The Role of Business Angel in Financing Small Business

Rafiu Akinpelu Olaore
Directorate of Entrepreneurship Development, Osun State Polytechnic, Iree
olaoreakin@yahoo.com
Samson Adegbesan. Adetoye
Department of Office Technology & Management, Osun State Polytechnic, Iree

Abstract
Angel investors can also be referred to as business angels or informal investors. These are prosperous and comfortable people in the society who are ready to invest their money into small businesses especially feasible start-up firm or nascent business while in many cases they request for ownership equity or some form of convertible debt in exchange for their investment. Business Angels carry out a crucial purpose in rendering seed capital or start up financing where the size of the funding is considerably small and no other investor is ready to serve the purpose. Small businesses are important innovators in most economic development. It was observed that the death of many small businesses was due to lack of fund to survive and or expand. Due to limited fund available to small businesses to operate at the start up, they have to rely on personal resources, bank credit, friends and relatives, trade finance, government aids and business angels as primary sources of fund to commence operations and planning for future development. This paper addresses the different sources of financing, the significant of business angel and the impact on the small business. The study proposes an understanding to fortify a very good structure in which small business can benefit abundantly from business angel. The research survey was carried out from a case study of design consultant who has benefited from business angel in United Kingdom. Moreover, the study recommends that Nigeria government should provide an entrepreneurial framework conditions for business angel operations and also emulate and encourage the use of business angels in financing small business to reduce unemployment.
Keywords: Small Business, Business Angel, Sources of finance, Equity capital, Network

1. Introduction

One of the most important issues facing small business generally is their ability to raise fund because they are at early stage of the firm, lack tangible assets and debt financing is usually not the best option (Denis, 2004; Maier, II and Walker, 1987). Cornwell et al., (2009) state that equity financing can be an effective source of funding for entrepreneurial ventures, particularly for businesses that cannot meet the funding requirements to use only debt financing or that need more capital than can realistically be raised through debt.

The purpose of this paper is to discuss the main sources of finance in small business and to specifically address the significance of business angels to the sustainability of small to medium size businesses. “While most business start-ups are small in terms of the finance required to get them off the ground, a small but growing number of businesses may be funded in part from either business angel money or money from venture capitalists”, Bridge et al., (2009). Moreover, Burns, (2001) explains that the typical business angel makes only one or two investments a year and some have preferences about sectors or stages (seed, start-up, early stage, expansion, management buy-out or buy-in) of investment while many prefer local investments in companies within their reach.

The paper examines the definition of small business in relation to other types of businesses, sources of financing small to medium business, why Business Angels are very important, Influence of Business Angel Networks such as The British Private Equity Venture Capital Association (BUCA), British Business Angels Association and some others. It further explores how a design consultancy, d3o, Richard Palmer found a business angel to invest in his business. Finally, the conclusion and recommendation were drawn subject to the review of literatures and findings.

2. DEFINITION OF SMALL BUSINESS

Most of the definitions of a small business attempts to provide a proxy for what is the essence of “smallness” in business units. Smallness is about being autonomous yet having limited resources of manpower, time, skills, sales turnover, expertise and total funds invested, and therefore having to be dependent on external support. It is about having to cope with greater uncertainty and about carrying greater risk while having few opportunities for risk spreading (Bridge, et al, 2009, McLaney, 2003).

McLaney, (2003), opines that small businesses are an important part of the private sector. Refers to the Bank of England reports, during 2000 in the UK, businesses with fewer than 50 employees accounted for 45 per cent of employment and 37 per cent of the sales turnover of all businesses. The Department for Business, Enterprise and Regulatory Reform (BERR), UK (2007) gives official definitions of small business as small firm that have of up to 49 employees, micro firm has up to 9 employees, medium firm of 50-249 employees and large firm of up to 250 employees and over (www.berr.gov.uk).

3. FINANCE AND SMALL BUSINESS

Cornwell et al (2009) state that financing of small business can come through self-financing, debt financing, and equity financing. They observed that the type of financing used for a venture depends on the nature of its business model, the financial and non-financial aspirations of the entrepreneur, and the stage of the business in its life cycle.

Carter & Jone-Evans (2006) argues that after business owners dip into their pockets and convincing friends and relatives to invest in their business ventures, many entrepreneurs still find themselves short of the seed capital they need. Therefore, the next stop on the road to business financing will be private investors. In another development, Jarvis (2006), establishes that the proportion of equity invested in small firms is much less than that of large firms, by and large, small tend to rely on bank lending and other types of financial products.

4. SOURCES OF FINANCING SMALL BUSINESS

Understanding finance for business can help business owners understand their options for getting the money required to start or grow, and can also introduce them to potential sources of finance. Dimitraki (2012) defines capital as any form of wealth employed to produce more wealth. Stated that while fixed capital is used to purchase a company's fixed assets, working capital is used to sustain day-to-day operations and growth capital is used to expand an existing business or to change its primary direction. Raising capital from external investors in return for handing over a share of one's business can be through equity finance. Carter et al, (2006), delineate equity as the finance contributed by the owner(s) of the enterprise while Cornwell et al , (2009), opine that equity financing can be an effective source of funding for entrepreneurial ventures, particularly for businesses that cannot meet the funding requirements to use only debt financing or that need more capital than realistically be raised through debt.

Berger and Udell, (1998), emphasise that most of the equity financing for small businesses is internal capital supplied by the principal owners while the remaining other equity is likely partially composed of the "nearly internal funds provided by other members of the start-up team, family and friends. Equity financing represents the personal investment of the owner(s) of the business. The primary advantage of this type of financing is that is does not have to be repaid with interest. Due to lack of fund to run the business successfully, small businesses tend to rely on three main primary sources of outside equity financing; Venture capital funds, Angel Investors, and Business growth/Corporate investors (Denis, 2004).

Scarborough et al. (2009), highlight equity capital sources at various stages of company growth as shown in the table below;

Table 1.
Equity capital sources at various stages of company growth

	Start-up	**Early**	**Expansion**	**Profitability**
Characteristics	Business is in conceptual phase and exist only on paper	Business is developing one or more products or services but is not yet generating sales	Business is selling product or services and is generating revenues and is beginning to establish a customer base.	Company has established a customer base and is profitable

Possible Sources of Funding	**Likelihood of using each source: H = Highly likely; P = Possible; U = Unlikely**			
Personal savings	H	H	H	H
Retained earnings	U	U	U	H
Friends and Relatives	H	H	P	P
Angel Investors	H	H	P	U
Partners	H	H	P	U
Corporate Venture Capital	P	H	H	H
Venture Capital	U	P	H	H
Initial Public Offering	U	U	P	H
Regulations S-B Offering	U	U	P	H
Small Company Offering Registration	U	P	P	H
Private Placement	U	P	P	H
Intrastate Offerings (rule 147)	U	P	P	H
Regulation A	U	P	P	H

Source: *Scarborough N. M., D. L. Wilson, & T. W. Zimmerer, (2009), "Effective Small Business Management: An Entrepreneurial Approach", 9th edition, USA: Pearson Prentice Hall*

5. ANGEL INVESTORS

An Angel Investor are normally a well-off individual that is looking for an investment opportunity in an area that they understand, or have an interest in, whereby they provide funding and sometimes expertise, in exchange for an equity share of the business. Denis, (2004), defines Angel Investors as a high net worth individuals who invest their personal capital in a small set of companies. According to Scarborough et al, (2009), an Angel Investors are private investors, wealthy individuals, often entrepreneurs themselves, who invest in business starts-ups in exchange for equity stakes in the companies. Angel investors commonly show their readiness to finance small business based on the recommendation from family and friends. Frequently business angels come together and form groups known as angel groups or angel networks, so, they combine their resources, capital, and necessary data for the usefulness of each other.

It was argues by Carter et al, (2006), that business angels are a source of informal venture capital, who are wealthy individuals, rather than financial institutions that tend to have considerable business experience and are willing to invest in start-ups, early-stage or expanding enterprises. According to Dimitraki, (2012). It was observed that angels release fund at an early stage of the business and adequately provide few post-investment assistance to support the venture. Mason and Harrison, (1996), express that business angels are involved in financing stages from seed capital through to management buyouts. They are predominantly involved at the start-up (29%), and early stages (19%), however, a significant proportion are involved in providing expansion finance (38%). Moreover, it was estimated that there are between 20,000 and 40,000 business angels in the UK investing £500 million to £1 billion annually, mostly for start-up and early stage finance (Bridge, et al., 2009).

European Trade Association for Business Angel (EBAN), (2009) highlights some of the benefits of having business angels on board a company as:

* 2 wings: business angels provide not only capital but also mentoring/coaching
* Invest early – take a higher risk
* Invest in different sectors
* More flexible and reactive than other investors
* BAs give access to networks and new potential customers
* BAs acts as an ambassador for the business = credibility
* Make easier to raise follow-on funding

6. Business Angel Network

Business Angel Networks are an attempt to overcome the problems associated with the invisibility of informal investors and the high search costs for businesses seeking investors and vice versa. (Mason and Harrison, 1996). Bruton et al., (2010), point out that business angel will want to maintain and build their reputation and networks so that they will be approached to make investments in other ventures as serial angels. In the UK pools of potential, business angels are being developed by the restructured business links, banks and others through a variety of local and regional networks (Bridge et al., 2009). In another development, "Angels are more likely to invest in a company that was referred to them by someone they know and trust", says Marianne Hudson, director of the angel initiative at the Kauffman foundation, means "Network is the key". Asking friends, attorneys, bankers, stock-brokers, accountants, other business owners, and consultants for suggestions and introductions is a good way to start (Scarborough et al., 2009). Therefore, by following the right step of connections, business owners can obtain more funds and a very good network of consultants from corporate business angels than from individual investors.

Individual business angel (BA) investors, or syndicates, can be found through BA networks in the UK and Europe. (Business Link website, UK)

BA networks include:

- British Business Angels Association (BBAA)
- Beer & Partners
- European Business Angel Network (EBAN)

BA networks help companies find an investor who is right for their funding needs. They also give investors details of companies they might want to invest in.

Methodology

An interview was conducted with Richard Palma D30,

Findings

D3O, the Impact Protection Company, was a small but growing business established in 2001 by Richard Palmer. The firm was located in Ports lade by Brighton & Hove, London, UK.

By the start of 2003, d3o lab had patented d3o, an innovative shock-absorption material, and wanted to start manufacturing and selling the product. But founder Richard Palmer needed finance so he could fully exploit the opportunity. The company developed a product of high lucrative technology but required additional finance to manufacture, sell and promote the product.

The firm prepared committed, focus and professional business plan, detailing how the business angel finance

would develop the business and what involvement potential investors might have. For easy access to business Angel, the firm contacted the British Business Angels Association that later introduced it to many reliable and registered business angels in UK. The business proposal was pitched to the shortlisted investors. An investor, David Richard decided to invest after first meeting with him. In the process, benefits, growth targets and respective responsibilities were negotiated in other to get the funds on time.
"When I was initially pitching for investment, I was trying too hard to make the business cash-positive in one single stage. Had I appreciated that the business would develop and grow in value so quickly, I would have outlined my longer-term investment requirements more strategically." Richard Palmer.
Lastly, Legal adviser was involved to negotiate the investments terms, such as financial forecast of the firm with the Investor for due diligence checks and to affirm the deal agreement. (UK Department of Business, Innovation & Skill website).

CONCLUSION

The findings in this paper analyse a number of facets on small business finance, Investors and the networking involve. The researchers argued constructively on the sources of financing small businesses and it can be observed that Angel Investors unlike Venture capitalist invest their own money in the business early and give necessary support and advise to develop the business to higher level. Although, the size of capital may be very small, but capable of sustaining the business at start-up and early stage of developing.
Mason, and Harrison, (1996), argues that the use of Angel investor provides an appropriate resolution for the new small business equity gap because it lowers the information and monitoring costs that are incurred in borrowing from external sources and there is less likelihood of owner-equity value dilution.
Business Angel Network also add value to the successful funding by matching entrepreneur and angels and by increasing trust through code of conducts (EBAN, 2009). Business Angels play an important role in the financing of small enterprises, but not so significantly to claim that this source of funds will address market failure and resolve the finance gap (Carter et al., 2006). More so, depending on the investor, it may make a firm losing certain amount of power to make management decisions.
Finally, with all submission from researchers and findings, it can be concluded that Business angels contribute to the dramatic growth of small businesses as an important component of economic development. The government should give more support like tax reduction, and financial subsidies to the services of BAs than other sources of finance because most employments are generated by small businesses and their economic values.

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