”. Effectively the role of the entrepreneurial team (management) is to make the transformation of creative ideas into commercial realities, and most venture capitalists would prefer to engage an A grade entrepreneurial team with a B grade idea than the reverse (Holt 1992). The manager’s prior experience in the target area and general management experience are very significant in assessing the likely success of the venture (Sykes 1986). A professional management team on board at start-up is recommended (Allen 2003). Forsyth et al. (1991, p.7) have argued that entrepreneurship per se is a form of management with an emphasis upon creativity and risk taking, and that the entrepreneurial zeal that brings the venture into existence is also a driving force through the life cycle.
(iv) Investor input (the financial assessment)

Venture capitalists are concerned with an exit route in order to liquidate their investment, generally within three to seven years (Barrow 1993), and take a profit and release funds for new ventures. Ruhnka and Young (1987, p. 181) have noted that “venture capital investors even in the ‘exit stage’ are never completely free from risk of loss until they are able to cash out of their investments”. From a risk perspective, the funding decision can be influenced by the risk of losing the entire investment, being unable to bail out if necessary or to implement the venture idea, and risks associated with competition, management and leadership failure (MacMillan et al. 1985). A behavioural framework which can predict how venture capitalists make the investment decision in order to minimise risk and maximize potential returns is far more complicated than a wholly subjective ad hoc process (Ruhnka and Young 1991).

There are always other factors promoting the investment pitch by the entrepreneur, such as being able to show good prospects for capital growth in a sizable market and having a defensible niche position within that market (Ronstadt 1985). Bruno and Tyebjee (1985) have suggested that an entrepreneur should possess prior business experience before seeking capital, have a management team well rounded in relevant skills and expect the capital-raising process to take longer and involve more effort than planned. In addition the entrepreneur should understand the cost of raising external capital, in terms of equity relinquished, which is more than adequately compensated by the rapid rate of growth of the enterprise. Failure to obtain venture capital is not the end of the enterprise, as capital can be sourced through other avenues.

Table 3.3 provides a summary of previous research relating to the decision of the venture capitalist.
### TABLE 3.3  The venture capitalist investment decision

<table>
<thead>
<tr>
<th>Study</th>
<th>Relevant considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bodde (2004)</td>
<td>A strong management team</td>
</tr>
<tr>
<td>Drucker (1985)</td>
<td>A strong management team</td>
</tr>
<tr>
<td>Fried and Hisrich (1994)</td>
<td>The ability of management and the personal integrity of the entrepreneur and leadership skills under pressure</td>
</tr>
<tr>
<td>Golis (2002)</td>
<td>Valuation is an important factor and risk occurs when the investor pays too much</td>
</tr>
<tr>
<td>Holt (1992)</td>
<td>The role of the entrepreneurial management team is most important</td>
</tr>
<tr>
<td>Jain (2001)</td>
<td>The importance of managerial performance, focused strategies from the early stages of development and due diligence</td>
</tr>
<tr>
<td>Leland and Pyle (1977)</td>
<td>Investors should consider the proportion of the entrepreneur’s wealth that is invested in the enterprise and strike a valuation accordingly</td>
</tr>
<tr>
<td>Macmillan et al. (1985)</td>
<td>Irrespective of product, market and financial criteria, it is the entrepreneur who is critical, as is the business plan</td>
</tr>
<tr>
<td>Macmillan et al. (1987)</td>
<td>Traditional view that venture capitalists rely upon “gut feel” for investment whilst concerned about competitive attack, high levels of protection, a market-maker product and distribution skills</td>
</tr>
<tr>
<td>Oates (1987)</td>
<td>Representation on the board and support for the management team if necessary</td>
</tr>
<tr>
<td>Rah et al. (1994)</td>
<td>Management capability, market attraction very important</td>
</tr>
<tr>
<td>Robinson (1987)</td>
<td>Management capability is a critical factor</td>
</tr>
<tr>
<td>Sykes (1986)</td>
<td>The venture manager’s prior experience and the general management experience</td>
</tr>
</tbody>
</table>

### 3.2.4  The venture capitalist’s rejection of the deal

The experience of Shen Venture, Inc., a venture capital firm in Virginia, illustrates the reasons for firms rejecting deals (Holt 1992). Shen Venture invested in only three opportunities of 43 proposals. Nearly every project was rejected for lack of leadership quality, whereas each of the three projects chosen had a sound team. Deficiencies in management account for up to one-third of rejections by venture capitalists (Bruno and
Tyebjee 1985), although entrepreneurs put the rejection figure at less than one fifth, but they may be reluctant to report lack of success whilst on the capital-raising circuit.

Entrepreneurs should avoid bringing the wrong proposal to the wrong venture capital firm, shopping around too much for finance, being too inflexible on the issues of control and profit (it is, after all, the venture capitalist’s money that is being sought) and bringing along outside “experts” (Ronstadt 1985). There is merit in having a management team with a good track record, as well as having an introduction to the venture capital firm through a respected source, an amount of own capital in the venture and drawing modest salaries. Having the right chemistry also assists.

Fried and Hisrich (1994) have described how pricing issues are negotiated earlier in the evaluation process, followed by venture capitalist screening and then evaluation and closing. The instinct that some venture capitalists bring to the investment decision based upon their experience fails to match that of an actuarial model of bootstrap funding, the actuarial model being consistent across different proposals and time (Zacharakis and Meyer 2000). This study concentrated on venture capitalists in the Denver / Boulder metropolitan area and in Silicon Valley in California. The participants suggested that their decision style was much less formal than their East Coast peers. Table 3.4 summarises the reasons advanced by venture capitalists for rejecting a deal.
TABLE 3.4 Venture capitalist reasons for rejecting the deal

<table>
<thead>
<tr>
<th>Study</th>
<th>Reasons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bruno and Tyebjee (1985)</td>
<td>Deficiencies in management</td>
</tr>
<tr>
<td>Ronstadt (1985)</td>
<td>The entrepreneur bringing the wrong proposal and being inflexible on control and profit issues</td>
</tr>
<tr>
<td>Tyebjee and Bruno (1984)</td>
<td>Deal does not fall within the investment portfolio scope</td>
</tr>
</tbody>
</table>

3.2.5 Key similarities and differences in investors’ decisions

There are occasions where business angels and venture capitalists reach an investment decision for similar reasons, others where they follow different reasoning processes.

(i) Similarities

Business angels share with venture capitalists a concern about the management ability of the enterprise team and demonstrable evidence of a demand for the product or service, preferably in a market with potential (Haar et al. 1988). A division in the roles of the business angel investor and the venture capitalist should not be seen as hard and fast. Dimov et al. (2007) have found that more reputable venture capital firms are more likely to invest in start-up and early-stage enterprises than their less reputable counterparts. A venture capitalist with a higher reputation and greater resources may experiment in early-stage investment. From another perspective, a better reputation might bring the venture capital firm better opportunities, ready resources and expertise.

(ii) Differences

Business angels differ from venture capitalists by typically investing in markets with known technologies and synergistic investment objectives (Prasad et al. 2000). They
differ in terms of the time span of the investment (business angels may accept a longer exit term), the location (business angels tend to invest closer to their base), the contribution to the venture (business angels contribute more know-how and capital), and risk and reward (business angels are willing to accept more risk for less reward). Business angels may have more affinity with the entrepreneur and the struggle to succeed, as they are often past or present entrepreneurs themselves (Prasad et al. 2000). Venture capital funding is available only to a small proportion of start-up firms, but it can supply considerably more capital and management expertise to young firms, albeit at a higher price in terms of the share of equity that must be surrendered to receive such assistance (Bruno and Tyebjee 1985).

Venture capitalists are seen as “participating investors seeking to add value through ongoing longer-term involvement with continuing business development” (Ronstadt 1985, p.665) with three main characteristics: an expectation of equity participation and an advisory role, an ongoing relationship of five to 10 years, and a high return on investment well in excess of mainstream investments to compensate for what may be a high-risk play. By staying the distance, the venture capital investor is able to alleviate the risk as the enterprise reaches each stage of development (Ruhnka and Young 1987). Venture capitalists are more likely to place stringent controls upon an entrepreneur than might angel investors (Erlich et al. 1994) and also find unique value in strategic information about the product or process, the patentability prospects, the marketing of the product and the management team. They use that information more directly than other commercial lenders such as bankers (Rosman and O’Neill 1993).

The issue arises as to whether business angels should become more diversified or hold more capital in reserve, similar to a venture capitalist. Wiltbank et al. (2009) have
suggested that using venture capitalist processes might not necessarily lead to business angel success in investing, and that business angels should bring their entrepreneurial expertise to bear on these challenges. Business angels may choose to take more control of the investment process, thus experiencing fewer negative exits or may adopt predictive strategies using financial modelling to predict outcomes (Dew et al. 2008). Essentially this is a form of controlling the outcome by attempting to predict the future and limit risk.

Business angels rely on more personal networks, whereas venture capitalists consult formal networks and associates at other venture capital firms for market information (Fiet 1995). Venture capitalists may be influenced in their decision-making process if the proposal comes from a trusted source, with much less focus in these instances on the entrepreneurial team and early strategy (Hall and Hofer 1993). However, the decisions of experienced venture capitalists may not always be superior, or more successful, than those of inexperienced venture capitalists (Shepherd et al. 2003).

Kotler et al. (2004, pp 26-27) have noted that business angels tend to invest as individuals or sometimes in syndicates of individuals, while venture capitalists normally ply their trade in specialist venture capital firms that raise funds from other parties. In other words, whereas angels invest their own money, venture capitalists typically invest someone else’s. Unlike venture capitalists, “angels do not make such investments their primary business” (Elitzur and Gavious 2003, pp.709-710). The intervention of a third party, which occurs in the venture capital investment process and not in the business angel process, influences the protocol followed by these firms to ensure that they limit the risks involved with an entrepreneur’s potential misuse of the investor’s money (Van Osnabrugge 2000).
Business angels differ in making only a few investments a year and are more reliant on a successful result, as a loss of capital could devastate the profitability of the entire portfolio. A venture capitalist could make considerably more investments a year and be better placed to absorb such a loss (Benjamin and Margulis 2005). The dollar amount of venture capital investment tends to be far more substantial than that of business angels (Haar et al. 1988).

Overall, venture capitalists have more sector experience than business angels, invest in larger enterprises, are more thorough in demanding and analyzing the financials, do more research and take longer to invest (Van Osnabrugge 2000). This ex ante approach signals to the entrepreneur the competence of the venture capitalist as a way of protecting the investment. In contrast, business angels tend to rely more upon ex post investment involvement as a means of risk reduction, investing their own money, and being more personally and directly involved in the success or failure of the deal.

Venture capitalists are more easily located than their private business angel counterparts, and so much of the research has concentrated on these professional investors and their decision-making processes (MacMillan et al. 1985; Khan 1987; MacMillan et al. 1987; Hisrich and Jankowicz 1990; Riquelme and Rickards 1992; Hall and Hofer 1993; Rosman and O’Neill 1993; Fried and Hisrich 1994; Muzyka et al. 1996; Riquelme and Watson 2002; Shepherd et al. 2003; Franke et al. 2006). These studies confirm the more public presence of venture capitalists who act as professional investors on behalf of their clients, investing clients’ funds of their and focusing on the key criteria of the proposal fit within the firm’s lending guidelines.

Mason and Harrison (1999) point out that given the very distinctive skill sets that are required by venture capitalists in order to undertake their role, there has been
surprisingly little research focused on them. Little is known about how a venture capitalist’s decisions impact the entrepreneurial process (Tyebjee and Bruno 1984b). Venture capitalists try to avoid what Franke et al. (2006, p. 823) refer to as “the similarity biases” where the ideal venture is rated more favourably because the venture capitalists and the promoters of the enterprise have similar characteristics. However, that said, venture capitalists are better able to make investment decisions than their investors (Fried and Hisrich 1994) and are perceived as professional investors who make their profits by investing in new firms, and are considered to possess much experience in distinguishing winners from losers (Riquelme and Rickards 1992).

Some hold that venture capital investment carries no more risk than investment in small to medium-sized stocks (Chiampou and Kallett 1989). However, new ventures, by their very nature, carry high levels of risk (Muzyka et al. 1996). Venture capital is also known as “risk-capital … a high risk form of investment” (Tyebjee and Bruno 1984b, pp.185, 191). Investors must be willing to bear the risk of no liquidity whilst investing in products or ideas which are often untested (Anson 2002). Accordingly, they expect a reasonable rate of return. Venture capitalists are said to expect target rates of return of 30 per cent or more in the case of established companies, rising to 60 per cent or more for seed or start-up investments to support the risk (Mason and Harrison 1999).

It can be argued that greater emphasis is given to the “softer” factors in the business angel or informal decision process than in the venture capital or formal process, with such factors not solely related to the financial viability of the venture (Lesonsky 2007). Venture capitalists are said to operate in an “information rich” environment consistent with the more structured state of the latter stage enterprise, whereas angel investors, in assessing more intangible and less defined assets, have to place greater reliance upon
softer factors such as the attributes of the business (Shepherd et al. 2003). Entrepreneurs may better capture the interest of angel investors by working on investment readiness and by assessing the post-investment role of the angel investor (Paul et al. 2007) and by targeting the needs of traditional lenders and venture capitalists in order to secure funding (Barrow 1993). Lenders’ criteria include issues of loan security and repayment capacity, not issues of management or profits. Investors focus on the risk and returns of the deal, high growth and short repayment of the advance, an exit strategy, and a substantial stake in the business.

Table 3.5 lists similarities and differences of business angels and venture capitalists.

<table>
<thead>
<tr>
<th>Study</th>
<th>Similarities business angels and venture capitalists</th>
</tr>
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<tbody>
<tr>
<td>Dimov et al. (2007)</td>
<td>Similarities</td>
</tr>
<tr>
<td></td>
<td>Some more reputable venture capitalists invest in start-up and early stage enterprises</td>
</tr>
<tr>
<td>Haar et al. (1988)</td>
<td>A concern about management ability</td>
</tr>
<tr>
<td></td>
<td>Differences</td>
</tr>
<tr>
<td>Benjamin and Margulis (2005)</td>
<td>Venture capitalists make more investments</td>
</tr>
<tr>
<td></td>
<td>Better able to absorb a loss</td>
</tr>
<tr>
<td>Bhide (2000)</td>
<td>Venture capitalists are seen to be inappropriate for most start-ups</td>
</tr>
<tr>
<td>Bruno and Tyebjee (1985)</td>
<td>Venture capitalists are able to supply more capital and management experience</td>
</tr>
<tr>
<td>Khan (1987)</td>
<td>Venture capitalists are more easily located</td>
</tr>
<tr>
<td>Riquelme and Rickards (1992)</td>
<td>Perceived as professional investors</td>
</tr>
<tr>
<td>Shepherd et al. (2003)</td>
<td>Venture capitalists operate in an information rich environment angel investors place greater reliance on softer factors</td>
</tr>
</tbody>
</table>
### TABLE 3.6 Factors that may influence the investment decision

<table>
<thead>
<tr>
<th>Accepting the deal</th>
<th>Rejecting the deal</th>
<th>Q. 9 letter</th>
<th>Grouping</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Quality management</td>
<td>Poor or non-existent management</td>
<td>9j</td>
<td>Entrepreneur/management</td>
</tr>
<tr>
<td>2 Sound business plan</td>
<td>No business plan or poorly prepared</td>
<td>9k</td>
<td>Entrepreneur/management</td>
</tr>
<tr>
<td>3 Good growth prospects/potential</td>
<td>Limited growth potential</td>
<td>9q,r</td>
<td>Investor input</td>
</tr>
<tr>
<td>4 Entrepreneur is investor ready</td>
<td>Entrepreneur is unprepared</td>
<td>9h,I,k,l</td>
<td>Entrepreneur/Management</td>
</tr>
<tr>
<td>5 Realistic debt or equity proposal</td>
<td>Entrepreneur has unrealistic expectations of investment</td>
<td>9d,e,f,g</td>
<td>Equity/control</td>
</tr>
<tr>
<td>6 Appropriate exit strategy</td>
<td>No plan for exit</td>
<td>9m</td>
<td>Investor input</td>
</tr>
<tr>
<td>7 Acceptable rate of financial return and reward</td>
<td>Unacceptable rewards and motivation for investor</td>
<td>9n</td>
<td>Investor input</td>
</tr>
<tr>
<td>8 Satisfactory valuation</td>
<td>No valuation or unrealistic</td>
<td>9l</td>
<td>Entrepreneur/Management</td>
</tr>
<tr>
<td>9 Good chemistry entrepreneur</td>
<td>Poor relationships</td>
<td>9h,I</td>
<td>Entrepreneur/Management</td>
</tr>
<tr>
<td>10 Superior product or idea</td>
<td>Product lacks vital factors</td>
<td>9q</td>
<td>Investor input</td>
</tr>
<tr>
<td>11 Trade secrets or IP protected</td>
<td>Easily copied idea or product</td>
<td>9q</td>
<td>Investor input</td>
</tr>
<tr>
<td>12 Readily accessible market</td>
<td>Difficult market</td>
<td>9q</td>
<td>Investor input</td>
</tr>
<tr>
<td>13 Lack of competition</td>
<td>No particular advantages</td>
<td>9q</td>
<td>Investor input</td>
</tr>
<tr>
<td>14 Referenced through reliable network</td>
<td>Not know entrepreneur</td>
<td>9s</td>
<td>Investor input</td>
</tr>
<tr>
<td>15 Well planned or established distribution networks</td>
<td>No lines in place or planned Networks</td>
<td>9t</td>
<td>Investor input</td>
</tr>
<tr>
<td>16 Investment fits with financial strategy of investor</td>
<td>Investment outside comfort zone or not a good mix</td>
<td>9a,b,c,</td>
<td>Access deals</td>
</tr>
<tr>
<td></td>
<td></td>
<td>9d,e,f,g,</td>
<td>Equity/control</td>
</tr>
<tr>
<td></td>
<td></td>
<td>9m,n</td>
<td>Investor input</td>
</tr>
</tbody>
</table>
The factors listed in Table 3.6 can be categorized into four groupings or themes considered to be fundamental to this research. The research question draws upon a review of the existing literature and in particular an examination of these themes and is discussed in the following section.

### 3.3 The research question

As Neuman (2003, p.142) notes all research begins with a topic but that is only a starting point and researchers must narrow that topic into a focused research question. The research question emerges from a study of what is already known in the existing literature (Denscombe 2002):

*What is the relative importance of different factors and what are the interrelations among decisions taken by business angels and venture capitalists to invest or not invest in the private marketplace within Australia?*

### 3.4 The construction of the hypotheses

The literature review in Chapter 2 and here has highlighted gaps in our understanding of the factors and their relative roles in the decision making of business angels and venture capitalists as to whether to invest or not invest in the private marketplace in Australia.

The literature reveals that the different factors and the interrelations among decisions can be grouped under four broad themes: (i) the location and type of the venture and the stage of the deal (the physical issues); (ii) the ownership structure and control issues between entrepreneur and investor (the legal relationship); (iii) the abilities of the
entrepreneur and management team (the managerial relationship); (iv) the merits and
details of the deal from the investor’s perspective (the financial assessment).

These four themes overarch the nine research hypotheses of this study, eight of which –
(H₁-H₈) focus on the relative importance of these themes and one hypothesis (H₉) proposes that venture capitalists place greater importance upon the financial assessment
of the venture in their investment decision than do business angels. Hypotheses link the
theoretical causal chain and can take a number of forms. As Neuman (2003) notes, they
test the direction and strength of a relationship between two or more variables (Neuman
2003; Ruane 2005) with the accuracy of the hypotheses evaluated by determining the
statistical likelihood that the data reveal true differences (Cooper and Schindler 2003).

Those hypotheses are set out hereunder. The first eight predict a positive relationship
between the factors referred to and the making of a decision to invest or not invest in the
private marketplace within Australia. The ninth hypothesis predicted a significant
difference between the business angels and venture capitalists and is discussed
separately at the conclusion of the first eight. In all cases the alternative hypothesis
predicted that a tested or causal relationship existed. The null hypothesis in hypotheses
numbered 1, 2, 4, 5, 6 and 8 predicted that there was no relationship between the factor
considered and the making of the investment decision. In hypotheses numbered 3 and 7
the null hypothesis predicted that no particular factor was more important than any other
factor in the investment decision and in hypothesis numbered 9 the null hypothesis
predicted that there was no significant difference between business angels and venture
capitalists as to the importance that each gave to the financial assessment of the venture
in their investment decision.
Hypothesis 1 (H₁): Business angels regard access to deals as a factor that must be considered when making an investment decision in the private marketplace.

Hypothesis 2 (H₂): Business angels regard the degree of equity / control in the venture as a factor that must be considered when making an investment decision in the private marketplace.

Hypothesis 3 (H₃): Business angels regard the quality of the entrepreneur / management team in the venture as the most important factor to be considered when making an investment decision in the private marketplace.

Hypothesis 4 (H₄): Business angels regard investor input being the financial assessment of the venture as a factor that must be considered when making an investment decision in the private marketplace.

Hypothesis 5 (H₅): Venture capitalists regard access to deals as a factor that must be considered when making an investment decision in the private marketplace.

Hypothesis 6 (H₆): Venture capitalists regard the degree of equity / control in the venture as a factor that must be considered when making an investment decision in the private marketplace.

Hypothesis 7 (H₇): Venture capitalists regard the quality of the entrepreneur / management team in the venture as the most important factor to be considered when making an investment decision in the private marketplace.
Hypothesis 8 (H₈): Venture capitalists regard investor input being the financial assessment of the venture as a factor that must be considered when making an investment decision in the private marketplace.

Hypothesis 9 (H₉): Venture capitalists place greater importance upon the financial assessment of the venture in their investment decision in the private marketplace than do business angels.

The ninth hypothesis (H₉) predicted a significant difference between the two groups concerning the relative weight placed upon the financial assessment of the venture in the investment decision. This assessment considers the financial factors as defined in section 1.2 being the valuation of the enterprise, the level of monetary risk, the projected return and potential of the investment, the liquidity and security of the investment, the ability to exit same and ensuring the right to further invest.

It is to be noted that frequently entrepreneurs and the management team are indistinguishable in a formative period. Accordingly, whereas it might be that some hypotheses might entail some structural overlap, those from whom data are elicited in this study would understand the generalization made.

Other factors relate to taxation concessions and benefits, the marketability of the venture, ensuring performance milestones for the investment and the investor electing to be actively involved in the management of the venture. The investor may seek a level of comfort in investing if the investment is through a trusted network. These matters are raised in the questionnaire under the sub-heading “investor input” and responses were sought to questions 9(m) to 9(t) concerning these factors for testing as to the relative importance of same to business angels and venture capitalists. Against that background the methodology for testing these hypotheses is discussed in Chapter 4.
Chapter 4

Research methodology

“…..academic tradition looks backward to a yet remoter dawn – when the truth was indefatigably sought but could never be prisoned in a cage, when no hypotheses were left unquestioned and even the very instruments of thought were incessantly scrutinized, reforged, and exchanged with one another.”


The methods of enquiry and analysis adopted in this study for testing of hypotheses arising out of the research question are discussed in this chapter. An outline of the research paradigm is followed by an overview of the research process and a discussion of the approach taken. Alternative research methods and their relevance are discussed followed by a delineation of the research design, implementation, data collection issues and ethical considerations.

4.1 The research paradigm

“There are competing approaches to social research based on different philosophical assumptions about the purpose of science and the nature of social reality” (Neuman 2003, p.90). The three broad approaches – the positivist approach, the interpretive approach and the critical approach – were considered. As research may be based upon and operated within one approach or in combination of the elements from one or other alternative approaches whilst representing fundamental differences in outlook and
alternative assumptions about social science research, a combination was selected for this study. No single philosophical approach is suitable for all research. In this research the positivist approach was taken with its aim of obtaining quantitative data through the use of a survey instrument. This approach allowed for the hypotheses to be tested by carefully analyzing the data thereby confirming or refuting the existence of a causal relationship amongst a number of positive assumptions.

### 4.2 Research design

The design of this research took into account the dictum of McGrath et al. (1982) that there is no such thing as too much research or flawless research. There are issues involved in design strategy, namely; type, purpose, timeframe, scope, and environment (Cooper and Schindler 2003) and dilemmas inherent in research design (McGrath et al. 1982). Such dilemmas can be either problems or opportunities or the identification of symptoms (Cooper and Schindler 2003). Arguably, they are best handled by the use of multiple methods for all constructs imbedded in multiple designs, using multiple strategies to gain information about the research problems (McGrath et al. 1982, p.101). Whereas qualitative and quantitative research methods differ in approach they are also complementary (Patton 1990; Ticehurst and Veal 1999; Bauma 2000; Neuman 2003). The design of the research acknowledged the difficulty in accessing the participants, business angels in particular in this instance, in the private marketplace. Venture capitalists are more easily accessed through venture capital firms. Secondly, there is a need to address the issues arising from the subject matter in researching the little publicized and not well documented private marketplace and thirdly there is a need to establish an audit trail. There is a lack of knowledge of the size of the population of
informal investors (Wetzel 1983). Business angels in particular have exhibited a reluctance to respond to surveys, consistent with the private nature of their activities and their desire not to be identified (Haar et al. 1988; Hindle and Wenban 1999). A small incentive unrelated to the topic was proposed in order to encourage responses to the questionnaire (James and Bolstein 1990; Teisl, Roe and Vayda 2006). With such a sensitive topic care had to be taken to protect respondents’ privacy (Ruane 2005).

Neuman (2003) points out inherent differences in the design of the research when giving consideration to qualitative and quantitative styles. Qualitative research following an inductive line focuses on the issues subsequently arising from this approach with the development of insights and generalizations which may or may not become apparent once the body of data is analysed. Ekanem and Smallbone (2007) note that an investigation of the process of investment decision-making in small manufacturing enterprises should be based upon a qualitative methodology because it assists the researcher in capturing the full range of responses and observing the subjects as they respond to the questions. This is particularly so where the subject actually enjoys talking about the research topic, rather than completing questionnaires or does not wish to commit the responses to print. Such research proceeds by way of an inductive approach, moving from a detailed investigation of the topic towards identifying preliminary relationships, upon which a grounded theory may be built. This is in essence a “bottom up” or theory building approach (de Vaus 2001) requiring the collection of data in order to establish theoretical positions that may become propositions as a result of the findings. The case study approach is an appropriate qualitative method of collecting data where the purpose of the research is to identify factors that are constant or that vary among a few cases (Neuman 2003). The limitations in the approach from arguing from particular to general and the lack of breadth and
universality, mean that the case study approach is unsuitable for a broadly based study, but should be considered in identifying the target audience for the survey.

Quantitative research adopts a deductive approach. It requires detailed planning of the process by which the body of data is collected and analysed prior to drawing conclusions and making policy recommendations. Sohl and Sommer (2006) consider the preferred methodology for their research into activities in the angel investment market to be survey based through a comprehensive survey mail out. This mechanism acknowledges a logical relationship between or among concepts then moves towards establishing evidence supporting that relationship. It is in essence a “top down” approach, moving from a theory expressed in propositions to a hypothesis or hypotheses to be tested. A social theory will also contain a causal mechanism for the proposed relationship. It can be seen as a theory testing approach (de Vaus 2001). The present study entailed empirically testing or evaluating a hypothesized causal relationship as to why individuals made affirmative or negative investment decisions.

4.3 The position of the research

Previous investigations of investor decision-making have adopted one of two strategies. One involves the analysis of protocol data and the mapping of the decision-making process through the input of the participants; the other being the administration of a questionnaire to a large number of investors (Feeney et al. 1999). Each has its strengths and weaknesses, advocates and detractors. By virtue of its focus, the present study was thought likely to benefit most from a predominantly quantitative approach with some qualitative data injected from the focus groups established in the pilot study. The
research design also reflected the fact that the outcome(s) from the research should be linked to its purpose (Denscombe 2002). The outcomes being the outputs from the research, might reasonably take a variety of forms such as:

- a body of new information; or
- a contribution to theory and knowledge; or
- recommendations and guidelines for good practice (Denscombe 2002).

4.4 The testing of the hypotheses

Chapters 2 and 3 discussed and developed an exploratory framework through the review and analysis of the literature. Propositions emerged based on the findings arising from that examination of the literature relating to the relative importance of various factors in the decision-making processes of business angels and venture capitalists. In particular the key similarities and differences between the two groups in the decision making process were considered. These propositions were developed so that they could be expressed as nine hypotheses and incorporated in the questionnaire drafted for consideration by the focus groups in the pilot study. Thereafter, subject to the appropriate additions or alterations, this was distributed in a survey format to the wider target population of business angels and venture capitalists.

Consistent with Ruane (2005, p.66) the hypotheses to be tested (as set out in section 3.4) satisfy his definition that “[a hypothesis is a] testable statement that predicts a specific relationship between two or more variables”. The purpose of the survey in this study was to test a number of hypotheses so as to determine the accuracy of the
hypothesis and to establish the statistical likelihood that the test data reveal true differences – not random sampling error (Cooper and Schindler 2003). Conclusions could then be drawn on the basis of the evidence collected (Bouma 2000).

4.4.1 The construction of the questionnaire

The survey process conducted through a written questionnaire took into account that it conformed to a number of themes: an adoption of the theoretical position, that the data collected would be subjected to statistical analysis, an ability to generalize from the results, a consideration of any causal links, a need for standardization to ensure accurate measurement of the results, that the design be such as to facilitate replication of the questionnaire to check for bias and a focus on statistical profiles and patterns of attitudes or characteristics (May 2001). To this end the questionnaire provided for a number of closed questions to elicit direct and unequivocal responses based upon a scale and a ranking system. Closed questions are cheaper to use and easier to analyse and permit comparability between answers of different respondents. A Likert scale was employed placing responses on an attitude continuum (May 2001).

Every effort was made to avoid complexity or ambiguity in the structure of the questionnaire which carried a clear and precise statement at the commencement of the questionnaire form that the survey was being carried out independently of the researcher who would at all times remain unaware of the identity of all respondents (Ruane 2005).

Question 9 in the questionnaire carried forward the emerging themes and grouping classification as set forth in Table 1.4 in Chapter 1 with the questions aligned to each of the four broad groupings that have been identified as relevant to the research question
being, access to deals; equity/control issues; entrepreneur/management issues; and investor input. The proposed framework of factors as set forth in Table 3.6 listed alongside each item a designating letter coinciding with the numbering of the sub-question contained in Question 9 as well as a classification of the sub-question in one or more of the four broad groupings in Table 1.4.

The questionnaire used here conforms to the dominant structure of such survey instruments. There, the purpose of questionnaires is generally depicted as measuring “some characteristics or opinion of its respondents, depending upon its aims, the procedures it adopts and a number of people who were interviewed, generalization can then take place from the sample of people interviewed to the population as a whole” (May 2001, p.65). The tendency to employ a type of sampling is based upon theories of probability from mathematics and is known as ‘probability sampling’ (Neuman 2003). As to the construction of the questionnaire Black (2002, p.25) notes that “the most difficult part of starting a research project is often that of identifying the best question to ask, one that is meaningful, whose answer contributes to the discipline, and whose resulting research can be carried out with the resources available”. The questions to be asked need to be reasonably precise in order to provide sufficient direction for the research being undertaken. Good problem statements in the form of questions should express a relationship between variables, be stated in unambiguous terms in question form and imply the possibility of empirical testing (Black 2002). Stem and Steinhorst (1984) propose certain criteria that should be performance tested as part of the questionnaire, namely the issues of understandability of the instructions accompanying the request and of the respondent’s degree of confidence in the protection and confidentiality provided by the mail questionnaire technique. For this study, the final form of questionnaire in survey format became the primary means of collecting data.
4.5 Data collection methods

Data comprise the empirical evidence collected, recorded and analysed with a view to supporting or rejecting the theory posed. Data are the facts presented to the researcher from the environment which is the subject of the study (Cooper and Schindler 2003). Rich data can be drawn from multiple sources such as observations, conversations, formal interviews, records, reports and journals (Denzin and Lincoln 2000). As Bouma (2000, p.19) notes “data are facts produced by research. Data, like facts, by themselves are meaningless. They acquire meaning as they are related to theories”.

4.5.1 Qualitative and quantitative techniques

Usually two kinds of data collection and analysis are used in the social sciences: qualitative and quantitative. Qualitative techniques (Krathwohl 1993; Berg 2004; Ekanem and Smallbone 2007) and quantitative techniques (Bryman 1988; Gorard 2003) are both viewed as appropriate methods for collecting data. Qualitative data collection methods in the form of an interview process allow the researcher to study in depth and in context small samples of people (Miles and Huberman 1994). Similarly this applies where feelings or attitudes are being sought or where a form of questionnaire may not be sufficiently explicit in its request for responses (Audet and d’Amboise 2001; Gray 2004). Field research – unstructured, non-directive, in depth interviews – differs from formal survey research interviews insofar as there is no clear beginning and end to the interview. The questions can be tailored as the researcher requires and there is a mutuality in approach between the interviewer and the respondents in terms of the tone, pace, and direction of the interview (Neuman 2003).
Quantitative research allows for a broader access to the target population than a qualitative approach, with the aim of assessing larger numbers of context stripped cases, and thereby seeking statistical significance (Miles and Huberman 1994). Accordingly, in this study the focus was conducive to quantitative research methods, with a pilot study undertaken initially in to test the draft questionnaire upon two focus groups. Gorard (2003, p. 114) notes that all research designs need to be piloted or pre-tested. Focus groups “combine the strengths of in-depth group interviewing and observation in a group context” (Bouma 2000, p. 181) and are an interview style which is designed for small groups (Berg 2004).

4.5.2 The pilot study

The pilot study allowed for the testing and refining of survey instrument, the draft questionnaire, whilst simultaneously providing data on the investing experiences of a focus group of business persons being neither business angels nor venture capitalists, and a focus group comprising business angels and venture capitalists. This process allowed for an awareness of any particular issues or concerns raised by the latter focus group that distinguished it from the former, with a view to ensuring that when refining the final survey instrument these particular issues or concerns were considered and addressed where appropriate. The small size of each focus group allowed all participants the time and opportunity to express opinions and argue points of view.

This format is consistent with Gorard’s (2003) two stage pre-testing process, with the members of the first group not being drawn from the intended sample. The findings of the focus group of business persons were not included in the final reporting.
The pilot study format detects weaknesses in design and instrumentation and provides proxy data for the selection of a probability sample (Cooper and Schindler 2003). Focus groups allow for the subjects to interact with each other as well as with the researcher (Ticehurst and Veal 1999) and provide answers which can be actively and freely probed by the interviewer for elaboration (Payne and Payne 2004). These interviews test the questionnaire and its respondent selection (Hindle and Wenban 1999; Berg 2004) and are a way of collecting qualitative data analysed using content or thematic analysis (Wilkinson 2004). MacMillan et al. (1987) undertook a pilot study of 14 venture capitalists in order to ascertain the criteria used to evaluate investment propositions and then classified the criteria into six major groups, incorporated in a questionnaire and mailed out to 150 venture capitalists. The pilot study format is flexible, permitting observations of participants and accessing substantive information and results expeditiously. In this particular pilot study the proceedings were recorded and transcribed (Ticehurst and Veal 1999; Payne and Payne 2004).

4.5.3 Focus groups – selection of participants

For this study the first group comprised six (non-angel and non venture-capitalist) business people. These participants were selected from a cross-section of the experienced business population known to the researcher and from personal contacts.

The second focus group comprised three business angels and four venture capitalists. To access these respondents the research relied upon “trust and goodwill” being “a hidden resource that researchers use to improve their prospects of collecting valid information” (Denscombe 2002, p. 75). For this group existing resources and personal contacts within the investment marketplace were drawn upon by the researcher.
Whilst it was a condition of obtaining the co-operation of business angel investors and venture capitalists that their privacy and identity would not be compromised, the research can state that all business angel investors had been active in the private marketplace over a number of years. None of the three had a public profile as a business angel investor, although two were reasonably well known business figures in Australia. The third was active in community and charitable enterprises in addition to operating a successful private commercial real estate venture. As to the venture capitalists of which there were four, all were well established and were connected to venture capital firms within Australia. Two of the venture capitalists were attached to firms that are well known in the venture capital and business community within Australia. Some of their successful and unsuccessful investments are a matter of public record. The other two venture capitalists were each the principal of their own firms with reported successes.

This aspect has significance in terms of the breadth of the research. First, the Australian economy is relatively small, second the local investor market is not as mature as in some other countries and third, the level of investor activity in start-up enterprises is only a small percentage of economies such as the United States where there is a massive flow of funds into angel and venture capital investments (Etemad 2004). The survey of Australian business angels by Hindle and Wenban (1999) framed questions that were extensively modified to make them more appropriate in this study to the Australian marketplace with its limitations of size.

The two meetings with the focus groups were conducted separately. Respondents were asked to set aside one hour in all including time for formalities and introductions. The sessions were each limited to productive time of 45 minutes overall, with 15 minutes assigned to the questionnaire and 30 minutes to discussion. The meetings were
conducted in a suburban location for the first group and a city location for the second group. Both meetings were held over lunch and in the case of the business angel / venture capitalist group there was limited time available to fit around their professional obligations. After a formal introduction and some initial discussion concerning the topic, each member was given a copy of the questionnaire to answer separately in writing, without interruption or group discussion. The completed questionnaires were collected and the members of each respective group were then asked the series of identical questions again and given the opportunity to comment upon any issues or problems arising from the questions, any favourable aspects and matters of content, their respective relevance and difficulty. The responses were recorded for later transcription. The responses of the focus groups were taken into account when determining the final structure and content of the questionnaire.

The interview protocol adopted was designed to allow the research to focus accurately on matters that might illuminate the subject under investigation. The questions asked needed to be on target (Denscombe 2002) whilst allowing for flexibility in the line of questioning which is one of the strengths of field research (Babbie 1992).
4.5.4. Quantitative techniques – sampling methods

The second stage, incorporating the sampling phase and the data collection, analysis and reporting phase, followed on from the research design. It reviewed the processes required to implement that design effectively. These processes included the selection of a cross-section of the population by purposive sampling “selecting members of a difficult to reach, specialized population” (Neuman 2003, p. 213); the format to be followed for conducting quantitative research on that sample; the construction of the appropriate form of questionnaire arising from the results of the focus groups; formulating the means by which the respondents are to be approached; overcoming barriers to such approaches by means of intermediaries and other trusted sources; structuring the recording of written responses and analyzing in detail those responses to the questionnaire.

There was a need to target a population, namely business angels and venture capitalists, to develop a specific list, the sample frame (Phillips 1981; Neuman 2003) that closely approximated all the elements in the population (Neuman 2003) and which had an understanding of the terminology and awareness of the investment decision making process in the private marketplace within Australia. It is acknowledged that qualitative and quantitative researchers have different approaches to sampling (Neuman 2003). Whereas the goal of quantitative research is to draw a representative sample (Bryman 2004) by probability sampling it has its limitations by virtue of difficulties in determining the size and nature of the larger group or population from which the sample is to be taken.

Here, for the focus groups a non-probability sampling technique was adopted in the absence of any intention that it be representative of the population. Neuman (2003) lists
examples of non-probability sampling being haphazard, quota, purposive, snowball, deviant case, sequential and theoretical. Here, purposive sampling was used. Purposive sampling, according to Neuman (2003, p.213), is “an acceptable kind of sampling for special situations”.

This study addresses a special population. As a result the research cannot claim to be representative of a larger population. It was not random with each member of the target population having an equal chance of selection with limitations arising there from (May 2001). As far as possible, the element of bias was kept to a minimum (Bryman 2004). Mason and Harrison (1997) comment that in the absence of precise particulars of the population it is not possible to undertake any survey which is based upon a representative sample of informal investors. Coveney and Moore (1997) note that the conclusions reached by Mason and Harrison (1997) were based on a series of small scale surveys and a set of focused case studies, whereas Coveney and Moore (1997) state that the greatest contribution that they could make to the research was to generate a large pool of predominately quantitative data by the use of a large scale mail questionnaire to elicit from British business angels their investment activities and characteristics. Of course identifying and locating them was the first problem and they were sought to be accessed with the help of a number of business introduction services.

To identify samples of informal investors, Hindle and Wenban (1999) note that researchers have used the following approaches, namely:

- Large scale postal surveys, often using lists that have been purchased, of owners or mortgagors of high-value properties who may or may not fit the definition of angel investors (Freear et al. 1994);
• Contacting informal investors through enterprises which have angel investors (Aram 1989);

• A targeted snowball approach by identifying some business angels willing to be surveyed and seeking referrals from them to other business angels they know (Wetzel 1983).

Different approaches to identify informal investors each have associated advantages and dis-advantages (Mason and Harrison 1997). Yet another approach involves a combination of a postal survey with a targeted snowball approach (Landstrom 1993).

4.5.5 Questionnaire format and delivery

Design of and items in the written questionnaire used in the research were against the background of a number of studies both within Australia and internationally (Freear et al. 1994; Coveney and Moore 1997; Harrison et al. 2003; Lumme et al. 1996; Hindle and Wenban 1999; Venkatesan and Soutar 2000; Hindle and Rushworth 2003), with a view to adopting a research format that would provide a rich flow of data.

Bearing in mind suggestions that questionnaires can be administered as mail questionnaires (Summerhill and Taylor 1992; Ticehurst and Veal 1999; Venkatesan and Souter 2000; Gray, Densten and Sarros 2003) or by making use of computer technology through the internet as on-line questionnaires (deVaus 1991), and that low response rates are a problem for mail surveys (Ticehurst and Veal 1999), a decision was made to deliver the questionnaire through the internet using the e-mail subscription list maintained by the editor of the Australian Private Equity & Venture Capital Journal, a journal founded in 1992 and owned by Private Equity Media. The Journal has an on-line
circulation of 11 monthly issues (by excluding January) a year in the private marketplace to 280 subscribers including business angels and venture capitalists as well as other investors throughout Australia. The readership of the Journal was estimated at 2,000, with approximately two thirds located in Sydney and Melbourne with the remainder in the other capital cities in approximately proportional numbers to the populations of those cities. The editor advised that the largest groups comprised roughly equal numbers of individuals, being personnel in private equity and venture capital firms, angel investors, corporate advisers and lawyers. There was no evidence that there was a potential bias in terms of the number of angel investors, of whom there are substantially more in the investment community than venture capitalists. Approximately two per cent of subscribers were from overseas, mainly New Zealand. It was not possible to quantify the exact number of business angel and venture capitalists readers of the Journal. However, only those readers would be asked to respond.

The questionnaire was forwarded to respondents by e-mail with the request that responses be forwarded to the Journal. Each questionnaire incorporated the pro-forma statement of the steps taken to ensure the confidentiality, anonymity and privacy of all respondents in relation to all information collected which would be securely stored at all times and subsequently destroyed following analysis of the data obtained from the questionnaire. A copy of the pro-forma statement is annexed as appendix E.
4.6 Validity and reliability

Validity and reliability are central measurement issues (Neuman 2003). *Validity* requires that a research instrument measure what it is intended to measure (Babbie 2004; Gray 2004; Ruane 2005) thus requiring a full and thorough investigation of the construct. *Reliability* dictates that a research instrument consistently measure what it sets out to measure (Gray 2004). Thus it is a matter of dependability (Babbie 2004).

Validity and reliability issues can overlap with some aspects common to more than one category. In the first instance criteria validity requires objective, empirical evidence that explicitly demonstrates the validity of the measurements undertaken which can be shown by demonstrating the predictive validity of the research in obtaining similar results from another measurement of the same concept at the same time.

Construct validity was achieved by using a combination of theory and hypothesis in order to demonstrate that the measures in place were valid. A hypothesis is “a testable statement that predicts a specific relationship between two or more variables” (Ruane 2005, p.66).

Confirmability whereby an independent reviewer of the research could reach similar conclusions from the same data was achieved through the following processes:

- A peer review process was conducted as required by the Ethics Application.
- The focus group studies were recorded and transcribed.
- The samples and the analysis of the data were reviewed by the supervisors.
- An audit trail enables other researchers to follow and test the findings.
As to reliability, it was necessary to establish that the research would consistently measure what it set out to measure thus ensuring the credibility of the enquiry. This was achieved by ensuring that the focus group research was appropriately reported and that the survey research was consistent in its standards and used high quality methodology. The research took the following steps to meet these requirements:

- By conducting preliminary discussions with business angels and venture capitalists, editors of journals, academics and business proprietors;
- by ensuring as far as possible that the research sought to canvass broad issues for consideration;
- by using a pilot study of two focus groups conducted in close succession to each other with forms of measurement based upon clearly conceptualized constructs.
- by engaging the editor of a professional business journal at arms length from the researcher to distribute the questionnaire and information on-line to subscribers.

### 4.7 Caveats

The research acknowledges potential limitations in this study, identified as follows:

#### 4.7.1 The sample – its size and limitations

For the pilot study the research relied upon the cooperation of individuals who were in business but not active in the private marketplace for one focus group and individuals who were familiar with the presence and functioning of the private marketplace as
active participants in that marketplace, being business angels or venture capitalists. The research has noted the difficulties experienced by other researchers in accessing such investors, in particular business angels and this proved to be the case for this research resulting in a limited sample size and resulting limitations arising from the sample size. The responses provided rich data, albeit from relatively small samples without achieving the generalisability that is provided by a measurement of responses based upon rigorous sampling and standardized measurements.

4.7.2 Limitations inherent in the methodology

The study acknowledges that there are two schools of thought as to the relative merits of the two styles of social research, qualitative and quantitative research (Bauma 2000; Cooper and Schindler 2003; Neuman 2003). The research used predominantly quantitative methodology. There was some qualitative research in the form of the pilot study and focus groups preceding the quantitative research, in order to achieve fuller and more comprehensive results (Bauma 2000).

4.7.3 The exploratory focus of the study

The exploratory focus of this study is a limitation that could be overcome by the testing of the findings from this study, in subsequent studies based upon more extensive quantitative (and qualitative) methodology, in particular a comprehensive semi-structured or unstructured interview process. This is undertaken with a view to eliciting a qualitative depth by allowing interviewees, business angels and venture capitalists, to talk about the subject within their own terms of reference (May 2001).
4.8 Ethical clearance

Ethical clearance was obtained prior to conducting the research from the Human Research Ethics Committee of the University of Newcastle. A copy of the Approval of the Committee is annexed in Appendix B. All participants in the focus groups and in the survey were to be informed of their rights and the voluntary nature of the participation. Copies of information sheets and consent forms are annexed in Appendices C, D and E.

4.9 Summary

The research used a pilot study in the form of two focus groups as the initial stage with the purpose of introducing the proposed questionnaire to each group. The first group comprised six individuals with knowledge of or association with business processes through their engagement and occupation in business and commercial ventures and the second group comprised three business angels and four venture capitalists currently active in the private marketplace. The research anticipated that through the use of personal and professional relationships for the small focus groups and the services of a well known private equity journal, the particular issues involved in locating and gaining the confidence and cooperation of the relevant parties in the private marketplace would be overcome. This process allowed the researcher to consider, modify and develop the structure and content of the questionnaire.

The questionnaire gathered biographical and financial data to test the hypotheses arising from the investigation of the research and emerging themes as set forth in Chapter 1 concerning possible factors involved in the investment decision making processes followed by business angels and venture capitalists.
The responses obtained from the implementation of the pilot study in the form of the focus groups and the responses to the questionnaire forwarded to subscribers to the *Australian Private Equity & Venture Capital Journal* published in Australia were the subject of statistical analysis in Chapter 5.
Chapter 5

Data analysis and interpretation

“The natural languages are of very great value in reasoning, but full of innumerable equivocations and unable to function in a calculus; for if they were able to do this, errors in reasoning could be uncovered from the very form and construction of the words.... Hitherto only the arithmetical and the algebraic notations have offered this admirable advantage”.


Chapter 5 reports on an analysis of the data arising from the research and addresses the issues raised in the research hypotheses. Notwithstanding the limitations apparent in the research this chapter highlights a number of issues drawn from the research which might raise an awareness of the investment decision making processes of business angels and venture capitalists in the private marketplace.

An audit of the results obtained from the pilot study and the questionnaire, is a basis for a synopsis of the research and an analysis of the results. Accordingly, here a review is undertaken of the issues arising in the previous chapters, particularly of the gap in the previous research and as indicated by the research question:

What is the relative importance of different factors and what are the interrelations among decisions taken by business angels and venture capitalists to invest or not invest in the private marketplace within Australia?
As to emerging themes from the qualitative data, business angels expressed a variety of (sometimes conflicting) views concerning the investment decision in the private marketplace relating to the rate of return on offer, the better opportunities and returns likely as a result of the global financial crisis or a reluctance to invest during such turbulent times. For yet others there was no change in investing attitudes with the focus of the exit strategy regardless. Lack of government support for such investments was a concern for some and there was a continuing focus upon careful research to avoid ventures affected by the crises, either directly or indirectly.

In contrast, venture capitalists noted that the fall in the public markets required a shift to the private marketplace with liquidity a key issue in present investment strategy, whilst the lack of finance resulted in the collapse of leveraged deals. Some issues remained constant such as investing in businesses with good management.

The hypotheses referred to four groups of factors that both business angels and venture capitalists might be expected to consider when making an investment decision with the most important group being the quality of the entrepreneur / management team in the venture. The emerging themes confirmed that the degree of equity / control and the financial assessment of the venture are factors that both business angels and venture capitalists consider.

For business angels access to deals was a factor that must be considered, but not for venture capitalists. The most important issue for business angels and one of the two most important issues for venture capitalists was the quality of the entrepreneur / management team in the venture. Venture capitalists are professional investors who, as the research has shown, assert their influence through the active role they take in management. Accordingly, for them the quality of the team, prior to their intervention is
of less significance than for business angels who may choose to remain passive and allow the existing entrepreneur / management team to continue operate the enterprise. As to the importance of financial factors in the decision making of business angels and venture capitalists, it is clear that these are important issues for both groups.

This study had hypothesized that venture capitalists place greater importance upon the financial assessment of the venture than do business angels and the findings did not confirm this view. The entrepreneur’s investment pitch to a business angel should take into account the same important financial aspects of the deal, such as the proposed exit strategy, the rate of return and potential of the venture and the superiority of the product or idea as would be pitched to a venture capitalist.

5.1 Qualitative responses

As discussed in section 4.3 the present study was thought to benefit most from a predominantly quantitative approach with some data becoming available through the business angel and venture capitalist focus groups and the responses of survey participants to the open ended questions at the end of the questionnaire. These data are considered here.

5.1.1 Final samples and response rates

The business angel and venture capitalist participants in the second of the two focus groups recommended that the questionnaire include open questions at the conclusion as to reasons for investing or not investing and as to any effect of the global financial
crisis may have had upon decision-making in contrast with two years previous. Section 5.1.3 records the written responses of those survey participants who contributed. The research identified a number of groupings of issues relevant to the research question and the questions were framed to enquire into those emerging themes.

Chapter 4 dealt with the interview protocol followed by the two focus groups selected to pre-test the draft questionnaire. This two stage testing process allowed the research to understand the particular issue that the business angels and venture capitalists focus groups might perceive relevant in comparison with a group of business persons not falling within these categories. It was anticipated that some questions would elicit responses from a particular line of questioning and provide rich data which were not the subject of the original interview protocol. The responses that emerged expanded the original terms of reference with necessary modifications to the questionnaire. The quantitative responses, data coding and analysis are reviewed in sections 5.3 and 5.4.

5.1.2 The responses of business angels and venture capitalists

Business angel and venture capitalist participants to the pilot study responded to the particular questions posed in the draft questionnaire and to broader issues concerning investment as outlined in Table 5.1.
### Identifying issues for business angels and venture capitalists

<table>
<thead>
<tr>
<th>Resp.</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 (VC)</td>
<td>You ask us whether we borrow funds for investment but you haven’t asked us why we fund seed and early stage investments.</td>
</tr>
<tr>
<td>6 (VC)</td>
<td>There is a need to question what investors think about deal flow. Where are they investing now?</td>
</tr>
<tr>
<td>7 (VC)</td>
<td>The current financial crisis is an issue. Consider what investors might do in a different time frame.</td>
</tr>
<tr>
<td>5 (VC)</td>
<td>There are fundamental problems with the Venture Capital industry as a whole – how Venture Capitalists access capital. At the moment there are VCs with no money to invest and they can’t do anything. Frame the context in how investors would answer i.e. theoretical responses. What deals would you invest in?</td>
</tr>
<tr>
<td>3 (VC)</td>
<td>There are problems in the VC industry. In the US, perhaps 30% to 40% of VCs will be out of business in the next couple of years.</td>
</tr>
<tr>
<td>7 (VC)</td>
<td>When the investment climate is bearish looking backwards is not always helpful in moving forward. There has been a paradigm shift.</td>
</tr>
<tr>
<td>6 (VC)</td>
<td>You need to deal with this in the preamble to the questionnaire. The investor must put aside how they feel now.</td>
</tr>
<tr>
<td>3 (VC)</td>
<td>The world is full of people who don’t have a clue what to do next. They don’t know how the present crisis will pan out. That immobilizes people. Returns on equities might be less than returns on cash deposits. Why would you invest either for dividends or capital gains as dividends need to come out of current profits? Bonds returns are capital guaranteed.</td>
</tr>
<tr>
<td>2 (BA)</td>
<td>You might have a couple of questions around how you perceive the market now. You may be measuring only one or two factors at present.</td>
</tr>
<tr>
<td>5 (VC)</td>
<td>There is a common misconception of VCs needing to have a controlling interest, whereas a lot of VCs favour entrepreneur having a really significant chunk more than the management team. Control in other business decision making processes. Percentage terms are not the issue.</td>
</tr>
<tr>
<td>2 (BA)</td>
<td>The questionnaire need to define the terms as it sees them such as control, timing issues, early stage.</td>
</tr>
<tr>
<td>3 (VC)</td>
<td>Two things drive Venture Capitalists. Capital preservation is one as you are dealing with other people’s money. There needs to be a shareholders agreement and you need to deal with the downside in an investment. There is the concern over how boards operate to ensure that entrepreneurs and management teams don’t make rash decisions. Then there is the funding risk.</td>
</tr>
<tr>
<td>5 (VC)</td>
<td>The questionnaire needs to define early stage. How far from being cash positive is that stage? Business angels might be prepared to invest in companies that are close to profitability whereas VCs might be willing to take a bigger risk and go early. The issue is the next round of funding, need for follow up investment.</td>
</tr>
<tr>
<td>6 (VC)</td>
<td>Angels and VCs are in independent silos. It is not common to have angel rounds of investment leading to VC rounds. Angels may want to carry the deal through and don’t want the dilution and loss of control that comes with having a VC involved. Angels generally steer companies away from VCs but too many angels is a problem for the company share register.</td>
</tr>
</tbody>
</table>

(continued overleaf)
Table 5.1 (continued)

<table>
<thead>
<tr>
<th>Participant</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 (VC)</td>
<td>Angels will have ordinary shares and we VCs come in with a preferred class of share which protects us in the event of loss of capital. VCs might offer $2M as opposed to angel investment of $200,000. VCs need to explain why we are doing what we have to do.</td>
</tr>
<tr>
<td>6 (VC)</td>
<td>There is a problem of less VC money available and no angels willing to come in. There is no collaboration between VCs and angels and a lack of capital. It is a big issue for VCs.</td>
</tr>
<tr>
<td>3 (VC)</td>
<td>The problem is world wide today. Investor superannuation funds are saying to VCs that they would rather we invest in companies that are profitable and not put half in start-ups that may not be profitable for years to come and need further funding to keep them alive. The investors are telling the VCs not to diversify as much and are talking to VCs more. The whole separation between the two groups has gone.</td>
</tr>
<tr>
<td>7 (VC)</td>
<td>The investors are asking the VCs to slow down the rate of investment.</td>
</tr>
<tr>
<td>2 (BA)</td>
<td>The questionnaire needs descriptive questions to ascertain the characteristics of the people being researched. A predictive model with short cases as to how an investor would react.</td>
</tr>
<tr>
<td>5 (VC)</td>
<td>Very few Comet companies go on to receive professional VC investment.</td>
</tr>
<tr>
<td>6 (VC)</td>
<td>Rise of professional angels and demise of VCs with a further drop in funding expected.</td>
</tr>
<tr>
<td>1 (BA)</td>
<td>An angel may choose different criteria in different deals. Get independent insights and rely upon the strength of the syndicate. It was difficult to complete some questionnaire items with one tick. The criteria are different from a year ago.</td>
</tr>
<tr>
<td>2 (BA)</td>
<td>Look for differences in the two groups. Specify what financial information members of each group may require.</td>
</tr>
<tr>
<td>3 (VC)</td>
<td>As a VC our group has done start-ups, about 50 in the last few years. We might look at 500 business plans a year but 400 won't have an addressable market. Angels are different. They will look at deals which might be evergreen provided they get returns that are superior to returns from public equities.</td>
</tr>
<tr>
<td>7 (VC)</td>
<td>VCs and angel investors have a different state of mind. Angels need more help in managing and have portfolios of industries that they know. They can't manage their investments in the same manner as they manage their core job.</td>
</tr>
<tr>
<td>3 (VC)</td>
<td>Entrepreneurs may go back to the same angel investors three or four times.</td>
</tr>
<tr>
<td>7 (VC)</td>
<td>The idea would be to rank five or six of the most important factors.</td>
</tr>
<tr>
<td>1 (BA)</td>
<td>Perhaps the investor should consider how they thought two or three years ago and how they think today. Rank the five most important factors two years ago and today.</td>
</tr>
<tr>
<td>5 (VC)</td>
<td>Need to consider the amount needed for profitability and differences for VCs and business angels. Also a VC may not invest if the deal is only passive.</td>
</tr>
<tr>
<td>5-7 (VC)</td>
<td>Tax is not a decisive factor when investing. You can always access grants.</td>
</tr>
<tr>
<td>4 (BA)</td>
<td>Tax is not an issue.</td>
</tr>
<tr>
<td>1-7 (BAVC)</td>
<td>The networks are important as to the quality of the referral</td>
</tr>
</tbody>
</table>

Source: Developed from a content analysis of the interview transcripts of second focus group
Table 5.1 highlights a number of issues relating not only to the content of the questionnaire but also to its format. The relevance of different factors in reaching an investment decision is indicated by the following comments. Respondent number 3 (venture capitalist) noted that the venture capital industry had major problems at present securing funding and that the extraordinary times of 2008-09 in financial terms could immobilize investors. Respondent number 1 (business angel) noted that in various deals there may be different views about the importance of a syndicate. Investors might rely upon the strength of the syndicate in deciding to invest.

In terms of the eight main hypotheses, concerns were expressed about access to deals, the degree of equity / control, the quality of the entrepreneur/management team and investor input. In relation to hypothesis 9 (H9), venture capitalists in particular expressed anxiety regarding the importance of financial factors, in particular the access to capital.

The questionnaire took into account the key themes emerging from the respondents’ insights and perceptions when delivering the questionnaire in its final form seeking responses from the survey population. A copy of the questionnaire in its final form is annexed as Appendix F.

5.1.3 Responses to the open ended questions

There were 30 usable responses to the questionnaire. It is proposed to discuss the qualitative aspects of these responses at this point in the research before proceeding to an analysis of the quantitative responses contained in the questionnaire. Respondents numbered 1, 2, 3, 7, 8, 9, 11, 13, 15, 17, 18, 19, 20, 22, 23, 24, 25, 28, 30, 31 and 32
were business angels. Respondents numbered 4, 5, 10, 16, 21, 26, 27, 29, and 33 were venture capitalists. Respondent numbered 6 did not indicate a category and respondents 12 and 14 placed themselves in both categories.

The responses of respondents to the open ended questions located at the end of the questionnaire were insightful. Respondents were invited to comment as to their reasons for investing or not investing in the private marketplace and their experiences concerning same. They were also invited to comment upon whether the then present global financial crisis, the survey having been conducted in 2009, had influenced their investment decisions in the private marketplace and (if so) to rank the five most important investment criteria as at the date of the survey and two years before 2009. Comments were received from a number of respondents as follows.

As to experiences in the private investment marketplace, business angel respondent 1 noted the aim of investing in the private marketplace was to get a return of five percent per annum over the return for listed markets. Venture investment in Australia had yet to live up to expectations and that “due to the denominator effect in asset allocation many investors have less money to put into private equity”.

Respondent 4, a venture capitalist, commented that his future investments had been severely limited by the demise of ASX stocks such as ABC Learning and Centro Properties. His superannuation fund had “just evaporated”. This respondent’s rural background had taught him that MIS (Managed Investment Schemes) such as investing in timber companies were non-viable. His former agronomy clients had sold their farms to the MIS timber companies and were investing 10 percent of their capital in start-up and seed companies commercializing new inventions or IP (intellectual property) emerging from tertiary institutions. He noted that his company had a number of
technologies waiting to be commercialized and that most would go to Asia. His overall view was that “Australians are great inventors – very poor at commercializing their inventions”.

A business angel, respondent 24, reported that his group had invested in three projects and none had achieved the success sought. The Australian Government was seen as not supporting small scale ventures where expenditure was below A$20,000 each year. His group did not receive any research grants and /or support and this limited the ability to bring products to market. And respondent 28, also a business angel expressed the view that unless there was a very well developed and highly probable exit strategy capable of being executed within two years, he would not invest.

The responses from the following business angels indicated a divergence of views about the impact of the global financial crisis. The crisis, according to respondent 7, had produced good opportunities, whilst respondent 9 saw no change in investment decision-making. Respondent 20 indicated that the key criteria for investment had not changed with the focus remaining on a credible strategic exit opportunity. This view was shared by respondent 28 who felt that there were “lots of good opportunities for strategic value investments right now”. On this theme respondent 31 was more likely to think about using private equity now than say two years ago mainly due to what he perceived as better returns and opportunities.

On the other hand respondent 13, a business angel commented that in relation to the global financial crisis “all new investments have been frozen at least until the end of calendar 2009” whilst respondent 10, a venture capitalist, indicated that the global financial crisis had affected his company’s investment strategy and that “we find ourselves required to shift into a corporate advisory model for the time being, waiting
for compelling investments to present themselves”. He commented that the biggest change in influence on decision-making at present was liquidity and that he had sought companies that were slightly more established so that debt could be brought into deals more easily should that be a viable funding source for companies.

Respondent 12, a business angel commented that the global financial crisis affected some markets more than others and it was a subjective issue that had to be thoroughly researched for each deal. Investment criteria would affect the impact of the crisis; for example, an investment in a car parts company that dealt with General Motors in the United States would not be a good investment. However high volatility in the market might be exactly what an investor was looking for. This respondent believed that any investment with long term demographic trends which were immune to the global financial crisis such as investment in aged care, health care and social service type companies would still be good value as would “anything the government is propping up via stimulus packages”. Venture capitalist respondent 33 was finding it more difficult to get bank finance so leveraged deals were non-existent. Generally though she commented that “the key requirements we have for our transactions i.e. good management, profitable businesses operating in a niche have not changed as a result of the financial crisis. We are seeing more turnaround opportunities emerge though”.

Respondents were forthcoming in their comments about the open ended questions, particularly about the influence of the global financial crisis upon their investment strategies. To some investors the crisis caused them to refrain from undertaking new ventures, whilst other investors saw opportunities in the depressed investment climate. On the issue of respondents’ views and experiences in the private marketplace, poor returns and a lack of government support for the marketplace were seen as relevant issues. The following section reports on the quantitative responses.
5.2 Quantitative responses

As to the quantitative research, the methods of analysis depend upon the data produced (May 2001, p. 82). To that end ordinal scales measured the responses ranked on a Likert scale. The questionnaire calibrated the relationship between variables. The aim of the analysis was to examine patterns amongst replies and to explore potential relationships explaining them in terms of (what are known) as independent variables (May 2001).

5.2.1 Data cleansing and reliability testing

Data cleansing is an important process for the coding of data and accuracy is required in the coding process and when entering data into the computer (Neuman 2003). Verification of the coding process was undertaken by coding a random sample of the data and searching for coding errors.

5.2.2 The coding of the data

Table 5.2 sets out coding of the biographical data, investment protocol and quantum.
TABLE 5.2  The coding of the biographical and investment data

1. Please indicate your gender?

[ ] Male  [ ] Female

2. Please indicate your present age group

- Under 25 years  1
- 25 to 34 years  2
- 35 to 44 years  3
- 45 to 54 years  4
- 55 to 64 years  5
- 65 to 74 years  6
- 75 years and over  7

3. Please indicate your level of education

[ ] Secondary  [ ] Tertiary  
[ ] Postgraduate  [ ] Other

4. Do you categorise yourself as a business angel investor or a venture capitalist investor?

[ ] Business Angel  [ ] Venture Capitalist

(Please note: “Business Angel” investors are those who invest capital and/or business expertise at the seed or early stage of a start-up venture. Venture capitalists invest at a later stage generally in more formal circumstances).

(continued overleaf)
Table 5.2 (continued)

5. How many times have you invested in the private marketplace in Australia during the last five (5) years?

<p>| | |</p>
<table>
<thead>
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<tbody>
<tr>
<td>1</td>
<td>Once or twice in 5 years</td>
</tr>
<tr>
<td>2</td>
<td>Several times in 5 years</td>
</tr>
<tr>
<td>3</td>
<td>Once or twice a year in that period</td>
</tr>
<tr>
<td>4</td>
<td>Several times a year in that period</td>
</tr>
<tr>
<td>5</td>
<td>None</td>
</tr>
</tbody>
</table>

6. For what period of time would you generally make such an investment?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Less than a year</td>
</tr>
<tr>
<td>2</td>
<td>One to less than three years</td>
</tr>
<tr>
<td>3</td>
<td>Three years to less than five</td>
</tr>
<tr>
<td>4</td>
<td>Five years or more</td>
</tr>
</tbody>
</table>

7. In relation to such investments, what percentage of a shareholding would you normally require?

<p>| | |</p>
<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td>o Less than 10%</td>
<td>1</td>
</tr>
<tr>
<td>o 10% to less than 20%</td>
<td>2</td>
</tr>
<tr>
<td>o 20% to less than 30%</td>
<td>3</td>
</tr>
<tr>
<td>o 40% to less than 50%</td>
<td>4</td>
</tr>
<tr>
<td>o 50% or more</td>
<td>5</td>
</tr>
</tbody>
</table>

8. In what capacity do you normally invest in the Australian private marketplace?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Private Individual</td>
</tr>
<tr>
<td>2</td>
<td>Company Structure</td>
</tr>
<tr>
<td>3</td>
<td>Trust Structure</td>
</tr>
<tr>
<td>4</td>
<td>Partnership Structure</td>
</tr>
<tr>
<td>5</td>
<td>Other</td>
</tr>
</tbody>
</table>

9. See TABLE 5.5 and TABLE 5.6

(continued overleaf)
Table 5.2 (continued)

10. How much capital do you have currently invested in the private marketplace?

- Less than $250,000 1
- $250,000 to less than $500,000 2
- $500,000 to less than $1,000,000 3
- $1,000,000 to less than $1,500,000 4
- $1,500,000 to less than $2,000,000 5
- $2,000,000 to less than $5,000,000 6
- $5,000,000 to less than $10,000,000 7
- $10,000,000 and over 8

11. What amount would you usually invest in each venture?

- Less than $100,000 1
- $100,000 to less than $250,000 2
- $250,000 to less than $500,000 3
- $500,000 to less than $750,000 4
- $750,000 to less than $1,000,000 5
- $1,000,000,000 and over 6
- No usual amount 7

12. What percentage of what you usually invest is borrowed?

- Nil 1
- Less than 10% 2
- 10% to less than 30% 3
- 30% to less than 50% 4
- 50% and greater 5

5.3 Data analysis

An analysis of the biographical and financial data was undertaken manually whilst the investigation into the reasoning processes of business angels and venture capitalists was carried out on a personal computer using the SPSS categorization. Question 9 of the
survey asked respondents to rate the importance of particular factors when deciding whether to invest in the private marketplace in Australia. These responses were coded. The decision-making criteria were grouped according to the four themes emerging from the research: access to deals; equity/control; entrepreneur/management and investor input. Analysis of variance was used after obtaining the mean preference scores of the four categories to ascertain the differences between the four category means. Following a significant ANOVA, post hoc tests were carried out to ascertain the differences amongst the categories. Section 5.5 sets out that process.

5.3.1 The results of the survey questionnaire

All particulars of the 30 respondents who provided completed questionnaires were de-identified. The results for business angels and venture capitalists are set forth in Table 5.3, excluding the responses to Question 9, which are set forth in tables 5.4 and 5.5, respectively, and discussed in Section 5.6.
TABLE 5.3  Results of questionnaire for business angels and venture capitalists

<table>
<thead>
<tr>
<th>No</th>
<th>Category</th>
<th>Business angels</th>
<th>Venture capitalists</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Male</td>
<td>Male</td>
</tr>
<tr>
<td></td>
<td>Gender</td>
<td>Male</td>
<td>Female</td>
</tr>
<tr>
<td>1</td>
<td></td>
<td>19</td>
<td>8</td>
</tr>
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<td></td>
<td>Female</td>
<td>2</td>
</tr>
<tr>
<td></td>
<td>Age group</td>
<td>25-34</td>
<td>25-34</td>
</tr>
<tr>
<td>2</td>
<td></td>
<td>35-44</td>
<td>35-44</td>
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<td>45-54</td>
<td>45-54</td>
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<td></td>
<td></td>
<td>55-64</td>
<td>55-64</td>
</tr>
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<td></td>
<td>Age group</td>
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<td>45-54</td>
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<tr>
<td></td>
<td></td>
<td>55-64</td>
<td>1</td>
</tr>
<tr>
<td>3</td>
<td>Level of education</td>
<td>Tertiary</td>
<td>Level of education</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Postgraduate</td>
<td>Tertiary</td>
</tr>
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<td></td>
<td></td>
<td>8</td>
<td>2</td>
</tr>
<tr>
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<td></td>
<td>13</td>
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<td></td>
<td>21</td>
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</tr>
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<td></td>
<td></td>
<td></td>
<td>9</td>
</tr>
<tr>
<td>5</td>
<td>Investments last 5 yrs</td>
<td>Once or twice</td>
<td>Investments last 5</td>
</tr>
<tr>
<td></td>
<td></td>
<td>9</td>
<td>years</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Several times</td>
<td>Each year</td>
</tr>
<tr>
<td></td>
<td></td>
<td>5</td>
<td>Several per year</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>2</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Investment period</td>
<td>Less than a year</td>
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<td>0</td>
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</tr>
<tr>
<td></td>
<td></td>
<td>1 to less than 3</td>
<td>1</td>
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<td></td>
<td></td>
<td>3 to less than 5</td>
<td>3</td>
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<td></td>
<td>5 or more</td>
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<tr>
<td>7</td>
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<td>10% to less than 30%</td>
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<td>30% to less than 50%</td>
<td>2</td>
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<td>50% or more</td>
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<td>Partnership</td>
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<td>2</td>
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<tr>
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</tr>
<tr>
<td>10</td>
<td>Current invest</td>
<td>Less than $250,000</td>
<td>Current invest</td>
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<td>Less than $250,000</td>
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<td></td>
<td>$250,000 less than $500,000</td>
<td>4</td>
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<td></td>
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<td></td>
<td>$2M less than $5M</td>
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<td></td>
<td></td>
<td>$5M less than $10M</td>
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<td></td>
<td></td>
<td>$10M and over</td>
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</tr>
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<tr>
<td>11</td>
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<td>Less than $100,000</td>
<td>Current invest</td>
</tr>
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<td>Less than $100,000</td>
</tr>
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<td></td>
<td>$100,000 less than $250,000</td>
<td>5</td>
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<td></td>
<td></td>
<td>$250,000 less than $500,000</td>
<td>2</td>
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<td>$500,000 less than $750,000</td>
<td>0</td>
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<td></td>
<td></td>
<td>$1M and over</td>
<td>1</td>
</tr>
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<td>No usual amount</td>
<td>4</td>
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<td>Percent borrowed</td>
<td>Nil</td>
<td>Percent borrowed</td>
</tr>
<tr>
<td></td>
<td></td>
<td>11</td>
<td>Nil</td>
</tr>
<tr>
<td></td>
<td></td>
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<td>Less than 10%</td>
</tr>
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<td>4</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td></td>
<td>10% to less than 30%</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td></td>
<td>30% to less than 50%</td>
<td>0</td>
</tr>
<tr>
<td></td>
<td></td>
<td>50% and over</td>
<td>3</td>
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</tbody>
</table>

See Table 5.4
See Table 5.5

154
5.3.2 Analysis of responses by business angels / venture capitalists

Question 9 of the questionnaire surveyed decision making factors on a five-point rating scale (not at all important = 1, not very important = 2, moderately important = 3, very important = 4, extremely important = 5). Responses are tabulated in Tables 5.5 and 5.6.

**TABLE 5.4 Business angels’ responses to decision-making factors**

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<thead>
<tr>
<th>ACCESS TO DEALS</th>
<th>Not at all important</th>
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<th>Moderately important</th>
<th>Very important</th>
<th>Extremely important</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Geographic proximity of investment location</td>
<td>1</td>
<td>3</td>
<td>12</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>b. Industry type of venture</td>
<td>1</td>
<td>3</td>
<td>7</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>c. The stage of investment i.e. seed, start up, early or later stage, pre IPO</td>
<td>0</td>
<td>2</td>
<td>7</td>
<td>10</td>
<td>2</td>
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</tbody>
</table>

<table>
<thead>
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<th>EQUITY/CONTROL</th>
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<th>Not very important</th>
<th>Moderately important</th>
<th>Very important</th>
<th>Extremely important</th>
</tr>
</thead>
<tbody>
<tr>
<td>d. The venture has a corporate structure for investment</td>
<td>0</td>
<td>2</td>
<td>3</td>
<td>9</td>
<td>7</td>
</tr>
<tr>
<td>e. The investor has controlling interest in venture</td>
<td>1</td>
<td>8</td>
<td>8</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>f. Proportion of your holding in the venture</td>
<td>1</td>
<td>3</td>
<td>9</td>
<td>3</td>
<td>5</td>
</tr>
<tr>
<td>g. Proportion of your assets in the venture</td>
<td>0</td>
<td>3</td>
<td>3</td>
<td>8</td>
<td>7</td>
</tr>
</tbody>
</table>

(continued overleaf)
Table 5.4 (continued)

<table>
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<th>ENTREPRENEUR / MANAGEMENT</th>
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<th>Not very important</th>
<th>Moderately important</th>
<th>Very important</th>
<th>Extremely important</th>
</tr>
</thead>
<tbody>
<tr>
<td>h. Previous success of entrepreneur</td>
<td>0</td>
<td>3</td>
<td>3</td>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>i. Business expertise of entrepreneur</td>
<td>0</td>
<td>2</td>
<td>2</td>
<td>11</td>
<td>6</td>
</tr>
<tr>
<td>j. Business expertise of management team</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>9</td>
<td>9</td>
</tr>
<tr>
<td>k. Ent. supply business plan</td>
<td>0</td>
<td>3</td>
<td>3</td>
<td>6</td>
<td>9</td>
</tr>
<tr>
<td>l. Entrepreneur to supply financial reports, forecast, books, sets of accounts, info.memo., company profile</td>
<td>0</td>
<td>0</td>
<td>7</td>
<td>6</td>
<td>8</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>INVESTOR INPUT</th>
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<th>Not very important</th>
<th>Moderately important</th>
<th>Very important</th>
<th>Extremely important</th>
</tr>
</thead>
<tbody>
<tr>
<td>m. An exit strategy for the venture</td>
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<td>0</td>
<td>1</td>
<td>11</td>
<td>9</td>
</tr>
<tr>
<td>n. The rate of return and potential of the venture</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>11</td>
<td>8</td>
</tr>
<tr>
<td>o. The venture is high technology</td>
<td>6</td>
<td>4</td>
<td>8</td>
<td>3</td>
<td>0</td>
</tr>
<tr>
<td>p. There are taxation concessions or benefits</td>
<td>7</td>
<td>4</td>
<td>8</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>q. The venture has a superior product or idea and ready markets</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>7</td>
<td>13</td>
</tr>
<tr>
<td>r. The investment is linked to milestones to be achieved by the venture</td>
<td>0</td>
<td>1</td>
<td>6</td>
<td>11</td>
<td>3</td>
</tr>
<tr>
<td>s. The investment referral through trusted network</td>
<td>1</td>
<td>4</td>
<td>5</td>
<td>8</td>
<td>3</td>
</tr>
<tr>
<td>t. The investment is active</td>
<td>2</td>
<td>3</td>
<td>5</td>
<td>7</td>
<td>4</td>
</tr>
</tbody>
</table>
### TABLE 5.5  Venture capitalists’ responses to decision-making factors

9. When deciding whether to invest in the private marketplace in Australia, how important are the following factors? N.B. Numbers show the total responses.

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<thead>
<tr>
<th>ACCESS TO DEALS</th>
<th>Not at all important</th>
<th>Not very important</th>
<th>Moderately important</th>
<th>Very important</th>
<th>Extremely important</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Geographic proximity of investment location</td>
<td>0</td>
<td>2</td>
<td>3</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>b. Industry type of venture</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>c. The stage of investment i.e. seed, start up, early or later stage, pre IPO</td>
<td>0</td>
<td>0</td>
<td>2</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EQUITY/CONTROL</th>
<th>Not at all important</th>
<th>Not very important</th>
<th>Moderately important</th>
<th>Very important</th>
<th>Extremely important</th>
</tr>
</thead>
<tbody>
<tr>
<td>d. The venture has a corporate structure for investment</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>e. The investor has a controlling interest in the venture</td>
<td>0</td>
<td>1</td>
<td>4</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>f. Proportion of your holding in the venture</td>
<td>0</td>
<td>1</td>
<td>3</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>g. Proportion of your assets in the venture</td>
<td>0</td>
<td>2</td>
<td>4</td>
<td>2</td>
<td>1</td>
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<tr>
<th>ENTREPRENEUR / MANAGEMENT</th>
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<th></th>
<th></th>
<th></th>
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<tbody>
<tr>
<td>h. Previous success of entrepreneur</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>i. Business expertise of entrepreneur</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>j. Business expertise of management team</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>k. Entrepreneur to supply business plan</td>
<td>0</td>
<td>0</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>l. Entrepreneur to supply financial reports, forecast, books, sets of accounts, info. memo, company profile</td>
<td>0</td>
<td>0</td>
<td>3</td>
<td>5</td>
<td>1</td>
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(continued overleaf)
Table 5.5 (continued)

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<th>Not very important</th>
<th>Moderately important</th>
<th>Very important</th>
<th>Extremely important</th>
</tr>
</thead>
<tbody>
<tr>
<td>m. An exit strategy for the venture</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>n. The rate of return and potential of the venture</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>o. The venture is high technology</td>
<td>1</td>
<td>3</td>
<td>4</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>p. There are taxation concessions or benefits</td>
<td>1</td>
<td>5</td>
<td>2</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>q. The venture has a superior product or idea and ready markets</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>r. The investment is linked to milestones to be achieved by the venture</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>s. The investment referral is through a trusted network</td>
<td>0</td>
<td>1</td>
<td>5</td>
<td>2</td>
<td>1</td>
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<tr>
<td>t. The investment is active</td>
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The rating of factors for business angels/venture capitalists is in Tables 5.6 and 5.7.
### TABLE 5.6 Factors most frequently rated extremely important by business angels

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<tr>
<th>Criteria</th>
<th>Classification</th>
<th>Percent</th>
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<tr>
<td>1 9(q) Venture superior product/idea, ready markets</td>
<td>Investor input</td>
<td>62%</td>
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<tr>
<td>2 9(m) An exit strategy for the venture</td>
<td>Investor input</td>
<td>43%</td>
</tr>
<tr>
<td>3 9(j) Business expertise of management team</td>
<td>Entrepreneur/management</td>
<td>43%</td>
</tr>
<tr>
<td>4 9(k) Entrepreneur to supply a business plan</td>
<td>Entrepreneur/management</td>
<td>43%</td>
</tr>
<tr>
<td>5 9(n) The rate of return, potential of the venture</td>
<td>Investor input</td>
<td>38%</td>
</tr>
<tr>
<td>6 9(l) Entrepreneur supply financial reports</td>
<td>Entrepreneur/management</td>
<td>38%</td>
</tr>
<tr>
<td>7 9(d) The venture has a corporate structure</td>
<td>Equity/control</td>
<td>33%</td>
</tr>
<tr>
<td>8 9(h) Previous success of entrepreneur</td>
<td>Entrepreneur/management</td>
<td>33%</td>
</tr>
<tr>
<td>9 9(g) Proportion of investor assets in the venture</td>
<td>Equity/control</td>
<td>33%</td>
</tr>
</tbody>
</table>

### TABLE 5.7 Factors most frequently rated extremely important by venture capitalists

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Classification</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 9(n) The rate of return, potential of the venture</td>
<td>Investor input</td>
<td>67%</td>
</tr>
<tr>
<td>2 9(b) Industry type of venture</td>
<td>Access to deals</td>
<td>67%</td>
</tr>
<tr>
<td>3 9(j) Business expertise of management team</td>
<td>Entrepreneur/management</td>
<td>55%</td>
</tr>
<tr>
<td>4 9(t) The investment is active</td>
<td>Investor input</td>
<td>55%</td>
</tr>
<tr>
<td>5 9(m) An exit strategy for the venture</td>
<td>Investor input</td>
<td>45%</td>
</tr>
<tr>
<td>6 9(c) The stage of investment</td>
<td>Access to deals</td>
<td>45%</td>
</tr>
<tr>
<td>7 9(i) Business expertise of entrepreneur</td>
<td>Entrepreneur/management</td>
<td>45%</td>
</tr>
<tr>
<td>8 9(r) Investment is linked to milestones</td>
<td>Investor input</td>
<td>45%</td>
</tr>
<tr>
<td>9 9(q) Venture superior product/idea, ready markets</td>
<td>Investor input</td>
<td>34%</td>
</tr>
</tbody>
</table>
5.4 Hypothesis testing

Tests were conducted on the data arising from Question 9 of the questionnaire in relation to the hypotheses. Business angels and venture capitalists are referred to as BAs and VCs respectively in the tables, models and summaries in this section.

Hypothesis 1 (H1): Business angels regard access to deals as a factor that must be considered when making an investment decision in the private marketplace.

Tests were carried out as follows:

The linear regression with total consideration score (Total) was the dependent variable and the total access to deals score was the independent variable for business angels (BAs). This test would establish whether access to deals was significant in determining the total consideration score and the contribution of it to the total variance in the consideration score.

Descriptive statistics

<table>
<thead>
<tr>
<th>Descriptive Statistics(^a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
</tr>
<tr>
<td>TOTAL</td>
</tr>
<tr>
<td>TOTAL_Access_To_Deals</td>
</tr>
</tbody>
</table>

\(^a\) BA_VC = BA
Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>1</td>
<td>582.552</td>
<td>17.948</td>
<td>.000a</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>19</td>
<td>32.457</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>1199.238</td>
<td>20</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\[ a. \text{Predictors: (Constant), TOTAL\_Access\_To\_Deals} \]
\[ b. \text{Dependent Variable: TOTAL} \]
\[ c. \text{BA\_VC = BA} \]

The ANOVA table stated that the regression model was significant; \( F(1, 19) = 17.95, p < .001 \). That is, the independent variable selected (access to deals) affected the dependent variable (total – consideration of investment decision).

<table>
<thead>
<tr>
<th>Model Summary</th>
<th>( R )</th>
<th>( R^2 )</th>
<th>Adjusted ( R^2 )</th>
<th>Std. Error of the Estimate</th>
<th>Change Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
<td>( .697^a )</td>
<td>( .486 )</td>
<td>( .459 )</td>
<td>( 5.697 )</td>
<td>( .486 )</td>
</tr>
</tbody>
</table>

\[ a. \text{Predictors: (Constant), TOTAL\_Access\_To\_Deals} \]
\[ b. \text{Dependent Variable: TOTAL} \]
\[ c. \text{BA\_VC = BA} \]

The model summary stated that access to deals represented 48.6% of the variation of the total consideration score.
<table>
<thead>
<tr>
<th>Model</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>Beta</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>(Constant)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>TOTAL_Access_To_Deals</td>
<td>46.498</td>
<td>6.334</td>
<td></td>
<td></td>
<td>7.341</td>
<td>.000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>2.594</td>
<td>.612</td>
<td>.697</td>
<td>4.237</td>
<td>.000</td>
<td></td>
</tr>
</tbody>
</table>

a. Dependent Variable: TOTAL
b. BA_VC = BA

The coefficient table confirmed the ANOVA table result with the access to deals coefficient being significant, $t (19) = 4.24$, $p < .001$.

Since the linear regression model with Total and access to deals was significant for business angels, it could be concluded that business angels regard access to deals as a factor that must be considered when making a decision to invest in the private marketplace.

**Hypothesis 2 (H2):** Business angels regard the degree of equity / control in the venture as a factor that must be considered when making an investment decision in the private marketplace.

Tests were carried out as follows:

The linear regression with total consideration score (Total) was the dependent variable and the total equity/control score was the independent variable. This test would establish whether the degree of equity/control was significant in determining the total consideration score and the contribution of it to the total variance in the consideration score.
Descriptive statistics

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL</td>
<td>72.81</td>
<td>7.744</td>
<td>21</td>
</tr>
<tr>
<td>TOTAL_Equity_Control</td>
<td>14.10</td>
<td>3.032</td>
<td>21</td>
</tr>
</tbody>
</table>

a. BA_VC = BA

Model Summary

**ANOVA**

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>1</td>
<td>227.255</td>
<td>4.442</td>
<td>.049</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>19</td>
<td>51.157</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>20</td>
<td>1199.238</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), TOTAL_Equity_Control
b. Dependent Variable: TOTAL
c. BA_VC = BA

The ANOVA table stated that the regression model was significant; $F(1, 19) = 4.44, p < .05$. That is, the independent variable selected (degree of equity/control) affected the dependent variable (total – consideration of investment decision).

**Model Summary**

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
<th>R Square Change</th>
<th>F Change</th>
<th>df1</th>
<th>df2</th>
<th>Sig. F Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.435</td>
<td>.189</td>
<td>.147</td>
<td>7.152</td>
<td>.189</td>
<td>4.442</td>
<td>1</td>
<td>19</td>
<td>.049</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), TOTAL_Equity_Control
b. Dependent Variable: TOTAL
c. BA_VC = BA

The model summary stated that the degree of equity/control represented 18.9% of the variation of total consideration score.
The coefficient table confirmed the ANOVA table result with equity/control coefficient being significant, $t(19) = 2.118, p < .05$.

Since the linear regression model with Total and degree of equity/control was significant for business angels it could be concluded that business angels regard the degree of equity/control as a factor that must be considered when making a decision to invest in the private market place.

Hypothesis 3 ($H_3$): Business angels regard the quality of the entrepreneur / management team in the venture as the most important factor to be considered when making an investment decision in the private marketplace.

Tests were carried out as follows:

The linear regression with total consideration score (Total) was the dependent variable and total access to deals, total degree of equity/control, total entrepreneur/management and total investor input score were the independent variables for business angels. This would establish whether the set of independent variables were significant in determining the total consideration score and the effect of each of the set to the total variance in the consideration score. Once the effect of each independent variable was known, it would be possible to determine which had the greatest effect on the investment decision.
Descriptive statistics

<table>
<thead>
<tr>
<th>Descriptive Statistics</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL</td>
<td>72.81</td>
<td>7.744</td>
<td>21</td>
</tr>
<tr>
<td>TOTAL_Access_To_Deals</td>
<td>10.14</td>
<td>2.081</td>
<td>21</td>
</tr>
<tr>
<td>TOTAL_Equity_Control</td>
<td>14.10</td>
<td>3.032</td>
<td>21</td>
</tr>
<tr>
<td>TOTAL_Ent_Mgt</td>
<td>20.19</td>
<td>3.558</td>
<td>21</td>
</tr>
<tr>
<td>TOTAL_Inv_Input</td>
<td>28.38</td>
<td>3.598</td>
<td>21</td>
</tr>
</tbody>
</table>

a. BA_VC = BA

Model Summary

ANOVAb,c

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1199.238</td>
<td>4</td>
<td>299.810</td>
<td>2E+016</td>
<td>.000a</td>
</tr>
<tr>
<td>Regression</td>
<td>.000</td>
<td>16</td>
<td>.000</td>
<td></td>
<td>.000</td>
</tr>
<tr>
<td>Total</td>
<td>1199.238</td>
<td>20</td>
<td></td>
<td></td>
<td>.000c</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), TOTAL_Inv_Input, TOTAL_Equity_Control, TOTAL_Ent_Mgt, TOTAL_Access_To_Deals
b. Dependent Variable: TOTAL
c. BA_VC = BA

The ANOVA table stated that the regression model was significant; \( F(4, 16) = 2E+016, p <.001. \) That is, at least one of the independent variables selected affected the dependent variable (Total – consideration of investment decision).
The coefficient table confirmed the ANOVA table result with all independent variable coefficients being significant, $p < .001$.

By examining the standardized coefficient values of each of the independent variables it could be seen that the effect on the investment decision for business angels of the investor input (standardized coefficient = .465) and of entrepreneur / management (standardized coefficient of .46) were almost the same.

Since the sample size of the study was small, it was decided to conduct further testing to see whether the effects of investor input and entrepreneur / management were different. The sample size was not adequate for parametric analysis, so non-parametric tests were carried out to determine whether there were any differences in the mean scores of investor input and entrepreneur / management.

Tests were carried out as follows: Paired samples comparison test – Wilcoxon signed rank test.
Descriptives

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVG_Inv_Input</td>
<td>21</td>
<td>3.547619</td>
<td>.4497850</td>
<td>3.0000</td>
<td>4.2500</td>
</tr>
<tr>
<td>AVG_Ent_Mgt</td>
<td>21</td>
<td>4.038095</td>
<td>.7116714</td>
<td>2.4000</td>
<td>5.0000</td>
</tr>
</tbody>
</table>

a. BA_VC = BA

Ranks

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Mean Rank</th>
<th>Sum of Ranks</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVG_Ent_Mgt &lt; AVG_ Inv_Inp</td>
<td>4</td>
<td>10.38</td>
<td>41.50</td>
</tr>
<tr>
<td>AVG_Ent_Mgt &gt; AVG_Inv_Inp</td>
<td>17</td>
<td>11.15</td>
<td>189.50</td>
</tr>
<tr>
<td>AVG_Ent_Mgt = AVG_Inv_Inp</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>21</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. AVG_Ent_Mgt < AVG_Inv_Inp
b. AVG_Ent_Mgt > AVG_Inv_Inp
c. AVG_Ent_Mgt = AVG_Inv_Inp
d. BA_VC = BA

Test Statistics

<table>
<thead>
<tr>
<th></th>
<th>AVG_Ent_Mgt - AVG_Inv_Inp</th>
<th>Z</th>
<th>Asymp. Sig. (2-tailed)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>-2.573a</td>
<td>.010</td>
</tr>
</tbody>
</table>

a. Based on negative ranks.
b. Wilcoxon Signed Ranks Test
c. BA_VC = BA

The Wilcoxon test was significant; z = -2.57, p <.05. Therefore, it could be concluded that the difference between investor input and entrepreneur / management was significant for business angels. Since the average entrepreneur / management score was higher, it could be concluded that the most important factor in the investment decision was the quality of the entrepreneur / management team.
Hypothesis 4 (H4): Business angels regard investor input being the financial assessment of the venture as a factor that must be considered when making an investment decision in the private marketplace.

Tests were carried out as follows:

The linear regression with total consideration score (Total) was the dependent variable, and the total investor input score the independent variable. This test would establish whether the investor input was significant in determining the total consideration score and the contribution of it to the total variance in the consideration score.
Descriptive statistics

<table>
<thead>
<tr>
<th>Total</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL</td>
<td>72.81</td>
<td>7.744</td>
<td>21</td>
</tr>
<tr>
<td>TOTAL_Inv_Input</td>
<td>28.38</td>
<td>3.598</td>
<td>21</td>
</tr>
</tbody>
</table>

a. BA_VC = BA

Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>479.907</td>
<td>1</td>
<td>479.907</td>
<td>12.676</td>
<td>.002</td>
</tr>
<tr>
<td></td>
<td>719.331</td>
<td>19</td>
<td>37.860</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1199.238</td>
<td>20</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), TOTAL_Inv_Input
b. Dependent Variable: TOTAL
c. BA_VC = BA

The ANOVA table stated that the regression model was significant; $F(1, 19) = 12.68, p <.05$. That is, the independent variable selected (investor input) affected the dependent variable (Total – consideration of investment decision).
The model summary stated that the investor input represented 40% of the variation of total consideration score.

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 (Constant)</td>
<td>34.173</td>
<td>10.935</td>
<td>3.125</td>
<td>.006</td>
</tr>
<tr>
<td>TOTAL_Inv_Input</td>
<td>1.361</td>
<td>.382</td>
<td>.633</td>
<td>.002</td>
</tr>
</tbody>
</table>

The coefficient table confirmed the ANOVA table result, with investor input coefficient being significant, \( t(29) = 3.56, p < .05 \).

Since the linear regression model with Total and degree of equity/control was significant for business angels, it could be concluded that business angels regard investor input as a factor that must be considered when making a decision to invest in the private marketplace.

**Hypothesis 5 (H5): Venture capitalists regard access to deals as a factor that must be considered when making an investment decision in the private marketplace.**

Tests were carried out as follows:

The linear regression with total consideration score (Total) was the dependent variable and the total access to deals score was the independent variable for venture capitalists. This test would establish whether access to deals was significant in determining the total
consideration score and the contribution of it to the total variance in the consideration score.

Descriptive statistics

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL</td>
<td>76.78</td>
<td>8.772</td>
<td>9</td>
</tr>
<tr>
<td>TOTAL_Access_</td>
<td>12.00</td>
<td>1.871</td>
<td>9</td>
</tr>
<tr>
<td>To_Deals</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\*BA_VC = VC\*

Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>116.036</td>
<td>1</td>
<td>116.036</td>
<td>1.626</td>
<td>.243</td>
</tr>
<tr>
<td>Residual</td>
<td>499.520</td>
<td>7</td>
<td>71.360</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>615.556</td>
<td>8</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\*a. Predictors: (Constant), TOTAL_Access_To_Deals  
b. Dependent Variable: TOTAL  
c. BA_VC = VC\*

The ANOVA table stated that the regression model was not significant; \( F (1, 7) = 1.63 \), \( p > .05 \). That is, the independent variable selected (access to deals) did not affect the dependent variable (Total – consideration of investment decision).
The coefficient table confirmed the ANOVA table result, with access to deals coefficient being non-significant, $t(19) = 1.28, p > .05$.

Since the linear regression model with Total and access to deals was non-significant for venture capitalists, there was not enough evidence to conclude that venture capitalists regard access to deals as a factor that must be considered when making a decision to invest in the private marketplace.

**Hypothesis 6 (H6):** Venture capitalists regard the degree of equity / control in the venture as a factor that must be considered when making an investment decision in the private marketplace.

Tests were carried out as follows:

The linear regression with total consideration score (Total) was the dependent variable and the total equity/control score was the independent variable for venture capitalists. This test would establish whether the degree of equity/control was significant in determining the total consideration score and the contribution of it to the total variance in the consideration score.
Descriptive statistics

<table>
<thead>
<tr>
<th>Descriptive Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mean</strong></td>
</tr>
<tr>
<td>TOTAL</td>
</tr>
<tr>
<td>TOTAL_Equity_Control</td>
</tr>
</tbody>
</table>

a. BA_VC = VC

Model Summary

ANOVA

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>1</td>
<td>495.578</td>
<td>28.914</td>
<td>&lt;.05</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>7</td>
<td>17.140</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>8</td>
<td>615.556</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The ANOVA table stated that the regression model was significant; $F(1, 7) = 28.91$, $p < .05$. That is, the independent variable selected (degree of equity/control) affected the dependent variable (Total – consideration of investment decision).

Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted R Square</th>
<th>Std. Error of the Estimate</th>
<th>R Square Change</th>
<th>F Change</th>
<th>df1</th>
<th>df2</th>
<th>Sig. F Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.897</td>
<td>.805</td>
<td>.777</td>
<td>4.140</td>
<td>.805</td>
<td>28.914</td>
<td>1</td>
<td>7</td>
<td>.001</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), TOTAL_Equity_Control
b. Dependent Variable: TOTAL
c. BA_VC = VC
The model summary stated that the degree of equity/control represented 80.5% of the variation of total consideration score.

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Constant)</td>
<td>5.182</td>
<td>.387</td>
<td>.387</td>
<td>.710</td>
</tr>
<tr>
<td>TOTAL_Equity_Control</td>
<td>5.034</td>
<td>.936</td>
<td>.897</td>
<td>.001</td>
</tr>
</tbody>
</table>

The coefficient table confirmed the ANOVA table result, with equity/control coefficient being significant, $t (7) = 5.38$, $p < .05$.

Since the linear regression model with Total and degree of equity/control was significant for venture capitalists, it could be concluded that venture capitalists regard the degree of equity/control as a factor that must be considered when making a decision to invest in the private market place.

Hypothesis 7 (H7): Venture capitalists regard the quality of the entrepreneur /management team in the venture to be the most important factor to be considered when making an investment decision in the private marketplace.

Tests were carried out as follows:

The linear regression with total consideration score (Total) was the dependent variable and total access to deals, total degree of equity/control, total entrepreneur management
and total investor input score were independent variables for venture capitalists. This test would establish whether the set of independent variables were significant in determining the total consideration score and the effect of each of the set to the total variance in the consideration score. Once the effect of each independent variable was known, it would be possible to determine which had the greatest effect on the investment decision.

Descriptive statistics

<table>
<thead>
<tr>
<th>Descriptive Statistics</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL</td>
<td>76.78</td>
<td>8.772</td>
<td>9</td>
</tr>
<tr>
<td>TOTAL_Access_To_Deals</td>
<td>12.00</td>
<td>1.871</td>
<td>9</td>
</tr>
<tr>
<td>TOTAL_Equity_Control</td>
<td>14.22</td>
<td>1.563</td>
<td>9</td>
</tr>
<tr>
<td>TOTAL_Ent_Mgt</td>
<td>20.33</td>
<td>3.082</td>
<td>9</td>
</tr>
<tr>
<td>TOTAL_Inv_Input</td>
<td>30.22</td>
<td>4.577</td>
<td>9</td>
</tr>
</tbody>
</table>

a. BA_VC = VC

Model Summary

<table>
<thead>
<tr>
<th>ANOVA&lt;sup&gt;a,c&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
</tr>
<tr>
<td>1</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), TOTAL_Inv_Input, TOTAL_Access_To_Deals, TOTAL_Ent_Mgt, TOTAL_Equity_Control
b. Dependent Variable: TOTAL
c. BA_VC = VC

The ANOVA table stated that the variance - covariance matrix was singular for venture capitalists. In order to determine the most important factor in determining the
investment decision, it was decided to run the non-parametric tests; the K-related
sample comparing Friedman’s test was used.

<table>
<thead>
<tr>
<th>Descriptive Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVG_Inv_Input</td>
</tr>
<tr>
<td>AVG_Ent_Mgt</td>
</tr>
<tr>
<td>AVG_Equity_Control</td>
</tr>
<tr>
<td>AVG_Access_To_Deals</td>
</tr>
</tbody>
</table>

a. BA_VC = VC

<table>
<thead>
<tr>
<th>Ranks</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVG_Inv_Input</td>
</tr>
<tr>
<td>AVG_Ent_Mgt</td>
</tr>
<tr>
<td>AVG_Equity_Control</td>
</tr>
<tr>
<td>AVG_Access_To_Deals</td>
</tr>
</tbody>
</table>

a. BA_VC = VC

<table>
<thead>
<tr>
<th>Test Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>N</td>
</tr>
<tr>
<td>Chi-Square</td>
</tr>
<tr>
<td>df</td>
</tr>
<tr>
<td>Asymp. Sig.</td>
</tr>
</tbody>
</table>

a. Friedman Test
b. BA_VC = VC

Friedman’s test results ($p < .05$) stated that at least one of the means of four variables
was different from the other three. In order to determine the exact differences and to
locate which one had the highest effect, it was decided to run pairwise comparisons
using non-parametric procedures.
The comparisons were done in the following manner:

1. Access to deals – Degree of Equity Control

2. Access to deals – Quality of Entrepreneur / Management

3. Access to deals – Investor Input

4. Degree of Equity Control - Quality of Entrepreneur / Management

5. Degree of Equity Control - Investor Input

6. Quality of Entrepreneur / Management - Investor Input

<table>
<thead>
<tr>
<th>Descriptive Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVG_Equity_Control</td>
</tr>
<tr>
<td>AVG_Ent_Mgt</td>
</tr>
<tr>
<td>AVG_Inv_Input</td>
</tr>
<tr>
<td>AVG_Access_To_Deals</td>
</tr>
<tr>
<td>N</td>
</tr>
<tr>
<td>9</td>
</tr>
<tr>
<td>9</td>
</tr>
<tr>
<td>9</td>
</tr>
<tr>
<td>9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Test Statistics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Z</td>
</tr>
<tr>
<td>Asymp. Sig. (2-tailed)</td>
</tr>
<tr>
<td>-2.081&lt;sup&gt;a&lt;/sup&gt;</td>
</tr>
<tr>
<td>.351&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

These results suggested that only the differences between access to deals (M = 4.00, SD = .62) and equity control (M = 3.56, SD = .39) and between equity control (M = 3.56, SD = .39) and entrepreneur management (M = 4.07, SD = .62) were significant. The analysis of numerical values with the results confirmed that the lowest effect was from
the equity / control followed by access to deals and entrepreneur / management respectively. No significant statistical difference was detected between the two highest affecting factors. Therefore, using non-parametric testing it could be concluded that entrepreneur / management and access to deals were the most important factors affecting the investment decision for venture capitalists.

Hypothesis 8 (H8): Venture capitalists regard investor input being the financial assessment of the venture as a factor that must be considered when making an investment decision in the private marketplace.

Tests were carried out as follows:
The linear regression with total consideration score (Total) was the dependent variable and the total investor input score was the independent variable for venture capitalists. This test would establish whether investor input was significant in determining the total consideration score and the contribution of it to the total variance in the consideration score.

Descriptive statistics

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>N</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL</td>
<td>76.78</td>
<td>8.772</td>
<td>9</td>
</tr>
<tr>
<td>TOTAL_Inv_Input</td>
<td>30.22</td>
<td>4.577</td>
<td>9</td>
</tr>
</tbody>
</table>

a. BA_VC = VC

Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>1</td>
<td>472.745</td>
<td>23.172</td>
<td>&lt;.05</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>7</td>
<td>20.402</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>8</td>
<td>615.556</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), TOTAL_Inv_Input  
b. Dependent Variable: TOTAL  
c. BA_VC = VC

The ANOVA table stated that the regression model was significant; \( F(1, 7) = 23.17, p < .05 \). That is, the independent variable selected (investor input) affected the dependent variable (Total – consideration of investment decision).
The model summary stated that the investor input represented 76.8% of the variation of total consideration score.

The coefficient table confirmed the ANOVA table result, with investor input coefficient being significant, $t(7) = 4.81$, $p < .05$.

Since the linear regression model with total and degree of equity/control was significant for venture capitalists, it could be concluded that venture capitalists regard investor input as a factor that must be considered when making a decision to invest in the private market place.

**Hypothesis 9 (H9): Venture capitalists place greater importance upon the financial assessment of the venture in their investment decision in the private marketplace than do business angels.**
Tests were carried out as follows:

The mean investor input of business angels was compared with that of venture capitalists using a non-parametric independent samples test (Mann-Whitney Test) to determine whether a statistically significant difference existed between them.

<table>
<thead>
<tr>
<th>Ranks</th>
<th>BA</th>
<th>Mean Rank</th>
<th>Sum of Ranks</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVG Inv_Input</td>
<td>BA</td>
<td>14.71</td>
<td>309.00</td>
</tr>
<tr>
<td></td>
<td>VC</td>
<td>17.33</td>
<td>156.00</td>
</tr>
<tr>
<td>Total</td>
<td>30</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Test Statistics</th>
<th>AVG Inv_ Input</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mann-Whitney U</td>
<td>78.000</td>
</tr>
<tr>
<td>Wilcoxon W</td>
<td>309.000</td>
</tr>
<tr>
<td>Z</td>
<td>-.750</td>
</tr>
<tr>
<td>Asymp. Sig. (2-tailed)</td>
<td>.453</td>
</tr>
<tr>
<td>Exact Sig. [2*(1-tailed Sig.)]</td>
<td>.476a</td>
</tr>
</tbody>
</table>

a. Not corrected for ties.

b. Grouping Variable: BA_VC

The Mann-Whitney test yielded a non-significant result, $p > .05$. Thus there was lack of evidence to conclude that the venture capitalists place greater importance upon the financial assessment of the venture in their decision to invest or not invest in the private market place investment than do business angels.

However, the graphical analysis showed that the preference of venture capitalists for financial factors was higher than that of business angels.
5.5 Interpretation of results of hypothesis testing

The hypotheses (H₁) to (H₉) were concerned with determining the relative importance of different factors and the interrelations among decisions taken by business angels and venture capitalists to invest or not invest in the private marketplace within Australia.

In relation to access to deals, for business angels this was a factor that must be considered when making an investment decision, whereas for venture capitalists this was not so.

In relation to the degree of equity / control in the venture, for business angels this was a factor that must be considered when making an investment decision in the private marketplace as it was for venture capitalists.
In relation to the quality of the entrepreneur / management team in the venture, for business angels this was the most important factor to be considered when making an investment decision in the private marketplace. For venture capitalists there was some support, albeit limited because of the sample size, that this was one of the two most important factors for venture capitalists to consider when making an investment decision. When taken into account with the qualitative findings on this issue, it would appear reasonable to draw such a conclusion.

In relation to investor input being the financial assessment of the venture, for business angels this was a factor that must be considered when making an investment decision as it was for venture capitalists.

The final hypothesis that venture capitalists place greater importance upon the financial assessment of the venture when making an investment decision than do business angels was not supported. The result confirms that business angels and venture capitalists have a similar concern as to the relevance and significance of financial factors in the decision making process.

5.6 The research findings

Business angels and venture capitalists in the focus group did not express particular concerns about geographical issues or industry type in accessing deals. However venture capitalists were concerned about investing in start-up ventures that might not be profitable for a number of years. The issue of diversification of their investments also meant that they would not be as willing to pursue these ventures, particularly with the downturn in the supply of funding from investors. There also was a view that business
angels might wish to carry the start-up or early stage of the enterprise without the dilution and loss of control that would come with venture capital funding.

On the issue of equity/control, venture capitalists in particular expressed less concern about the percentage of equity issues, provided they were able to exercise sufficient control through other means and assert policy direction and control.

Business angels and venture capitalists considered ventures with sound management principles and appropriate entrepreneurial leadership as important matters when making the investment decision. They regarded networks as important for the investment referral.

Concern was expressed particularly by the venture capitalists as to investor input being the financial aspects of the deal and the need for a rate of return commensurate with the risk and a credible exit strategy for the investment with some expressing serious concerns about the liquidity of their industry and the profitability of potential deals. Both business angels and venture capitalists believed that the extraordinary financial times created by the global financial crisis could lead to decision making reflective of the times. There was insufficient comment from the business angels to discern any noticeable difference between them and venture capitalists in terms of their weighting of financial factors in making a decision to invest or not invest in the private marketplace. However the venture capitalists present perceived themselves as quite distinct from business angels, operating in different silos and with different levels of risk awareness.

The questionnaire was revised in order to allow respondents to comment on their investment patterns and in particular the impact of the global financial crisis upon decision making processes. Both business angels and venture capitalists took the opportunity to respond to these issues in the questionnaire with varying views being
expressed about investment attitudes and in particular the emergence of the financial crisis as a catalyst for either positive or negative investment practices.

The potential implications arising from the views expressed by business angels and venture capitalists concerning investment decisions in the private marketplace and the importance of certain factors in the decision making process suggest the need for further research into this area. A richer understanding of the factors influencing these investment decisions is pursued in Chapter 6.
Chapter 6

Conclusions and implications

“All opinions, properly so called, are stages on the road to truth. It does not follow that a man will travel any farther; but if he has really considered the world and drawn a conclusion, he has travelled as far.”

Crabbed age and youth: R.L. Stevenson (1850–1894)


The aim of the study was to achieve a richer understanding of the reasoning processes of business angels and venture capitalists in making an investment decision in the private marketplace. A conceptual model for evaluating decision making factors is proposed as part of this process.

The findings here reveal particular factors that are perceived by business angels and venture capitalists to be relevant to their investment decisions in the private marketplace. The quality of the entrepreneur / management team is regarded as the most important factor. It follows that investors would be strongly advised to undertake due diligence as to the past performance of the entrepreneur and the management team, their capability to undertake a new or emerging venture and their capacity for working in conjunction with active or passive investors.
6.1 An awareness of past studies and the present undertaking

A paucity of studies on business angels’ and venture capitalists’ investment decisions underpinned this study. Internationally, studies of the investment decision making of private marketplace investors have focused upon particular aspects - Feeney et al. (1999) and Maula et al. (2003) concerning the determinants of business angels and those of MacMillan et al. (1985), Sandberg, Schweiger and Hofer (1988), Riquelme and Rickards (1992), Hall and Hofer (1993), Knight (1995) and Shepherd et al. (2003) concerning venture capitalists. Duxbury, Haines and Riding (1996) studied the characteristics of business angel investors as opposed to non-investors. Lerner (1998) and Aernoudt (1999a) considered public sector support for business angels. Feeney et al. (1999) comment upon the decision from the dual perspective of business angel and venture capitalist, but with a particular focus upon the business angel investment decision of which they note there is little published research. Apart from Erlich et al. (1994), Van Osnabrugge (2000) and Lesonsky (2007) there has been little attention paid to the investment decision making process from a comparative perspective of business angels and venture capitalists.

Within Australia there have been a number of studies: Hindle and Wenban (1999) concerning the privacy of business angels and Hindle and Rushworth (2002), Hindle and Rushworth (2004), Schaper and Volery (2004) and Schaper et al. (2007) concerning the entrepreneur’s perspective on private investment. But again few studies have focused upon a discussion of the factors that might be relevant in the investment decision making process and none from a perspective of both business angels and venture capitalists.
6.2 Implications of this study

By giving a better understanding of how business angels and venture capitalists juggle the various factors pertaining to private marketplace investment it is possible to gain the necessary insights required for extending further enquiry. Such insights involve, firstly the raising of awareness of investment opportunities on offer in the private marketplace and the development of networks and relationships to expose these opportunities, the investigation of the reasons why certain high net worth investors choose not to invest in this marketplace, the promotion of administrative and legislative procedures that offer investment incentives and the encouraging of female investors and entrepreneurs in particular who would bring to the marketplace a wealth of additional skills and knowledge in service and retail areas where they are prominent. These initiatives are outlined below with the view expressed that their implementation should lead to an increase in innovation in the private marketplace with resulting commercial benefits.

6.2.1 Public awareness of investment opportunities

One of the observations of the study has been the private manner in which entrepreneurs, investors, deals and funding are brought together. There is no obvious public scrutiny of the marketplace or its participants. Networks are noted to be important in connecting the parties to each other. Action taken to raise public awareness of the private marketplace and its attendant benefits might encourage investors into this space. As noted by Cutler (2008, p. 9) “there is a global and systemic funding gap in the availability of capital for early stage ventures”. Hence the need for programs that nurture, maintain and develop innovation and enterprise by early stage ventures.
6.2.2 Investors not in the private marketplace

The study by Freear et al. (1994) of business angels with and without investing experience reveals that there might in fact be a third group of high net worth investors that should be studied. This group comprises investors who never become business angels. This would involve a different form of methodology in locating high net worth individuals who are not necessarily business angel investors. An enquiry that has as its focus the reason(s) why high net worth individuals choose to not invest in this private marketplace may be an appropriate topic for further research.

6.2.3 Legislative and administrative incentives

The findings from the study confirm the results of prior research that the private marketplace would benefit from the adoption of government policies that promote investment in the private marketplace and from assistance in the form of government grants and incentives. This study has revealed that funding grants, especially in the early stages of the venture, are preferred to taxation concessions which are of value only when the venture is profitable. Responses from the focus group and questionnaire noted that the impact of the taxation regime was not an influencing factor in early stage investment.

6.2.4 Investor “gender equity”

The private marketplace has an unusually high proportion of male investors, generally of a mature age and very few female investors. Females may be attracted to the
marketplace if they are provided with better access to investment and entrepreneurial opportunities and through investor networks that are strategically marketed to women. These initiatives would allow for a broader range of opportunities for investment especially in areas where female entrepreneurs are most likely to be present such as service and retail businesses (Treichel and Scott 2006). Robb and Coleman (2009) note that whilst the lower level of start-up capital for female-owned firms is a factor in the success rate for these enterprises, female-owned businesses still under-perform firms owned by males. There may be other factors at work which call for further research into the motivations and performance outcomes of female-owned firms.

6.2.5 Commercial implications

The value of funds committed to venture capital and later stage private equity in Australia as at 30th June 2008 was shown by this study to be A$17.1 billion excluding seed and early stage funding. In 2008 in Australia there were approximately 16,100 active angel investors investing A$1.69 billion in more than 5,000 entrepreneurial companies. This translates into 35,000 jobs within Australia. The Review of the National Innovation System (Cutler 2008) notes that innovation within Australia is not the problem: It is the answer. Innovation can provide imaginative responses to opportunities. The private marketplace is well positioned to take up this challenge through investment by business angels and venture capitalists.
6.3 A richer understanding of the decision-making process

How business angels and venture capitalists determine and evaluate the relative importance of different factors and the interrelations among decisions taken to invest or not invest in the private marketplace within Australia is central to the research question.

Forecasts as to the likely success of a venture are made by business angels and venture capitalist and these forecasts call for judgements to be made by these investors. Comment by Bunn and Wright (1991, p. 502) notes that “surveys of corporate forecasting practices show that most important forecasts involve judgement”. If the judgements are made by expert, informed, judges then their judgements may prove superior to statistically based forecasting models (Bunn and Wright 1991). Many of the difficulties arising in a new venture are hard to foresee and are related to human rather than financial resources (Wu 1988). Decision makers can err in such situations particularly where the information upon which the decision is based is limited and indeterminate (Fischhoff 1975) or where the judgement is distorted by cognitive biases that stem from the reliance of judgemental heuristics (Tversky and Kahneman 1974). And there will be situations where actuarial prediction is superior to human judgement in diagnosing and predicting human behaviour (Dawes, Faust and Meehl 1989; Grove and Meehl 1996) or where the claim for superior stock-picking ability by investment journalists is not substantiated (Metrick 1999). In the extreme case where the decision process simply follows rules with provision for multiple contingencies, the decision-maker ceases to have a meaningful role where the degree of personalistic control is absent (Eilon 1969).

The findings in this study suggest that for business angels and venture capitalists certain factors are separately important and may be interrelated in the investment
decisions taken in the Australian private marketplace. *Access to deals* is a factor that must be considered according to business angels, whereas for venture capitalists it would appear that this factor may not be core to the decision.

The *degree of equity / control* in the venture is a critical factor in the investment decision according to both groups of investors. Neither business angels nor venture capitalists require a high level of control or a major share of equity necessarily and each group is able to maintain a secure foothold in the venture through indirect means. Business angels establish *security* through being actively involved in the business and (or) through a strategic percentage of the shareholding. Venture capitalists can secure their position through shareholder agreement clauses or through preferred share structures and the *investor input* being the financial assessment of the venture is a factor that must be considered by business angels and venture capitalists in reaching an investment decision.

It emerges that the *quality of the entrepreneur / management team* is of most importance to the business angel and no investment decision should be made without giving this issue serious consideration. For venture capitalists it would appear that this factor is one of the most important factors.

A financial assessment of the venture is core to the decision making of both business angels and venture capitalists and there is a lack of evidence to conclude that venture capitalists place greater importance upon this factor than business angels. Business angels and venture capitalists both have similar concerns as to the rate of return and potential of the venture and a realistic exit strategy in order to assure a return of funds invested. Entrepreneurs in their investment pitch to business angels should anticipate
that these investors will be concerned about the “hard” financial aspects of the deal as well as the “soft” non-financial factors in investment decision making.

In any evaluation of a deal, investors as part of their due diligence should require that an entrepreneur supply a business plan before they give the matter serious consideration - a plan outlining all aspects of the deal including the quality of the market opportunity in terms of future profitability and the soundness of the business model. The plan should also address the financial projections and rate of return of the investment and in particular should chart a proposed exit strategy for the investment. An investor would also expect the entrepreneur to address the issue of risk in the offering and take steps to mitigate same.

Entrepreneurs should be “investor ready” and able to meet and address any concerns on the part of the investor within a reasonable time. This research has noted that the investment proposition should be properly valued as to the shareholding on offer. Issues relating to the degree of equity on offer and/or the level of control to be exercised by the entrepreneur and the investor should be addressed at the earliest possible opportunity before the parties enter into binding contracts. Such discussions should be part of the early negotiations and reduced to writing as part of the term sheet offering.

6.4 A conceptual model for evaluating decision-making factors

Prior studies addressed decision models for investment in new ventures and for related issues (Khan 1987; Fried and Hisrich 1994; Prasad, Bruton and Vosikis 2000; Elitzur and Gavious 2003; Astebro 2003; Cho and Lee 2006; Wiltbank, Read, Dew and Sarasvathy 2009; Kollmann and Kuckertz 2010), there the main theme to emerge was
that actual outcome models display better predictive ability than venture capitalists and that there can be evaluation uncertainty in the decision criteria of venture capitalists. For angel investors it may not be in their best interests to pursue best practice procedures employed by venture capitalists and they may be better advised to adopt a model based upon the signals of quality of the venture as expressed by entrepreneurs. Perceived risk plays a critical role in human behaviour and this particularly applies to decision-making under uncertainty (Cho and Lee 2006). Importantly, the literature indicates that venture capitalists have a poor record when picking successful investments and a statistical model may prove superior (Astebro 2003). Studies on judgmental versus statistical decision-making models have established that statistical models are at least equal and mostly superior to judgmental decision making models (Dawes et al. 1989; Grove and Meehl 1996).

The greater number of prior studies investigating this issue has focused on the role of the venture capitalist and not the business angel (Elitzur and Gavious 2003). Prasad et al. (2000) noted that whilst the investment decision-making processes of business angels is still evolving, it is possible to gain some insight into their processes by examining the signaling theory as it applies to entrepreneurs and venture capitalists, in a business angel context. To this end, signaling theory argues that signals from the entrepreneur to the venture capitalist help the venture capitalist to more accurately evaluate the information received (Leland and Pyle 1977; Elitzur and Gavious 2003).

Business angels, behaving as principals rather than as agents or consultants, are less likely than venture capitalists to engage an outside expert to evaluate the new venture (Feeney et al. 1999) since such extensive due diligence is not required when investing one’s own funds (Wu 1988). The judgment factors deemed important by venture capitalists and forming the basis of the decision-making criteria may not have been
successfully calibrated against actual outcomes making it difficult to know whether the factors venture capitalists believe to be important actually are important (Astebro 2003).

In light of the findings of this study, the better approach might be to construct two linear models, each based upon (i) the judgement of the business angel, or that of the venture capitalist as the case may be, represented by expected outcomes for investments and (ii) the actual outcomes of the investments. There could be separate models for start-up ventures and for early stage ventures or they could be incorporated in the one model as “start-ups” and non start-ups”. Hoffman (1960) first proposed the possibility that a linear model could be used to predict human judgement. The linear model is one in which judgments are described as a simple weighted sum of the values of the information available (Hoffman 1960, p. 119). Of particular interest, consistent with observations of Astebro (2003) and Khan (1987), the development of such models could test the factors that business angels and venture capitalists consider important by replicating the investor decision environment and statistically comparing the findings of the investors’ judgments against those of the theoretical models.

Drawing upon the study of Khan (1987) the “start-up” model would ask business angels and another model would ask venture capitalists to predict the success of a start-up venture, the expected outcome, based upon the judgment of the business angel / venture capitalist which would be statistically measured against the actual outcome, when that outcome became known. The expected outcome – Yi and the actual outcome – Yii, would be the criterion variables representing the investment outcome and would be scaled to reflect: (1) complete loss of all invested funds, (2) below average profit on invested funds, (3) average profit on invested funds, (4) above average profit on invested funds and (5) high profit on invested funds. A zero would indicate that the actual outcome was not yet determinable. The assessment of a profit for the purpose of
the questionnaire could be defined by reference to a rate of return on the invested funds on offer through a financial institution. The decision would be based upon the responses provided by the business angel / venture capitalist to a questionnaire incorporating a number of predictor variables selected from the 20 items listed in Question 9 of the questionnaire in Appendix F to this study. The respondents would be asked to assess each predictor variable on a five step Likert scale placing responses on an attitude continuum (May 2001) from “not important at all” to “extremely important” or alternatively from “poor” to “excellent”.

The results could be reflected in two separate tables: Table 1 noting correlations for the business angel decision model – criterion $Y_i$ and a Table 2 (not depicted) noting correlations for the actual outcome models in each case – criterion $Y_{ii}$. Start-up enterprises and non start-up enterprises could be modelled separately within Table 1 with a third regression combining them in an overall model if desired. A separate model would substitute venture capitalists for business angels.

**TABLE 1 Correlations for BA (or VC) decision models – criterion $Y_i$ (significance levels noted)**

<table>
<thead>
<tr>
<th></th>
<th>Model Vs Actual</th>
<th>Model Vs Judgement</th>
<th>Model Vs Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Start – ups</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Start-ups</td>
<td></td>
<td></td>
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<tr>
<td>Overall</td>
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<td></td>
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</tbody>
</table>
The first set of regressions would model the business angel / venture capitalist judgement $Y_i$ being the outcomes expected by the investor with the first column showing the correlations between the outcomes expected and the actual outcomes $Y_{ii}$. The correlations in the second column would indicate how well a linear model of the investors’ decisions was able to predict such decisions and the last column would present the correlations between the linear model and the actual outcomes.

In a Table 2 the first column would be the same as in Table 1 whilst the second column would show for each of the three cases the correlation between the predictions of the actual outcome model and the business angel / venture capitalist decisions. The third column would show the correlations between the linear model and the actual outcomes.

A further Table 3 (not depicted) could then well show the two most significant predictor variables for the business angel / venture capitalist decision model whilst a Table 4 (not depicted) could show the best predictor variables in the actual outcome model.

### 6.5 Peroration

Investment in the public marketplace is a broadly understood and well publicized facet of a modern economy. In contrast, previously, investment in ventures located in the private marketplace has been neither broadly understood nor well publicized. A critical aspect of the growth of a modern economic community requires the encouragement and support of business angel investors and venture capitalist who participate and invest in the private marketplace in such ventures. Exposing its critical features has provided critical input to its maturity.
But perhaps the last word belongs to William Shakespeare:

“There is a tide in the affairs of men,
Which, taken at the flood, leads on to fortune;
Omitted, all the voyage of their life
Is bound in shallows and in miseries.
On such a full sea are we now afloat:
And we must take the current when it serves,
Or lose our ventures.”

Julius Caesar, Act IV, Scene III

<table>
<thead>
<tr>
<th><strong>Glossary</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Accountant</strong></td>
</tr>
<tr>
<td><strong>Acquisition</strong></td>
</tr>
<tr>
<td><strong>Advisor</strong></td>
</tr>
<tr>
<td><strong>Agent</strong></td>
</tr>
<tr>
<td><strong>Angel</strong></td>
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<tr>
<td><strong>Asset backing</strong></td>
</tr>
<tr>
<td><strong>ASX</strong></td>
</tr>
<tr>
<td><strong>Audit</strong></td>
</tr>
<tr>
<td><strong>Balance sheet</strong></td>
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<tr>
<td><strong>Bank</strong></td>
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<tr>
<td><strong>Board of directors</strong></td>
</tr>
<tr>
<td><strong>Bond</strong></td>
</tr>
<tr>
<td><strong>Book value</strong></td>
</tr>
<tr>
<td><strong>Business</strong></td>
</tr>
<tr>
<td><strong>Business acquisition</strong></td>
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<tr>
<td><strong>Business sale</strong></td>
</tr>
<tr>
<td><strong>Call option</strong></td>
</tr>
<tr>
<td><strong>Capital</strong></td>
</tr>
<tr>
<td><strong>Capital employed</strong></td>
</tr>
<tr>
<td><strong>Capital expenditure</strong></td>
</tr>
<tr>
<td><strong>Capital gain</strong></td>
</tr>
</tbody>
</table>
**Capital gains**  A tax on the increase of the capital value of assets. The capital value is adjusted for tax purposes to factor in the increase in value due to inflation.

**Capital growth**  An increase in the value in an asset as opposed to income received from the investment.

**Capital structure**  The composition of a company’s source of funds, especially long-term funds.

**Cash flow**  The total receipts (inflow) or cash payments (outflow) arising from a given asset, or group of assets, for a given period; the measure of actual cash flowing in and out of a business.

**Collateral**  Assets that are given as security for a loan.

**Company**  An organization which is recognized as having a legal personality separate from its members. The characteristics of a company include autonomy, perpetual succession and the limited liability of its members.

**Compliance**  Adherence to statutory requirements, regulations, rules and ordinances imposed by external authorities on a company. Also the procedures that are undertaken to ensure that the regulations and/or laws are kept.

**Contractor**  Someone who contracts to provide supplies or perform work at a certain price or rate.

**Convertible note**  Hybrid fixed-interest security whereby the holder has the option of converting the debt to equity at some pre-arranged date and conversion price.
Corporation  Broadly speaking a company but excluding a body corporate.

Creditor  A person or company to whom a debt is owed.

Current assets  An asset that will be used in a relatively short time, usually a year.

Current liabilities  Liabilities that are due and payable within a year.

Deal  A deal is a private arrangement in commerce entered into by the parties for their mutual benefit or the potential for such an arrangement.

Deal flow  Venture capital term used to describe the number of proposals being received by a venture capital fund on some calendar basis such as three deals a week.

Debenture  A security issued by a company acknowledging a debt. Debentures are usually secured by a fixed or floating charge over the assets of the company.

Debt  Capital supplied for which there is a fixed income, fixed repayment period and fixed repayment schedule.

Debt funding  The process of debt financing through issuing debentures or bonds; or increasing other liabilities to finance operations, an alternative to equity funding.

Debtor  A person or company owing a debt.

Depreciation  The difference between the cost (or value) of an asset and its residual value allocated over the series of accounting periods in the asset’s useful life. Also, the periodic writing down of the value of an asset over time.
Development  Also know as expansion capital. Capital required by an established
capital  company to fund the expansion of the business

Dilution of  Stock market term whereby the issue of new shares results in the
equity  original shareholders owning a smaller share of the company.

Directors  Directors are appointed to take responsibility for the policy formation
and control of a company. A public company must have at least three
directors; a proprietary company may have one.

Disclosure  A prospectus or offer statement with the details of a new issue of
document  securities to ensure that investors are fully informed.

Discount  A deduction from a bill, commodity price or amount due, usually for
prompt payment or offered to a particular class of buyer.

Diversification  Investment in businesses spread over a number of non-related
industries to control risk.

Dividend  The after-tax profits of a company distributed to shareholders.

Downside  A hedge constructed to cushion investments against loss during
protection negative movement in the market or in resources pricing.

Due diligence  The process of researching a business and its management prior to
proceeding with a venture capital deal or not.

Early-stage  Also known as early expansion capital. Finance for companies to
capital  initiate commercial manufacturing and sales.

Earnings  Income or profit of an entity.

Enterprise  A venture, business or undertaking.
Entity  A legal, administrative or fiduciary arrangement, organizational structure or other party (including a person) having the capacity to deploy scarce resources in order to achieve the objectives.

Entrepreneur  A person who undertakes risks with the aim of establishing a business enterprise.

Equity  The proportion of a company that shareholders own, sometimes described as shareholders’ funds, shares or stock. Owners typically receive income in the form of dividends, have no security with regard to repayment of their investment, and there is no defined time period for holding their investment.

Equity  Capital raised by a company through issuing shares. An alternative to capital/funding debt funding.

Executive  An individual who is employed within the company on a full or part-time basis. Can also be a director of the company.

Exercise  The conversion of an option into its underlying security.

Exit strategy  The realisation of a return on investment. Private equity investors generally receive their principal returns via capital gain on the sale or flotation of investments. Exit methods include trade sale, flotation, share repurchase by the company or its management or refinancing.

Expansion/capital  Investment monies provided by way of the purchase of shares or equity for the raising of necessary debt. Also known as development capital and early-stage capital.

Expenses  Outgoings in the form of cash.

Finance  Monetary support for an enterprise.
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed interest</td>
<td>Interest which remains at a constant rate and does not fluctuate.</td>
</tr>
<tr>
<td>Float</td>
<td>The act of first putting a company’s shares on offer to the public.</td>
</tr>
<tr>
<td>Franchise</td>
<td>A contract under which a party (the franchisor) grants a licence to the franchisee to use a product, name, trade mark or business system, subject to the payment of a fee. Generally the franchise is restricted by location, duration and product offerings.</td>
</tr>
<tr>
<td>Franchise agreement</td>
<td>A legal contract setting out the operational terms and conditions of a franchise business. Usually covers franchisor and franchisee responsibilities, lease agreements, intellectual property, marketing.</td>
</tr>
<tr>
<td>Franchisee</td>
<td>A person or business that legally purchases the right to operate a franchise outlet.</td>
</tr>
<tr>
<td>Franchisor</td>
<td>A person or business that owns a franchise and agrees to sell the rights, within the terms of a franchise agreement.</td>
</tr>
<tr>
<td>Gearing</td>
<td>The ratio of debt to equity as stated in a company’s balance sheet.</td>
</tr>
<tr>
<td>Goodwill</td>
<td>The value that derives from the ability of a business to earn more than a normal rate of return on its physical assets; represented by the total value of a business less plant and equipment and inventory.</td>
</tr>
<tr>
<td>Government bond</td>
<td>A debt security issued by the government. Interest is usually paid at a fixed rate for the life of the bond, usually 10 years.</td>
</tr>
<tr>
<td>Hedge</td>
<td>The take up of an investment to counteract a risk from another investment.</td>
</tr>
</tbody>
</table>
**Income** The returns or receipts of money or money’s worth derived from remuneration for personal services, from property or from carrying on of a business.

**Index** A numerical measure of price movement in financial markets.

**Initial public offering (IPO)** The first fund raising done from the general public and which generally results in a listing on a stock exchange.

**Institutional investor** An organization whose primary purpose is to invest its own assets or those held by it in trust for others.

**Institution or Institutional**

**Intellectual property** A legal term used to describe the patents, licences, copyrights, trademarks and designs owned by a company (IP).

**Interest** An amount paid by a borrower to lender for the use of the money. Usually calculated annually, as percentage of money lent.

**Invention** New machinery, materials, products, materials or processes. To support the registration of a patent, an invention must be of some immediate utility, novel and an improvement in some respect over preceding knowledge or technology.

**Inventor** The creator or finder of new processes, materials, machinery or products.
<table>
<thead>
<tr>
<th><strong>Inventory</strong></th>
<th>Trading stock. It includes anything produced, manufactured, acquired or purchased for the purposes of sale, manufacture or exchange.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investee</strong></td>
<td>The firm or business in which investment has been made.</td>
</tr>
<tr>
<td><strong>Investment</strong></td>
<td>Funds that are used to acquire assets or interests in assets or businesses with the expectation of a return.</td>
</tr>
<tr>
<td><strong>Investor</strong></td>
<td>One who lays out money, usually by lending or purchasing, in the expectation of profiting from interest earnings or capital gain.</td>
</tr>
<tr>
<td><strong>Lease</strong></td>
<td>An agreement for the grant of possession of land or goods for a specified term on an agreed rental.</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td>Liabilities are future sacrifices of economic benefits stemming from present legal or constructive obligations of an entity to transfer assets or provide services to other entities in the future.</td>
</tr>
<tr>
<td><strong>Licence</strong></td>
<td>A licence or royalty agreement gives the right to use items such as intellectual property, equipment or machinery and/or creative materials, remove minerals or natural products in return for payment or equity interest.</td>
</tr>
<tr>
<td><strong>Limited liability</strong></td>
<td>The principle of company law whereby the liability of members of a company limited by shares is limited to any amount unpaid on shares held by that member.</td>
</tr>
<tr>
<td><strong>Liquid assets</strong></td>
<td>Assets that are easily and cheaply turned into cash—notably cash itself and short-term securities.</td>
</tr>
<tr>
<td><strong>Liquidation</strong></td>
<td>The process of converting securities or other property into cash. The winding up of a business by its members or its creditors. The assets are sold, liabilities settled as far as possible and any remaining cash returned to shareholders.</td>
</tr>
</tbody>
</table>
Liquidity  The availability of cash or liquid assets in a business and the speed with which assets may be converted to cash.

Management  Usually a leveraged buy-out by the existing management of the buy-out (MBO) company.

Market  Value of a company calculated by multiplying the number of shares on capitalization issue by the last sale price.

Market price  The highest price which a buyer, willing but not compelled to buy, would pay, and the lowest that a seller, willing but not compelled to sell, would accept; or the price for goods and services in a free and open market.

Mentor  An experienced and trusted advisor.

Merger  Two or more companies combined to achieve greater efficiencies of scale and productivity. This accomplished through the elimination of duplicated plant, equipment, and staff, and the reallocation of capital assets to increase sales and profits.

Mezzanine  Debts that incorporate equity-based options, such as warrants, with a lower-priority debt. Mezzanine debt is actually closer to equity than debt, in that the debt is usually only of importance in the event of bankruptcy.

Mezzanine financing  Financing obtained using instruments that fall between the bottom level of equity and the top level of secured debt.

Mortgage  A form of security for debt under which the borrower (mortgagor) assigns a legal title to the property to the lender (mortgagee) until the debt is repaid. The mortgagor retains possession of the property.
Net (t) assets  Total assets minus total liabilities, proprietorship, owner’s equity.

Net worth  The difference between the assets and liabilities of a company on its balance sheet. Net worth is equal to shareholder’s funds.

Offer  The price at which someone is prepared to sell shares (opposite to bid).

Option  A right to buy or sell property at a specified price within a stated period of time.

Ordinary shares  The equity in a company constituting ownership, ordinary shareholders are entitled to dividends and to vote.

Paid-up capital  The proportion of a company’s share capital which has in fact been paid.

Partnership  Two or more individuals carrying on a business together. Partnerships are not incorporated; each of the parties shares in the risks and rewards and is liable for all the partnership’s debts. Creditors can claim on the partners personally. In some partnerships, one (or more) partner provides capital by does not participate in the management of the business (silent partner).

Patents  A patent is a right in regard to any device, substance, method or process which is new, inventive and useful. A patent is legally enforceable and gives the owner the exclusive right to commercially exploit the invention for the life of the patent. Patents can provide protection for a specific country or for international patent protection.

Placement  The issue of newly created shares as a means of raising capital.

Portfolio  The collection of investment holdings of a particular investor with reference to its mix of securities such as bonds, shares.
Preference Shares that rank ahead of ordinary shares for dividends for payment shares upon winding up of the company.

Private A company limited to 50 members or less which can neither invite the company general public to subscribe for its shares or debentures nor take deposits from the public.

Product The strategy of defining new or current product features or benefits differentiation that distinguish the product from the competition.

Profit The surplus of earnings when all expenses have been provided for.

Profit and loss statement A statement showing the business’s earnings and expenses over a given period.

Pro-forma Balance sheets and profit and loss statements for future years prepared accounts in the same format as the current accounts.

Prospectus The document that must usually be issued by a company seeking to raise money from the public.

Public listed A company whose shares are traded on the stock exchange and are able to be bought and sold by members of the general public. Listed companies are subject to the detailed listing rules.

R&D This is the research and development stage before manufacture (or provision of services) and marketing have commenced.

Return The amount of money received annually from an investment, usually expressed as a percentage.
<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
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</thead>
<tbody>
<tr>
<td>Return of capital</td>
<td>If a company has capital in excess of its commercial needs it may, subject to the requirement of the Corporations Act, buy back shares with that capital. Return of capital may also be used to exchange high dividend rate preference shares for low interest rate debt.</td>
</tr>
<tr>
<td>Return on investment (ROI)</td>
<td>Net income as a proportion of net book value or of initial investment outlay.</td>
</tr>
<tr>
<td>Risk</td>
<td>The probability of adverse consequence or outcome of an investment decision.</td>
</tr>
<tr>
<td>Secured debt</td>
<td>Loan where the lender, in the event of a failure to meet either an interest or principal payment, gains title to an asset.</td>
</tr>
<tr>
<td>Securities</td>
<td>Debentures, stocks or bonds issued by a government, shares or debentures in a company or interests in a managed investment fund.</td>
</tr>
<tr>
<td>Seed capital</td>
<td>Financing allowing the development of a business concept.</td>
</tr>
<tr>
<td>Seed money</td>
<td>The first round of capital for initial development and growth for a start-up business. Seed money may be secured by a loan or preferred stock or convertible bonds, or common stock.</td>
</tr>
<tr>
<td>Share</td>
<td>The ownership of part of a company which gives the owner of the share some voting rights, information rights and the rights to participation in profits and assets in a distribution. Also referred to as stock or equity.</td>
</tr>
<tr>
<td>Share capital</td>
<td>The company’s issued and paid-up capital.</td>
</tr>
<tr>
<td>Start-up</td>
<td>A new venture with untested products and no liquidity, the highest level venture of business risk.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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<td>-------------------------------</td>
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</tr>
<tr>
<td><strong>Start-up capital</strong></td>
<td>Financing allowing product development and initial marketing.</td>
</tr>
<tr>
<td><strong>Stock</strong></td>
<td>In the context of the Australian share market, stock is a term used for equities or shares.</td>
</tr>
<tr>
<td><strong>Syndicate</strong></td>
<td>A group of people or businesses that join together for a purpose beyond the resources or economies of scale of any member acting alone.</td>
</tr>
<tr>
<td><strong>Term sheet</strong></td>
<td>A short two or three page document that outlines the investment agreement between an entrepreneur and investors.</td>
</tr>
<tr>
<td><strong>Trade sale</strong></td>
<td>The sale of the equity share of a portfolio company to another company.</td>
</tr>
<tr>
<td><strong>Trade secrets</strong></td>
<td>A trade secret is a type of intellectual property (IP) and a strategy for protecting the IP. It can provide effective protection for some technologies, proprietary knowledge, confidential information and other forms of IP. There is no registration process; these secrets are protected by their being kept strictly secret.</td>
</tr>
<tr>
<td><strong>Trademark</strong></td>
<td>A word, phrase, letter, number, sound smell, shape, logo picture, and aspect of packaging or a combination of these. A registered trademark gives the owner legal right to use, license or sell it within a specified country for the goods and services for which it is registered.</td>
</tr>
<tr>
<td><strong>Trust</strong></td>
<td>Money or property vested with an independent third part (the trustee) to administer on behalf of others (the beneficiaries of the trust).</td>
</tr>
<tr>
<td><strong>Trustee</strong></td>
<td>A person or organization which holds the property for the benefit of others.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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<td>---------------</td>
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</tr>
<tr>
<td>Turnaround</td>
<td>Company converted from making losses to profits. A turnaround situation is a company which is still making losses but which an investor believes has sufficient turnover to make potential profits.</td>
</tr>
<tr>
<td>Vendor</td>
<td>The seller of property.</td>
</tr>
<tr>
<td>Venture</td>
<td>See “business” and “enterprise.”</td>
</tr>
<tr>
<td>Venture</td>
<td>Money made available for investment in innovative enterprises or capital research, especially in high technology, in which both the risk of loss and the potential for profit may be considerable.</td>
</tr>
<tr>
<td>Venture</td>
<td>A fund providing capital for higher risk undertakings by companies in capital new business ventures, emerging technologies, new products, or services.</td>
</tr>
<tr>
<td>Venture</td>
<td>An investor of fund belonging to client at later stages of venture.</td>
</tr>
<tr>
<td>Capital</td>
<td>A venture capitalist may invest in early stage venture where investor appropriate. More formal than angel investment, active not passive.</td>
</tr>
<tr>
<td>Volatility</td>
<td>The extent of fluctuation in share prices, exchange rates, interest rates. The higher the volatility, the less certain an investor is of return and hence volatility is one measure of risk.</td>
</tr>
<tr>
<td>Working</td>
<td>Capital employed by the company to fund the excess of current assets (stock, debtors) over current liabilities (creditors, leave provisions, bank overdraft).</td>
</tr>
<tr>
<td>Yield</td>
<td>Income payable by an investee to an investor being the return of an investment expressed as a percentage.</td>
</tr>
</tbody>
</table>
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EXM Pty Limited
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Appendix B

Human Research Ethics Committee Approval
HUMAN RESEARCH ETHICS COMMITTEE
Certificate of Approval

Applicant: (first named in application)  Professor Robert Catley
Co-Investigators / Research Students:  Mr Kenneth McDonald
Emeritus Professor Frank Clarke
Protocol:  Investment in the private marketplace in Australia

In approving this protocol, the Human Research Ethics Committee (HREC) is of the opinion that the project complies with the provisions contained in the National Statement on Ethical Conduct in Human Research, 2007, and the requirements within this University relating to human research.

Note: Approval is granted subject to the requirements set out in the accompanying document Approval to Conduct Human Research, and any additional comments or conditions noted below.

Details of Approval

HREC Approval No: H-2009-0002  Date of Initial Approval: 27-Jan-2009

Approved to: 26-Jan-2010

Approval is granted to this date or until the project is completed, whichever occurs first. If the approval of an External HREC has been “noted” the approval period is as determined by that HREC.

Progress reports due: Annually.
If the approval of an External HREC has been "noted", the reporting period is as determined by that HREC.

Approval Details

Variation
15-Apr-2009
Variation to:

1. Revise the content of the Confidential Investor Survey

- Confidential Investor Survey, Version 2 dated 13 March 2009

Approved

Initial Application
Approved
The Committee ratified the approval granted by the Deputy Chair on 27 January 2009 under the provisions for expedited review.

Variation
15-Jul-2009
Variation to offer a double movie cinema pass to the first 50 participants who respond to the survey.
Approved
The Committee ratified the approval granted by the Chair on 12 June 2009 under the provisions for expedited review.

Authorised Certificate held in Research Services
Associate Professor Alison Ferguson
Chair, Human Research Ethics Committee
Appendix C

Focus group information statement
Information Statement for the Research Project:

Project title - Investment in the Private Marketplace

You are invited to participate in the research project identified above which is being conducted by Professor Bob Catley, Emeritus Professor Frank Clarke and Mr. Ken McDonald from the School of Business and Management at the University of Newcastle.

Why is the research being done?

The purpose of the research is to examine investment in the private marketplace by business angels and venture capitalists who as seed and early stage investors and as later stage investors respectively, provide capital to entrepreneurs and founders of enterprises in ventures that offer a rate of return on investment in excess of that offered in traditional markets. These investors also accept a higher degree of risk in consideration of the higher rewards on offer for successful outcomes. Previous research has shown that the private marketplace is significant for a national economy as it provides the opportunity for entrepreneurs and other parties to initiate and develop ventures that can grow and prosper eventually finding financial support in the public marketplace with economic and social benefits for the broader community.

Who can participate in the research?

The research is seeking both business angels and venture capitalists along with business people who do not invest in this marketplace to attend at a convenient location for all parties in order to be participants in one of two small focus groups of six persons each. One of the focus groups will comprise six persons three of whom are business angels and three are venture capitalist investors. The other focus group will comprise six persons who are involved in business but are neither business angels nor venture capitalists.

What choice do you have?

Participation in this research is entirely at your choice. Only those persons who give their informed consent will be included in the project. Whether or not you decide to participate, your decision will not disadvantage you. If you do decide to participate, you may withdraw from the project at any time without giving a reason and have the option of withdrawing any data that identifies you.
**What would you be asked to do?**

If you agree to participate, you will be asked to attend at a convenient location for you at a pre-designated time agreeable to you, with minimum disruption to your work or life-style and participate in a small focus group of six (6) persons in a relaxed setting.

**How much time will it take?**

If you consent to participate, this will involve attending a focus group which will take approximately 60 minutes of your time. There will be one (1) session only.

**What are the risks and benefits of participating?**

Your anonymity will be protected and you may choose to introduce yourself by given name or not at all to other participants. This research project is for academic purposes only and you will not be exposed to any commercial offer either directly or indirectly. The project has no sponsoring by any party. You will not be further contacted following the session.

You may find that the opportunity to discuss issues relating to investment in the private marketplace with other participants is a rewarding and informative experience. Business angels and venture capitalists in the one group may find that they are able to meet other participants in this marketplace and discuss issues of common interest relating to investing in this space. Other business participants may find the session enlightening as the private marketplace is not well understood or accessible to other than those who participate in it.

**How will your privacy be protected?**

All information collected from this focus group will be confidential, will be stored securely and will only be accessed by the researchers. It will be kept for a period of at least five (5) years at the University of Newcastle and will then be destroyed in accordance with University requirements.

In any event, the responses of all focus group participants will remain anonymous and it will not be possible to identify you from your answers. Participants at focus group sessions will be asked to maintain the confidentiality of the group discussion and not divulge the specific content of same to outside parties.

**How will the information collected be used?**

The data collected will be analysed and will subsequently be presented in a thesis to be submitted for a doctoral degree undertaken by the researcher Mr. Ken McDonald. Individual participants will not be identified in any manner relating to the writing or presentation of the thesis.

The focus group proceedings will be audio taped by the researcher conducting the focus group and participants will be able to review the recording in order to edit or erase their contribution. The recording will be transcribed and participants will be able to review same in order to edit or erase their contribution.

If participants in the focus groups would like feedback about the results of the study written in lay language they will need to provide the researchers with contact particulars for same.

**What do you need to do to participate?**

Please read this Information Statement and be sure you understand its contents before you consent to participate. If there is anything you do not understand, or you have questions, contact the researchers.

If you would like to participate, please attend the meeting to be held at ..........................on...................... Please complete the attached Consent Form and bring it with you to the meeting or return it by e-mail or in the reply paid envelope provided.
Further information

If you would like further information please contact Mr. Ken McDonald by post at School of Business and Management, P.O. Box 127, Chittaway Road, OURIMBAH NSW 2258 or by e-mail at ken.mcdonald@studentmail.newcastle.edu.au or by telephone (02) 92382222. You may also contact the Chief Investigator, Professor Bob Catley at School of Business and Management, P.O. Box 127, Chittaway Road, OURIMBAH NSW 2258 or by e-mail at bob.catley@newcastle.edu.au or by telephone (02) 43484156.

Thank you for considering this invitation.

Signature:

Name: Professor Bob Catley
Position: Chief Investigator

Signature:

Name: Emeritus Professor Frank Clarke
Position: Co-investigator

Signature:

Name: Kenneth Ian McDonald
Position: Research Student

Complaints about this research

This project has been approved by the University’s Human Research Ethics Committee, Approval No. H-2009-0002. Should you have concerns about your rights as a participant in this research, or should you have a complaint about the manner in which the research is conducted, it may be given to the researcher, or, if an independent person is preferred, to the Human Research Ethics Officer, Research Office, The Chancellery, the University of Newcastle, University Drive, Callaghan, NSW 2308, Australia, telephone (02) 4921 6333, email Human-Ethics@newcastle.edu.au.
Appendix D

Consent form for participation in focus group
Consent Form for the Research Project:

Project title - Investment in the Private Marketplace

Names of Researchers
Professor Bob Catley
Emeritus Professor Frank Clarke
Mr. Ken McDonald

I agree to participate in the above research project and give my consent freely.

I understand that the project will be conducted as described in the Information Statement, a copy of which I have retained.

I understand that the focus group proceedings will be recorded and I am aware of my right to review and edit the recording of my comments.

I understand I can withdraw from the project at any time and do not have to give any reason for withdrawing.

I consent to:
● participate in a focus group which will take approximately 60 minutes.

I understand that my personal information will remain confidential to the researchers.

I have had the opportunity to have questions answered to my satisfaction.

Print Name: ______________________________________________________

Signature: ____________________ Date: _____________________
Appendix E

Survey information statement
Information Statement for the Research Project:

**Project title - Investment in the Private Marketplace**

You are invited to participate, as a business angel or a venture capitalist investor, in the research project identified above which is being conducted by Professor Bob Catley, Emeritus Professor Frank Clarke and Mr. Ken McDonald from the Newcastle Business School at the University of Newcastle.

**Why is the research being done?**

The purpose of the research is to examine investment in the private marketplace by business angels and venture capitalists who as seed and early stage investors and as later stage investors respectively, provide capital to entrepreneurs and founders of enterprises in ventures that offer a rate of return on investment in excess of that offered in traditional markets. These investors also accept a higher degree of risk in consideration of the higher rewards on offer for successful outcomes. Previous research has shown that the private marketplace is significant for a national economy as it provides the opportunity for entrepreneurs and other parties to initiate and develop ventures that can grow and prosper eventually finding financial support in the public marketplace with economic and social benefits for the broader community.

**Who can participate in the research?**

The research is asking business angels and venture capitalists who invest in this marketplace to participate in a survey questionnaire.

**What choice do you have?**

Participation in this research is entirely at your choice. Only those persons who give their informed consent will be included in the project. Whether or not you decide to participate, your decision will not disadvantage you.

If you do decide to participate, you may withdraw from the project at any time without giving a reason and have the option of withdrawing any data that identifies you.

**What would you be asked to do?**

If you agree to participate, you will be asked to answer a series of questions in the form of a survey questionnaire which is to be forwarded to you by e-mail as a subscriber to the Australian Private Equity & Venture Capital Journal.
How much time will it take?

If you consent to participate, this will involve responding to a survey questionnaire which will take approximately five (5) to ten (10) minutes of your time. There will be one (1) survey questionnaire only.

What are the risks and benefits of participating?

Your anonymity will be protected and your identity will not be known to the researchers. The Editor of the Australian Private Equity & Venture Capital Journal will take such steps as are necessary to ensure that the identity of respondents is not disclosed to the researchers. This research project is for academic purposes only and you will not be exposed to any commercial offer either directly or indirectly. The project has no sponsoring by any party. You will not be contacted by the researchers.

You may find that the opportunity to consider issues relating to investment in the private marketplace is a rewarding and informative experience.

How will your privacy be protected?

All information collected from this survey questionnaire will be confidential, will be stored securely and will only be accessed by the researchers. It will be kept for a period of at least five (5) years at the University of Newcastle and will then be destroyed in accordance with University requirements.

In any event, the responses of the survey questionnaire will remain anonymous and it will not be possible for the researchers to identify you from your answers.

How will the information collected be used?

The data collected will be analysed and will subsequently be presented in a thesis to be submitted for a doctoral degree undertaken by the researcher Mr. Ken McDonald. Individual participants will not be identified in any manner relating to the writing or presentation of the thesis.

If you would like feedback about the results of the study written in lay language you will need to provide the researchers with contact particulars for same.

What do you need to do to participate?

Please read this Information Statement and be sure you understand its contents before you consent to participate. If there is anything you do not understand, or you have questions, contact the researchers.

If you would like to participate, please complete and return the attached survey questionnaire and return it in the reply paid envelope provided. This will be taken as your informed consent to participate.

Further information

If you would like further information please contact Mr. Ken McDonald by post at Newcastle Business School P.O. Box 127, Chittaway Road, OURIMBAH NSW 2258 or by e-mail at ken.mcdonald@studentmail.newcastle.edu.au or by telephone (02) 92382222. You may also contact the Chief Investigator, Professor Bob Catley at Newcastle Business School, P.O. Box 127, Chittaway Road, OURIMBAH NSW 2258 or by e-mail at bob.catley@newcastle.edu.au or by telephone (02) 43484156.

Thank you for considering this invitation.
Complaints about this research

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Appendix F

Survey questionnaire
Investment in the Private Marketplace

Confidential Investor Survey of Business Angel Investors and Venture Capitalists

This questionnaire should take approximately 5-10 minutes to complete

Definitions

**Private Marketplace** is the marketplace where *business angels* and *venture capitalists* invest in seed or start-up and in early and later stages of the venture, also known as the private equity marketplace.

**Business Angels** invest their own capital and/or business expertise at the seed or start-up of the venture and in the early stages of the venture. They may be active or passive investors.

**Venture Capitalists** invest the capital of their investor clients at later stages of the venture, although they may invest in early stages of the venture in appropriate circumstances. The investment is more formal and is not passive.

Confidentiality

All information collected through this survey is confidential.

Information will only be released in statistical form.

Particulars of all respondents including email and postal addresses will be removed before they are forwarded to the researchers.

You can choose not to complete any or all of the survey questions.

Returning the survey

Return the completed survey to Australian Private Equity & Venture Capital Journal, by email to info@privateequitymedia.com.au or by post to Private Equity Media Level 3, 30 Alfred Street, Milsons Point NSW 2061.

Additional information

If you require another survey form for any reason, please contact info@privateequitymedia.com.au
Investor Survey

Please refer to the previous sheet before completing this confidential survey. To answer questions, please either tick the box or circle the appropriate response, as appropriate.

1. Please indicate your gender?
   - Male
   - Female

2. Please indicate your present age group
   - Under 25 years
   - 25 to 34 years
   - 35 to 44 years
   - 45 to 54 years
   - 55 to 64 years
   - 65 to 74 years
   - 75 years and over

3. Please indicate your level of education
   - Secondary
   - Tertiary
   - Postgraduate
   - Other

4. Do you categorise yourself as a business angel investor or a venture capitalist investor?
   - Business Angel
   - Venture Capitalist

(Please note: Business angel investors are those who invest capital and/or business expertise at the seed or early stage of a start-up venture. Venture capitalists generally invest at a later stage in more formal circumstances).
5. How many times have you invested in the private marketplace in Australia during the last five (5) years?

☐ Once or twice in 5 years  ☐ Several times in 5 years

☐ Once or twice a year in that period  ☐ Several times a year in that period

☐ None

6. For what period of time would you generally make such an investment?

☐ Less than a year  ☐ One to less than three years

☐ Three years to less than five  ☐ Five years or more

7. In relation to such investments, what percentage of a shareholding would you normally require?

☐ Less than 10%

☐ 10% to less than 30%

☐ 30% to less than 50%

☐ 50% or more

8. In what capacity do you normally invest in the Australian private marketplace?

☐ Private Individual  ☐ Company Structure

☐ Trust Structure  ☐ Partnership Structure

☐ Other
9. When deciding whether to invest in the private marketplace in Australia, how important are the following factors?

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<thead>
<tr>
<th>ACCESS TO DEALS</th>
<th>Not at all important</th>
<th>Not very important</th>
<th>Moderately important</th>
<th>Very important</th>
<th>Extremely important</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Geographic proximity of investment location</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>b. Industry type of venture</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>c. The stage of investment i.e. seed, start up, early or later stage, pre IPO</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EQUITY/CONTROL</th>
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<th>Not very important</th>
<th>Moderately important</th>
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<th>Extremely important</th>
</tr>
</thead>
<tbody>
<tr>
<td>d. The venture has a corporate structure for investment</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>e. The investor has a controlling interest in the venture</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>f. Proportion of your holding in the venture</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>g. Proportion of your assets in the venture</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
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</tbody>
</table>

<table>
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<tr>
<th>ENTREPRENEUR / MANAGEMENT</th>
<th>Not at all important</th>
<th>Not very important</th>
<th>Moderately important</th>
<th>Very important</th>
<th>Extremely important</th>
</tr>
</thead>
<tbody>
<tr>
<td>h. Previous success of entrepreneur</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>i. Business expertise of entrepreneur</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>j. Business expertise of management team</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>k. Entrepreneur to supply a business plan</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>
Entrepreneur to supply financial reports, forecast, books and sets of accounts, information memorandum, company profile

INVESTOR INPUT

m. An exit strategy for the venture
n. The rate of return and potential of the venture
o. The venture is high technology
p. There are taxation concessions or benefits
q. The venture has a superior product or idea and ready markets
r. The investment is linked to milestones to be achieved by the venture
s. The investment referral is through a trusted network
t. The investment is active

10. How much capital do you have currently invested in the private marketplace?

- Less than $250,000
- $250,000 to less than $500,000
- $500,000 to less than $1,000,000
- $1,000,000 to less than $1,500,000
- $1,500,000 to less than $2,000,000
- $2,000,000 to less than $5,000,000
- $5,000,000 to less than $10,000,000
- $10,000,000 and over
11. What amount would you usually invest in each venture?

- Less than $100,000
- $100,000 to less than $250,000
- $250,000 to less than $500,000
- $500,000 to less than $750,000
- $750,000 to less than $1,000,000
- $1,000,000 and over
- No usual amount

12. What percentage of what you usually invest is borrowed?

- Nil
- Less than 10%
- 10% to less than 30%
- 30% to less than 50%
- 50% and over

Thank you for taking the time to do this survey.
Your participation will be of great assistance in providing more information about the private marketplace.

If you wish, please add any comments as to your reasons for investing or not investing in the private marketplace and your experiences concerning same.

Has the present global financial crisis influenced your investment decisions in the private marketplace?
If so, please rank your five most important investment criteria today and two years ago, so as to indicate any influence the current financial crisis may have made to your rankings or relativities of the factors and amounts noted in your answers to the previous questions.