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**Business Angels in Germany - How Business Angels in
Germany help new entrepreneurs**

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1 Introduction

For new companies in Germany, funding is a crucial milestone.¹ The financial resources of the founders are usually limited.² Internal financing is hardly ever possible at the early stages.³ The possibility of funding by borrowed capital is fairly limited as creditors are often unwilling to finance companies with a high risk of failure.⁴ The formal equity investment market is more likely to accept high risk funding, but deals below 1 million DM of investment volume are the exception; the expenditure and work necessary for the deal isn't proportional to the return.⁵

The result is a financing gap. According to research in the USA and England, business angels can bridge this gap.⁶ There is not yet any empirical proof to indicate whether or not this applies to Germany. This paper presents the first empirical findings from Germany: how do business angels choose their investments, what kind of return do they expect, when do they exit and how do they base their relationship between themselves and the start-up companies?

The purpose of this paper is to gain insight into the German informal equity investment market. This is of practical relevance in order to clarify whether or not young German companies in the early financial stages can benefit from business angels. Theoretically, this also raises an important question: to what extent should corresponding empirical research be carried out in Germany, in order to be able to answer the questions similarly discussed in the USA and England, such as the efficiency of the informal equity investment market?

¹ cf. empirical: LESSAT ET AL., *Beteiligungskapital*, 1999, p. 87.

² cf. ALBACH, *Potentiale und Lücken*, 1998, p. 12.

³ cf. BAIER/PLESHAK, *Finanzierung und Marketing*, 1996, p. 104.

⁴ cf. GERKE, *Market failure*, 1998, p. 618f.

⁵ cf. BELL, *Informeller Beteiligungskapitalmarkt*, 1998, p. 304.

⁶ cf. MASON/HARRISON, *Equity Gap*, 1995, LUMME/MASON/SUOMI, *Finland*, 1998, WETZEL, *Angels*, 1983, WETZEL/FREEAR, *United States*, 1996.

2 Classification of Business Angels and their Investments

Business angels are people who provide equity capital to companies without the intervention of a third party, such as a VC firm. This means that business angels invest directly, taking risks in unlisted firms. However, this kind of investment doesn't just mean considerable risks but also a return potential that is accordingly above average for the investors.⁷

Publications on the subject usually equate the terms "private investor", "informal investor" and "business angel". There are, however, two separate categories within the informal equity investment market: plain investors, in other words, passive private investors on one side, and active private investors on the other. Speaking for Germany, only the active private investor is considered a business angel.⁸

The main difference to passive private investors lies in the relationship between the creditor and the company seeking capital, as well as the business angels' achievements. Unlike passive investors, the relationship between business angels and the founders is characterised by involvement that goes beyond the purely financial transaction. Along with their investment business angels provide additional assets, through active assistance and acting in an advisory capacity.⁹ Generally, this added value arises from the professional background and experience of the business angels, which they then apply when assisting the company:

- Business angels have often founded, built up and possibly later on sold one or more companies themselves, thereby gaining extensive corporate experience.¹⁰

⁷ cf. FREEAR/SOHL/WETZEL, *Differences*, 1994, p. 109. cf. also MASON/HARRISON, *Survey*, 1994, p. 92.

⁸ In American publications on this subject, both of these groups are represented by the terms "business angels" and "informal investors". cf. HEMER, *Business Angels und JTU*, 1999, p. 103.

⁹ For this reason, LUMME, MASON and SUOMI differentiate between business angels and passive private investors, also in relation to the origin of private assets. According to their definition, business angels are "prosperous private individuals (...), who have obtained their personal assets independently by careful management.", whereby inherited capital is excluded. This emphasises the significance of the individual wealth of knowledge which business angels have. cf. LUMME/MASON/SUOMI, *Finland*, 1998, p. 11 and 23. cf. also MASON/HARRISON, *Market Expansion*, 1993, p. 23.

¹⁰ cf. MASON/HARRISON, *Market Expansion*, 1993, p. 23.

- They usually have business know-how, often a considerable weakness in young technologically orientated companies due to the predominantly technical training, experience and background of the founding team.¹¹
- During the course of their own career, most business angels have established a professional network of contacts to relevant decision makers within individual industries. In particular, they have contacts to suitable lawyers, tax consultants, business analysts and banks.
- Many business angels have specific technical knowledge in their respective specialist area.

With the help of these qualifications and this knowledge, business angels provide different kinds of benefits that are relevant for the capital-seeking company.¹²

- By establishing contacts or opening doors, business angels can, for example, initiate co-operation with other firms. They can also use their own resources to contribute towards securing the total funding. This applies particularly to additional capital of other business angels as well as funds that are often related to the dedication of expert investors.
- Business angels motivate and support companies through informal management and advice called “coaching”. The business angel can, for example, act as a catalyst for the formation of the company and the completion of the founding team. By using the above-mentioned network, this management can go as far as marketing the company to the IPO or a merger.¹³
- Sometimes business angels provide operational support ranging from part to full time participation in the company which is being financed.

The individual participation as well as the intensity of the involvement can vary considerably from one investor to another and even according to separate investments of an individual.

Anglo-Saxon publications on the subject differentiate potential angels even further according to the background of their current activity. “Virgin angels” are those who haven’t yet effected any business

¹¹ cf. BAIER/PLESCHAK, *Finanzierung und Marketing*, 1996, p. 18f.

¹² According to different specific experiences and backgrounds, not all business angels are in the position or are prepared to provide all of the following services listed.

¹³ cf. KIRCHNER, *Privatinvestoren*, 1998, p. 10.

angel investments but who intend to do so.¹⁴ “Latent angels” are business angels who have already been active in the past and have taken part in one or more investments, but do not hold any equity stakes at the moment.

Private Investors		
Active Business Angels	Potential Business Angels	Private Investors
<ul style="list-style-type: none"> • Can provide the company with additional value • Present shareholder • Are involved beyond merely their investment 	<ul style="list-style-type: none"> • Can provide the company with additional value • Not a present shareholder • Virgin Angels: Want to invest but cannot do so yet • Latent Angels: Have already been active in the past 	<ul style="list-style-type: none"> • Cannot or do not wish to provide the company with additional value • Purely return-oriented • No further contribution

Diagram 1: Summary of different types of private investors

Classifying business angels in Germany is particularly difficult. Books on the subject describe different starting points that attempt to form categories of angels according to various criteria.¹⁵ Considering these different typologies gives an indication of their heterogeneity. However, a number of existing classifications indicate that until now, no really well defined groups could be recognised. Apart from this, it has to be taken into account that all empirically based classifications are confined to the English-language domain. Consequently, there is as yet no classification that could be applied to Germany. It remains to be seen if it is at all possible to define groups of business angels in a sufficiently differentiated manner.

As with a suitable discernment of typologies, it is hardly possible to judge the volume of possible equity stakes by business angels in Germany. Indications for other countries as to the size of the accessible potential (of the total informal equity investment market) are already known:

¹⁴ cf. HEMER, *Business-Angels und JTU*, 1999, p. 104.

¹⁵ cf. e.g. TSCHAMMER-OSTEN, *Business Angel*, 1996, p. 717, or SULLIVAN, *Segmentation*, 1990, p. 34 and 72 ff.

- In the USA, WETZEL and FREEAR estimate the market for informal equity capital to be at least as large as the venture capital market, whereas the total theoretically available informal venture capital could be between 10 and 20 times bigger.¹⁶ Other authors even estimate it could be thirty times as big.¹⁷ The capital actually invested comes from over two million private investors,¹⁸ who have invested a total of between 100 and 300 million US dollars in the informal equity investment market and effect new investments of over 30 billion US dollars every year. This results in an average investment volume of between 400,000 and 1.2 Million US dollars per 1,000 inhabitants.
- For Great Britain, MASON and HARRISON estimate the number of investors in the British informal equity investment market at several thousand private individuals.¹⁹ The market volume is thought to be almost 2 billion British pounds, thereby surpassing the formal venture capital market by far. OSNABRUGGE extrapolates an even larger volume, with a total of almost 5 billion pounds informal investment capital, as opposed to slightly less than 1.3 billion pounds of early-stage investors from the formal venture capital sector.²⁰ This results in a volume of informal investments between 15,000 and 150,000 US dollars per 1,000 inhabitants.
- For Finland, LUMME, MASON and SUOMI estimate the size of the informal equity investment market to be a total of 1.500 informal investors with an entire volume of almost 850 million FIM invested capital.²¹ This corresponds to nearly 30,000 US dollars per 1,000 inhabitants.
- In the Netherlands, there are thought to be between 10,000 and 15,000 business angels, of whom 2,000 to 3,500 are active. The volume of the informal equity capital is estimated to be between 0.9 and 1.6 billion Euro, one to three times the formal equity investment market.²² This corresponds to between 60,000 and 120,000 DM per 1,000 inhabitants.

Despite the fact that these estimations are approximate, it can be recognised that the data for European countries are all at least within a comparable order. That is why one also assumes an enormous potential for business angels in Germany. Based on a European study,²³ the Fraunhofer

¹⁶ cf. WETZEL/FREEAR, United States, 1998, p. 61.

¹⁷ cf. HAKE, Amerikanische Firmengründer, 1997, p. 105, as well as ACS, Small firms, 1997.

¹⁸ cf. FREEAR/SOHL/WETZEL, Personal Investors, 1995, p. 87.

¹⁹ cf. MASON/HARRISON, Investment Process, 1996, p. 105.

²⁰ cf. OSNABRUGGE, Comparison, 1998, p. 2.

²¹ cf. LUMME/MASON/SUOMI, Finland, 1998, p. 98f.

²² cf. LESSAT ET AL., Beteiligungskapital, 1999, p. 161.

²³ cf. SOUTH WEST INVESTMENT GROUP, Business Angels, 1996.

Institute in Germany estimates a potential of about 220,000 business angels for the German informal equity investment market, including 27,000 who are active.²⁴ Furthermore, the Fraunhofer Institute estimates a potential investment volume of between 5 and 7 billion DM, apart from 0.6 to 0.8 billion DM actually invested capital. This would correspond to an actual investment volume of between 60,000 and 80,000 DM per 1,000 inhabitant.²⁵

3 Business Angels in Germany: Empirical Results

3.1 Introduction

The following results are derived from personal interviews with 48 business angels. A pre-structured interview manual was used for this. Critically speaking, the results of the existing study cannot claim to be representative with regard to the total number of business angels. However, it has to be taken into consideration that it is usually exceptionally difficult to be granted interviews with business angels at all. Studies of informal equity investments markets carried out in the US establish that identifying business angels is very difficult. They usually prefer anonymity to publicity as their personal prosperity makes them the target of petitions from various people and institutions, which are looking for sponsors for personal or charitable purposes. That is why there are no publicly accessible registers in particular with details of names or equity activities of business angels.²⁶ In addition, many business angels in the past proved to be reserved when it came to participating in studies for research purposes, as they were afraid of being flooded with a multitude of unwelcome investment opportunities. Consequently, the number and characteristics of the overall number of business angels remain unknown and almost impossible to ascertain. For this reason, it is not possible at this point to carry out an examination that would be relevant to a representative sample of the total number of business angels.²⁷

The angels interviewed were predominantly male and on average 48 years old. Geographically, the interviewed business angels were mainly concentrated in certain states of the Federal Republic of Germany, in particular Bavaria, Hesse, Hamburg or North Rhine-Westphalia. Usually they are located in or in the immediate vicinity of the cities of Munich, Frankfurt / Main, Hamburg, Cologne, Düsseldorf, Stuttgart and Berlin. The vast majority of the interviewed angels in Germany are very

²⁴ cf. HEMER, *Business Angels und JTU*, 1999, p. 106.

²⁵ Calculation based on 82.1 million inhabitants in 1998. cf. CIA, *World Factbook*, 1998.

²⁶ cf. WETZEL, *Angels*, 1983, p. 25, LUMME/MASON/SUOMI, *Finland*, 1998, p. 23.

²⁷ cf. also MASON/HARRISON, *Survey*, 1994, p. 71.

experienced businessmen; 75 percent of informal investors have already set up a company, two thirds of them have even implemented two or more set-ups.

Of those business angels who have set up a company themselves, over 80 percent are still involved with at least one of these companies, typically as a managing stockholder. Of the business angels who haven't founded a company up until now, 42 percent already have management experience in small and medium-sized companies. This means that altogether over 85 percent of the interviewed informal investors have management experience with these kinds of companies. On average, German business angels can look back on 12.5 years of management experience in small and medium-sized companies. Taking the average age of 48 into consideration, this corresponds to roughly half of the working life up until now.

Apart from the experience of setting up companies, the interviewed business angels' professional background is relevant; half of the business angels had professional experience in the High Tech area and a further 40 percent in the financial services sector. Functionally speaking, the majority of business angels mainly have experience in corporate management and financing. This can clearly be seen from the following diagram.

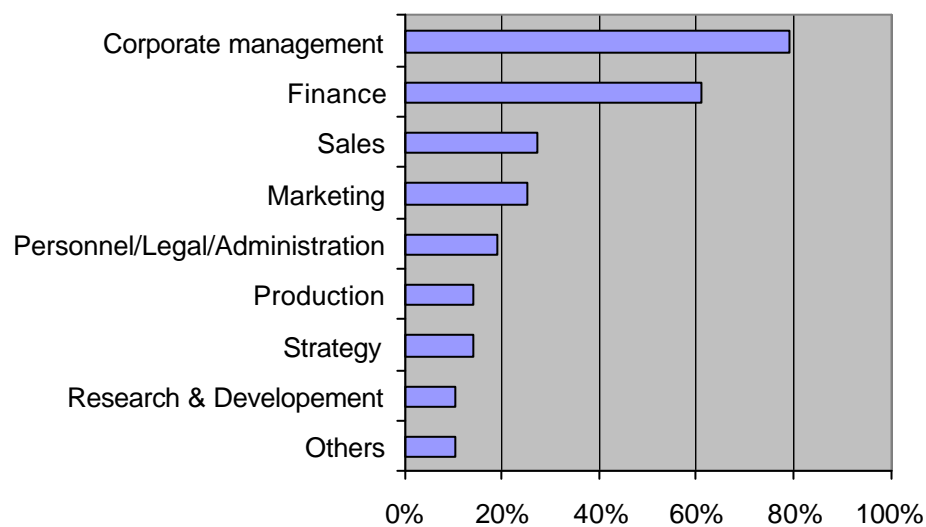


Diagram 2: Management experience of informal investors according to functional area

With regard to the size of the budgetary income and the private assets, it can be seen that nearly two thirds of the interviewed business angels have an annual income of more than 500 TDM. 38 percent even have a budgetary income of over 1 million-DM, 24 percent have five million-DM annually. In

addition, 83 percent of local business angels have private assets of over 3 million-DM. More than half of the German business angels have assets of over 10 million DM and about 30 percent of the interviewed informal investors declared private assets of over 20 million DM. This is shown in the following diagram.

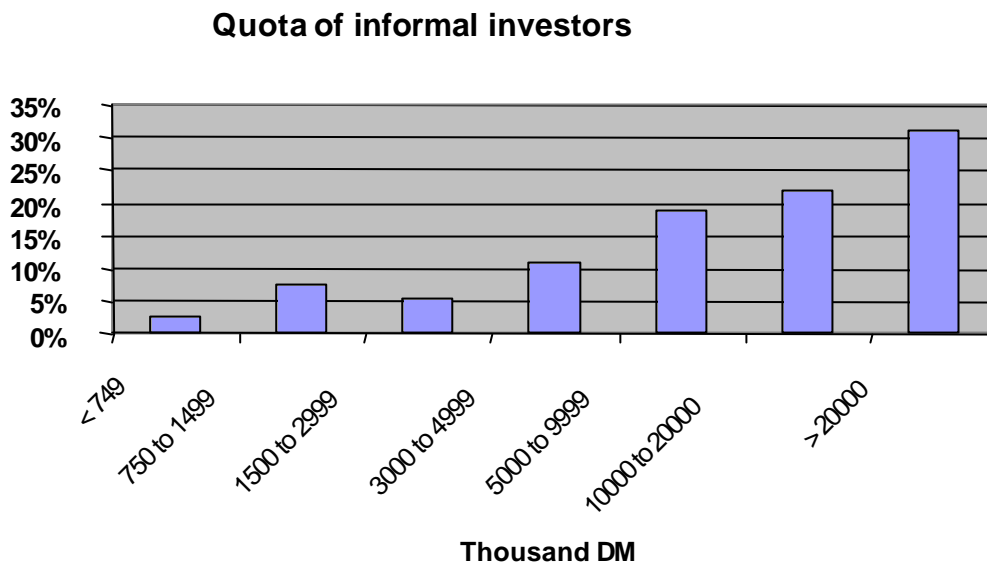


Diagram 3: Personal assets of informal investors

The available sample of German business angels deviates considerably from the results of comparable studies abroad, both in the size of budgetary income, as well as the extent of personal assets. The interviewed business angels do therefore have the necessary means at their disposal to participate in informal equity investments on a larger scale.

3.2 Investment opportunities

The business angels who took part in the interviews had accumulated more than 2,700 opportunities for informal equity investments over the past three years, with a median of 25 opportunities for each investor. Where these opportunities come from is shown in the table below.

Information Source	Opportunities in general		Participations entered into			Success Quota	
	Number of Investors	% of Investors	Number of Investors	% of Investors	% of all participations		
Informal Sources							
Business friends	44	92%	38	79%	63%	69%	
Active personal research	5	10%	1	2%	2%	17%	
Founder	21	44%	14	29%	12%	27%	
Formal Sources							
VC Firms	9	19%	7	15%	7%	39%	
Banks	11	23%	3	6%	2%	8%	
Investment Adviser	3	6%	1	2%	0%	7%	
Tax Consultant/ Business Analyst	10	21%	1	2%	1%	4%	
Lawyer	9	19%	2	4%	1%	5%	
Universities/ Research Institutes	4	8%	3	6%	2%	22%	
Organised Sources							
Investment Clubs/ Matching-Services	17	35%	8	17%	4%	12%	
Business Broker	2	4%	0	0%	0%	0%	
Newspapers	3	6%	1	2%	1%	14%	
Other Sources	9	19%	4	8%	5%	25%	

Diagram 4: Information sources for investment opportunities

The various information sources differ not only regarding the number of investors but also in relation to the quality of available investment opportunities. At 63 percent, business contacts were the original information source for by far the largest proportion of equity investments actually carried out. A further twelve percent of opportunities originated from direct contact with the company founder

searching for funds. After this, venture capital firms were the third most frequent source at seven percent for actual equity investments. Business contacts have the highest success rate as an information source ahead of venture capital firms.

3.3 Selecting the investment

After briefly looking at possible investments, business angels usually decide quickly if it is worthwhile to consider an individual opportunity more closely. At this stage, decision criteria are first impressions, as well as the question of how compatible the opportunity is with their personal investment preferences. This is often an intuitive decision. The majority of all opportunities are already excluded at this first stage. After this comes a detailed analysis of the opportunity, including personal contact with the company which is seeking capital.

The detailed analysis is carried out on the basis of criteria to which the interviewed business angels attributed varying degrees of importance.

Factors taken into consideration when making a decision	Significance		
	Very important	Important	Not Important
Management Team	96%	4%	0%
Growth potential of the market	58%	31%	11%
Uniqueness of the product or service	58%	31%	11%
Expected return	46%	42%	12%
Industry	38%	31%	31%
Competition	29%	44%	27%
Exit strategy	14%	40%	46%

Diagram 5: Factors taken into consideration about informal investments

The importance of personality-related factors, growth potential and the singularity of the product when making a decision is clearly emphasised by considering the exclusion criteria of investment opportunities. These exclusion criteria are listed in the diagram below, in addition to the factors previously mentioned.

Reasons which have led to the rejection of investment opportunities	Percentage of investors
Lack of confidence in the entrepreneur as a person	65%
Doubts as to the competence / ability of the management	50%
Weakness of the business plan	48%
Limited growth potential	37%
Unattractive line of business	31%
Unrealistic evaluation of the company	27%
Inability to assess the technical aspects	22%
Insufficient personal knowledge of the company	17%
Incompatibility with own long-term goals	17%
Lack of supplied information	11%
Lack of time to analyse the opportunity	11%
Own capital restriction/ unsecured total funding	11%
Participation too risky	9%
Inability to judge the value of the company	9%
Negative "gut feeling"	7%
Inability to agree on the extent of the participation	9%
Other factors	13%

Diagram 6 : Reasons for rejecting investment opportunities

Hence the two reasons most mentioned for ruling out investment opportunities are also related to the founder who is seeking finance, indicating a lack of confidence in the entrepreneur's character, as well as doubt as to his competence and ability. Equally important reasons are a weak business plan and limited growth potential. An unrealistic evaluation of the company is mentioned by 27 percent of the interviewed business angels as a reason. On the other hand, only 9 percent of investors mention the inability to agree about the stakes the business angel would hold for his investment

Altogether the selection process reduces the total number of investment opportunities of all the business angels from over 2,700 to 230 actual investments. This gives an overall acceptance rate of 8.4 percent.

3.4 Return expectations, duration of investment and exit strategy

By explaining how business angels select their investments, it has already become clear that the return is not the only decision criterion that influences the decision. In view of this, it is hardly surprising that there are seldom quantifiable expectations for a minimum return on the investment. 38 percent of the business angels have no minimal return expectations for their investment, whereas 46 percent can quantify a minimum return expectation. The expectation comes to an average of 42 percent annually, but it is not important to those interviewed at which stage the company is.

The duration of the investment anticipated by the business angels for their informal investments lies, for the most part, within a clear time span; 54 percent of investors expect their participation to last for three to ten years. A further 38 percent were either unable to anticipate a definite investment duration at the time of the interview, or else they found the question of length of investment to be fundamentally irrelevant. For each of the following, only 4 percent stated they expected their investment to last for less than two or more than ten years.

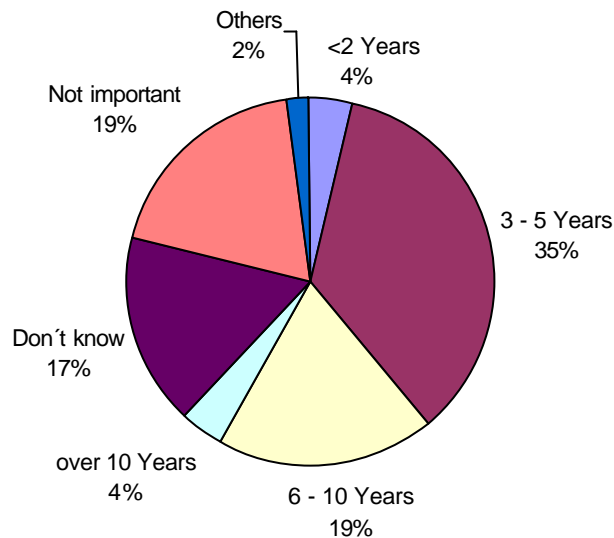


Diagram 7: Expected duration of investments for informal investments

At the end of the investment duration, the outsourcing of the company shares has to be dealt with, the so-called “exit strategy”. In relation to this, the investors were asked about what exit strategy they anticipate from their own investments. As it is difficult to generalise the type of exit strategy anticipated with various investments, it is possible to give several answers. The exit strategies which were aimed for the most were, by far, flotation at 50 percent and at 44 percent, the so called trade sale, selling to a strategic investor.

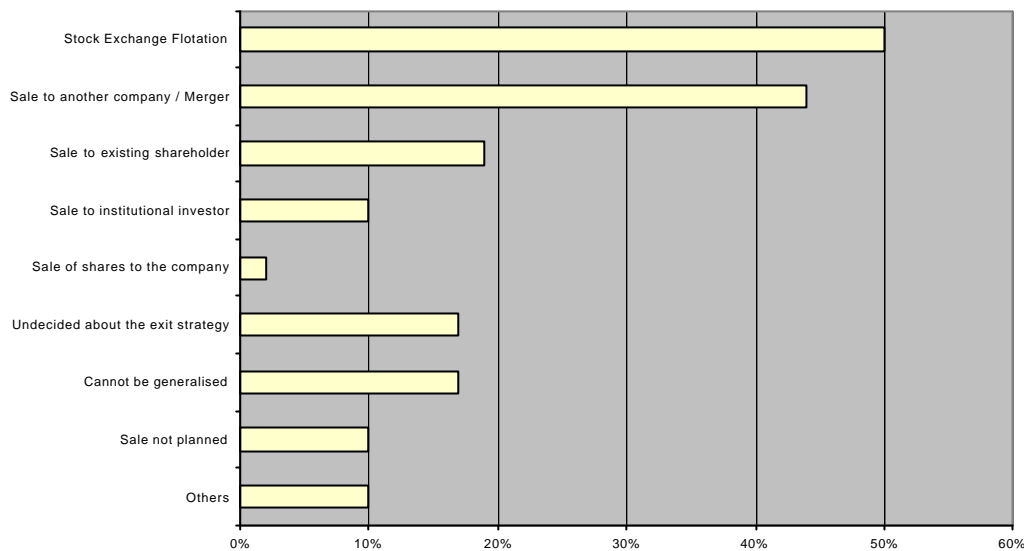


Diagram 8: Anticipated exit strategy for informal investments²⁸

3.5 Relationship between business angels and investments, and their type of assistance

The interviewed business angels are involved in various ways in their investments. Three quarters of the business angels stated that they were actively involved in the supervisory board, the advisory council and the shareholders' meetings and besides this, provided informal advisory help. A further 21 percent of the angels interviewed are involved either in these organs or provide advisory help. This help is usually free of charge; only two of the 200 companies, in which the angels were involved beyond the organs of the firm, had to pay for the advisory help provided by the business angels.

Representation in the organs of the firms is usually linked to exercising the right to vote. Thus, 96 percent of those interviewed have the right to vote in at least one firm. The importance the business angel attributes to having the right to vote and the weighting of this vote varies considerably in this regard; a total of 75 percent of informal investors state that having the right to vote is important for them. However, 21 percent regard having formal rights to be unimportant. These business angels are predominantly of the opinion that conflicts between company founders and investors in relation to young firms should not be dealt with by exercising formal rights, but rather on an informal and personal level.

²⁸ The sum of the percentages is greater than 100 due to the possibility of giving several answers.

Only 19 percent of the business angels have a majority vote. Practically half of these informal investors strive for majority vote and consider it important. However, the “typical” business angel doesn’t have a majority vote, nor does this bother him. On the contrary, a minority stake ensues intentionally, so that the founders aren’t deprived of the financial or idealistic motivation of running “their own company”. Apart from this, although business angels want to take part in “business joys and profits”²⁹, they don’t wish to hold any business responsibility.

Majority Vote	Significance	In possession of the Angels		Total
		Yes	No	
	Important	8%	4%	12%
	Not important	11%	77%	88%
	Total	19%	81%	

Diagram 9: Percentage of business angels with majority vote and the importance attributed to these majorities.³⁰

The informal advisory help provided by the business angels has a number of different characteristics. In order to be able to make differentiated statements in relation to this, the business angels were asked about the contributions they provided the companies with.

Apart from capital, which all angels have at their disposal, the contributions mentioned most often are the use of personal networks as well as assistance through coaching and financial know-how.

²⁹ Quote from one of the business angels interviewed.

³⁰ This analysis doesn’t only attribute the majority of the votes to a business angel if he alone holds the majority, but also if he holds the majority along with his informal co-investors.

Contribution of the Business Angels to their investments	General Contributions		Most important contribution	
	Number of instances	% of the Investors	Number of Investors	% of the Investors
Coaching	28	58%	14	29%
Network / Contacts	42	85%	14	29%
Finance Know-How	25	52%	5	11%
Marketing Know -How	15	31%	3	6%
Strategy	5	11%	2	4%
Capital	48	100%	2	4%
Management Know -How	22	46%	1	2%
Personnel Development	5	11%	1	2%
Industry Know -How	14	29%	1	2%
Other	6	13%	5	11%
<i>Total</i>			<i>48</i>	<i>100%</i>

Diagram 10: Contributions to their investments from the perspective of the business angels

Other contributions mentioned by the investors are using their own marketing, strategy and management know-how, their knowledge of the industry as well as searching for and choosing further executive personnel. For the latter, business angels once again use their personal network and knowledge of the industry.

The differences in the contributions provided by business angels are also reflected in the considerable amount of time which business angels spend on their investments. On average, each of the informal investors interviewed spends 6.2 days a month on his investments. This corresponds to an average of 1.34 days a month spent on each investment. At this point it should be mentioned that the amount of time spent per investment decreases rapidly, according to the duration of the investment. In particular, those business angels who have several investments stated that they spent most of their time on those equity investments that had been acquired most recently.

Naturally, including business angels in the business of a company can give rise to problems in the relationship between founders and informal investors; 77 percent of the business angels stated that they already had had problems in this respect. These are mostly due to specialised, strategic but also human factors. Although the active involvement of a business angel is usually extremely beneficial for the firm there is also a potential for conflict because of the close relationship and intensive

involvement. ROBERTSON, HENDERSON and HARVEY also refer to possible disadvantages of involving a business angel. These can partly result from assigning majority decisions or from personal differences between the business angel and the founders: “Angels can bring experience, skills, resources, ability, knowledge and wisdom to a company - all elements a successful business needs - on the other hand, they can also bring interference and loss of control - sometimes the chemistry just doesn’t work.”³¹

Despite these difficulties, most business angels are satisfied with the development of their investments. More than a third of those interviewed said that the development of their investments was considerably above their expectations. Apart from this large proportion of satisfied investors (44 percent), there is a proportion worth mentioning, of dissatisfied business angels whose investments were considerably below their expectations (14 percent).

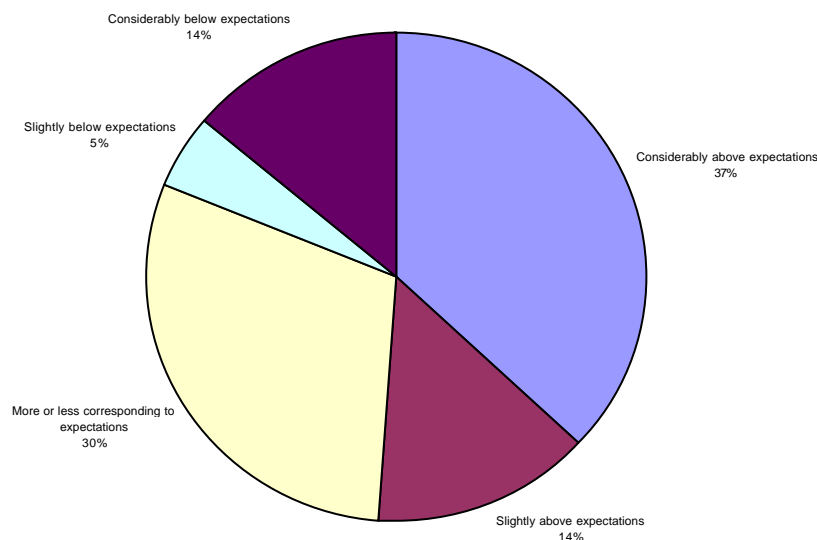


Diagram 11: Degrees of satisfaction of informal investors with the development of their investments

On the one hand, this can be explained by the naturally high risk involved in investing in young technological firms. On the other hand, the inherent risk of this market appears to be drastically underestimated by a proportion of informal investors.

³¹ ROBERTSON/HENDERSON/HARVEY, Beiträge, 1996, p. 45.

4 Summary and Outlook

Expanding on a general representation, the previous chapters presented the behaviour of business angels in Germany. These results come from an empirical examination of 48 angels, the first empirical study in Germany.

Firstly, the results show that business angels in Germany have the financial resources to support companies in the early stages. Secondly, they can also use their wisdom and contacts to help a young company on the road to success. Usually angels receive sufficient investment opportunities, of which they usually accept fewer than ten percent. More than half of the angels want to stay with the company they have invested in for more than three years and then wish their exit strategy to be flotation or a trade sale. Those angels interviewed were rewarded for their involvement by being considerably satisfied with their investments.

Through this first empirical study in Germany it could be shown that Business Angels play a similar role in Germany as they do in the USA and Great Britain by helping close the equity gap and as providers of capital and advice. However, this initial study with a sample size of 48 angels cannot be seen as representative. Additional research is necessary on the basis of larger samples, and issues such as, for instance, the Principal-Agent-relationship between start-up and investor need to be investigated.

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