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Venture Capital and Business Angels: Turkish Case

Suat TEKER[a], Dilek TEKER[b*]

[a]*Işık University, Istanbul, 34363, Turkey*
[b]*Işık University, Istanbul, 34363, Turkey*

Abstract

Venture capital (VC) may be defined as a support to entrepreneurial talents and appetite by turning ideas and basic science into products and services which are expected to envy the world. Although venture capitalists and business angels supply external funding for risky investments, the aspects of venture capitalists and business angels are different approaching the investment candidates.Business angels in the last decade have become undispansible players providing external capital for risky start-ups and contributing technological advancements and economic growth. Business angels could be either private wealth individuals or institutional venture capitalists. Private angels invest their own money that's why their invested capacity are limited while venture capitalists invest others'money with an extensive source. This research examines the the way of doing business for venture capitalists and business angels. Furthermore, venture capital market and business angels are reviewed for the Turkish case.

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Keywords: Venture captal, angel investors, startup companies, technology advancements, entrepreneurship.

1. Introduction

Venture capital (VC) may be defined as a support to entrepreneurial talents and appetite by turning ideas and basic science into products and services which are expected to envy the world. Venture capital funds are able to build companies from the simplest form to mature organizations (Teker et al (2016). Businss angels play an important role in the economy and in many countries substitute the largest source of external funding in newly established ventures. This has put angel investors in the center of attention for policy makers, who acknowlege their increasing improtance providng risk capital as well as contributing to economic growth and technological advances (Murray, 2007). Business angel investment activities are actually not a recent phenomenon. Private individuals have always had a tendency to invest in high-risk projects. One famous example is the decision by Queen Isabella of Spain to finance the voyage of Christopher Columbus. This turned out to be a highly profitable investment for Spain. Moreover, it may be argued that the investments made by the private individuals affected the industrial revoluition during the 19th and early 20th centuries. The business angel market first attracted the attention of US policy makers and in the late 1950s the Ferderal

* Corresponding author. Tel. + 90-532-241-9477

Email address: dilek.teker@isikun.edu.tr

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Reserve investigated initial financing of new technology-based firms and preceeded the Small Business Act in 1958. The interest in early financing of technology-based firms pointed the focus on angels as an important external source of finance for entrepreneurial ventures.

This reserach is organized as follows. The next section reviews the related literature. The following section examines the characteristics of business angels. The later section covers the Turkish case of angel investors. The final part presents the concluding remarks.

2.Literature Review

The first pioneering academic work conducted by Wetzel's study (1983) "Angels and informals risk capital" published in Sloan Management Review. He proposed that new technology-besed firms encountered problems when raising small amounts of early stage financing. The evidence indicated that business angels played a role in solving this problem. Wetzel put forward the common traits of business angels; wealthy, self-made, male, highly active investors who invested in close geographic proximity to their home and relied heavily on their network of friends and business associates.

The issue of angel investors is characterized by a growing number of research questions of interest, hence limiting the issue to one definition. Initially, a distinction between investments made by institutional venture capital investors and investments made by business angels. Wright and Robbie (1998) defines institutional venture capital as "Professional investors of long-term, unquoted, risk equity finance in new firms where the primary reward is eventual capital gain supplemented by dividends". Mason and Harrison (1999) states that "the institutional venture capital industry companies full-time professionals who raise finance from pension funds, insurance companies, banks and other financial institutions to invest in entrepreneurial ventures. Instştutional venture capital firms take various forms: publicly traded companies, 'captive' subsidiaries of large banks and other financial institutions, and independent limited partnerships."

Lerner (2000) defines a business angels as "a wealthy individual who invests in entrepreneurial firms. Although angels perform many of the same functions as venture capitalists, they invest their own capital rather than that of institutional or other individual investors"

Mason and Harrison (1994) describes business angels as "a high net worth individual, acting alone or in a forma lor informal sydicate who invests his or her own Money directly in an unquoted business in which there is no family connection and who , after making the investment, generally takes an active involvement in the business, for example, as an advisor or member of the board of directors".

Mason et al. (2004) emphasizes the business plan as the first step for the decision of angel investors. They point out that business plans should be prepared under different perpectives since bankers, venture capitalists and business angels consider different investment criteria. Bankers consider financial aspects as more important while giving less weight on entrepreneurs, amrket and other issues. Venture capitalists and business angels put a balanced weight on financial and market issues. Furthermore, business angels emphise entreprenurs and "investor-fit" more comparing to venture capitalists. Finally, they suggest that entreprenurs must prepare a business plan taking into account of seeking financing from business angels, venture capitalists or bankers.

Mitteness et al. (2012) investigate whether angel investors perceived passion play a significant role in investor funding decision making. They screened 64 angel investors in California region in the period of 2006- 2010. The angel investors examined 241 companies and made 3502 evaluations within the period. Angel investors deciden to fund 41 companies (17% of 241 companies). Out of 64 angels, 3 were femaile with a masters of PhD, and 42 had some startup experience, and more than half of angels held a graduate degree. The reserachers find a strong relationship and further state that the relationship is even stronger if angel investors are older, more intuitive, have open personality, those who are motivated to mentor.

Ding et al. (2014) try to explain why angel investors may have different selection criteria under different institutional environment. The work on Denmark and China to examine the comparetive institutional environment. They find that the relationship-based institutions are more common in China while rule-based intitutions are more common in Denmark. Angel investors in China give risks less wieght compared to those in Denmark and they tend to keep strong ties with the startup teams.

Aernoudt (2005) states that government policy to stimulate growth, innovation and creation of new companies/employment is mainly related to Access to finance through increasing suplly of capital. Hence, business angels play an important role in financing of seed and early stage of startups. The author suggests that government find out innovative ways to stimulate angel financing, and propeses seven ways for it; investor readiness, corporate orientation, business angel networks, business angel academies and the integrated finance concept to cope with information asymmetry in between start-ups and investors.

Collewaert (2014) investigates how perceptions of entrepreneurs and business angels about the degree of trust in their relationships affect the further assessments. He studied 54 cases for venture investments. His findings support that the performance of of ventures is evaluated more positively if angel investors perceive high trust. Morever, the information quality exchanged in between angel investors and entrepreneurs has an impact on the level of perceived trust. He concludes that the level of perceived trust and quaility of information exchanged may result in further benefits or threts in relationships of angel investors and entrepreneurs.

Collewaert et al. (2016) examines 58 Belgian companies and 123 pres-money valuation investment rounds to see whether human capital of angel investors afftect the valuation. A higher level of human capital of angels is defined by studied in college longer years, have a business degree and more experience in entrepreneurship. They argue that a higher level of human capital of angels supports more value creating options, a higher value adding potential post-investment and anhanced ligitimacy provided to the venture.

By using 419 exited angel investment in the period of 1972 and 2007, DeGannaro et al. (2014) calculated the expected returns for angel investors. They found that the expected returns for angel investors for the period are around 70% per year in excess of the risk free rate.

3. Characteristics of Angel Investors

Business angels differ from venture capitalists. Venture capitalists raise funds through private or public money to invest in businesses using managed funds. Venture capital firms incur a significant administrative cost that's why they need to be more selective to ensure a good return on the invested funds. Hence, they make less investments in startups and at seed stage. Therefore, business angels become more valuable by funding smaller amounts to businesses that can not be economically funded by the venture capital market. Angel investors normaly take equity shares in a business in return for providing funds. Angel investors do not only provide money to grow but also bring their experience and knowledge to push for success. Angels seek to exit over a period of 3-8 years. Table 2 shows the selection criteria of angel investors.

Apart from venture capitalists, business angels have different approach and smaller size of capital for risky funding. Business angels are concerned less about quick returns and exit over a short period of time but concerned more about engaging directly in due diligence, meeting in entrepreneurs and structuring legail investment documents. Angel investors may do these by themselves or in a sydicate. Later, angel investors actively involve in the investments by taking a sit on the board or cloesely supporting the business or acting passiveley as part of a group with a lead angel executing this role on their behalf. Table 1 below presents the differences in between venture capitalists and business angels.

Table 1. Comparison of Institutional Venture Capitalists and Business Angels

Key features	Institutional Venture Capitalists	Business Angels
Source of funds	Primarily institutional investors who act as limited partners invest others'money.	Private individuals that invest their own money
Responsibility	Limited personal financial responsibility but responsibility to management and owners	Significant personal financial responsibility
Investment experience and capacity	Considerable investment experience and investment capacity	Little investment experience and limited investment capacity
Time for due diligence	Extensive time for due diligence	Limited time for due diligence
Investment stage	Mostly later stage	Early stage
Operational engagement	Some hours per month	Some hours per week
Exit strategy	Very important	Less important
Length of holding period	3-5 years	3-8 years

Source: Avdeitchikova, S., H. Landstrom, N. Mansson, (2008) Companies can be candidates for angel investors at the stage of pre-revenue, pre-profit or profit-generating. The candidates at the stage of pre-revenue need to prove their concept. The candidates should build a defensive position by acquiring use of copyrights, legal registration of brands or patents. The candidates at the idea stage of idea are generally not in the scope if angel investors. Family members or friends may be the investors for this stage.

What angel investors look for in an investment candidate is listed below. The most significant aspect for angel investors evaluating a business for investment is the composition of the startup team; their experience, skills, motivation, what brings them together. Angel investors also carefully examine the core aspects of the business plan. A startup candidate may not meet all of the considerations below but is expected to meet at least five of these to have a good starting point for a positive evaluation. (www.ukbusinessangelsassociation.org.uk/services-for-entrepreneurs)

1. Whether the technology, service or product solving a problem.
2. Whether it is likely to make a real impact in the market.
3. Whether the technology or product has an identifiable intellectual property.
4. Whether it possesses a defensible market position. Whether it has first mover advantage.
5. Whether there exists a clear and identifiable money generating model. Whether profits margins are satisfactory.
6. Whether the business model is scalable and can achieve explosive growth.
7. Whether the business model has been tested with potential customs.
8. Whether the market size is sufficient to achieve a realistic market share.
9. Whether the deal is legally eligible.
10. Whether the entrepreneurs have desire and strategy to exit.
11. Whether the entrepreneurs willing to give up shares in return for investment and to have new investors on the board.

Table 2 below shows the selection criteria of angel investors. The table presents simplified evaluation descriptions for criteria considered by angel investors.

Table 2. Selection Criteria of Angel Investors

Variables	Description
Source of business plan	Startup Team / Personal Friends / Professionals
Investment return	Low / Medium / High Return
Risk of failure	Low / Medium / Huge Losses
Relationship between investors and members of startup teams	Strangers / Friends / Family
Compatibility with investor expertise and interest	Low/ Medium / High Compatibility
Startup team capabilities and track record	No Good / Good / Very Good
Opportunity for involvement in new venture	Not at All / Likely / Very Likely
Exit plan	No Exit Plan / Exit Plan Exists

Source: Ding, Z., S. L. Sun, K. Au. (2014).

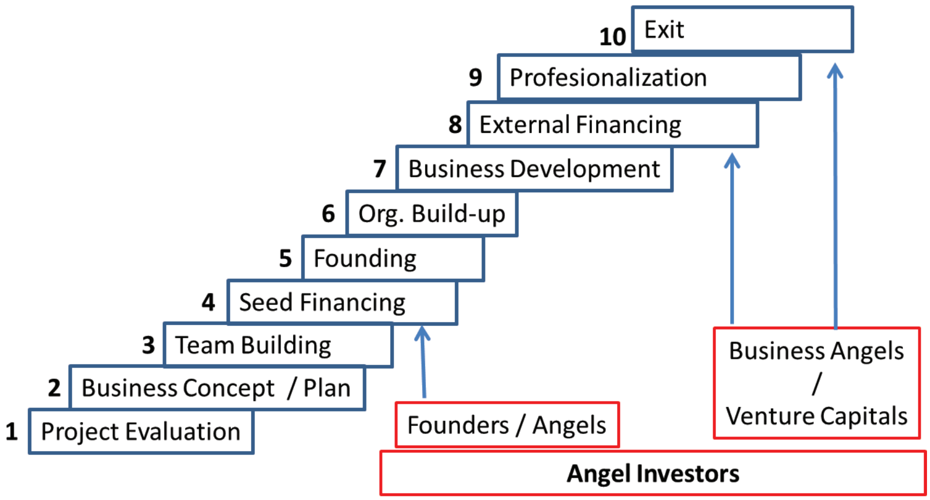

Figure 1. Stages of Startups

Figure 1 above illustrates the stages of startup company. Project evaluation is the first evaluation of market and technology. This stage includes a brief definition of R&D program and first assesment of the team and missing skills. The second stage is the developing a business concept. This stage covers a detailed definition of R&D programs, exit strategy, capital needs, and writing a business plan including detailed evaluation of markets and techology. The third stage is the team assesment including identification of missing skills, and recruitment of additional team members.The fourth stage is need for seed financing to pay for initial activities and secure the position. It is generally financed by entrepneurs or founder angels. The fifth stage is for the establishment of the startup company. The entrepreneurs evaluate the options about the legal form of the company and steer the founding process. The stage six is about building up the organization. The entrepreneurs evaluate the needs and constraints and then define the company processes and structures. The stage seven requires a business development based on the industry experience and network. The stage eight is for planning of investment round and searching for suitable investors, business angels or venture capitalists. This stage involves negotiations of conditions, contracts nad growth financing for the company. The stage nine is the movement to a structured comany by recruitment of additional management team members.The stage ten is for evaluating convinient exit options and planning of exit strategy.

4. Angel Investors in Turkey

4.1. Qualifications of being an Angel Investor in Turkey

Angel investor system is introduced in Turkish markets by June 2012. New law enacted by the Turkish Parliament in June 2012. Business angels are approved to operate in Turkey under the authorization of Treasury. The same law launches a temporary article in relation to tax incentives for business angels. The tax incentives for business angels indicates 75% participation shares qualifying Turkish resident joint stock companies held by business angels can be deducted from business angels annual income tax base in the related calender year which is capped at TRY 1,000,000. In order to benefit from tax reliefs, business angels is obliged to get a license from Treasury. Operations of the corporations financed by business angels should make a declaration to the treasury before the investment is made. Treasury underlines the features of the investors for licensing as wealth and experience (PWC, Business Angels in Turkey,Asset Management Bulletin, February 2013). For wealth qualifications; investors whose annual income is at least TRY 200,000 within the last two fiscal years or investors whose total amount of wealth including every type of moveble and immovable assets is at least TRY 1,000,000 are licensed.

Qualifications related to experience of angel investors;

- ✓ investors are required to have at least 2 years of experince as fund manager
- ✓ investors who work at least as deputy general manager or a higher position in a company with the annual turnover of at least TRY 50,000,000.
- ✓ İnvestors who have been members of an business angels network for 2 years and who have been shareholders in a non-public firm as angel investors for 3 years before getting the license.

Table 3 below show the number of licences are approved by the Turkish Treasury over years. The table indicates that the number of angel inevstors licenced in 2013 and 2014 were high compared to the ones later years.

Table 3. Number of Angel Investor Licences Approved in Turkey

Year	Number of Licenses
2013	155
2014	120
2015	69
2016 (april)	29
Total	323

3.2 Investment Outlook for Turkish Ecosystem

According to Treasury statistics, the licenced business angels have invested TRY 277,500 on the average for a average of 10% shares since June 2013. The firms that business angels invested consist of 92% of micro firms (less than 10 employees) and the other 8% of fims with 10-50. The number of founder/owners of firms receiving external funding from angel investors is listed in Table 4. It looks that the most startups have less than 5 entrepreneurs in the founders team.

Table 4. Number of Founder/Owners of Firms Received External Funding from Angels Investors

Number of founders / owners	Percentage
≤ 5	42%
5-10	23%
≥10	35%

Table 5 and 6 below present the industries that startups initiates and allocation of invested funding among expense items. The most attactive industry for startups in Turkey is the software creation and developing. More than half of startups initiated in software sector. E-trade and data mining appear to be two other popular industries attarcting angel investors. The startups allocate a half of external funding received for staff expenses (50%). The startups leave only 10% for equipment and 7% for marketing and sales activities.

Table 5. Industries of Startups Received External Funding

Operations	Percentage
Software and developing	54%
E-trade	23%
R&D	4%
Database mining	11%
Other	20%

Table 6. Budget Allocation of Invested Capital

Expense Item	Budget Share
Staff Expenses	50%
Machinery and Equipment	10%
Marketing and Sales	7%
Inventory	4%
Other Operating Expenses	5%
Rent	3%
R&D	1%
Other	20%

Table 7 presents the average net income expectations for the next three years of the startups received angel funding.The startups are expected to report an average loss of TRY285,000 in the first year, then an average of profits of TRY 611,000 and TRY 2,580,000 in the second and third year, respectively.

Table 7. Average Expected Net Income of Startups for the Next 3 Years

Year	Average Expected Net Income (TRY)
1	-285,000
2	611,000
3	2,580,000

Source: Turkish Treasury

Table 8. Angel Investmets by Country (Year 2013)

	#BAs	# BANs	BA Investment M€	BA Inv. 2012 M€	Jobs Created	Ave. Investment Per Company (€)	Ave. Investment Per BA (€)	Ave. Investment Per BAN (M€)
UK	4350	38	84,4	68,3	2354	157.757	19.402	2,2
Spain	2520	63	57,6	62,5	1485	235.102	22.857	0,9
Russia	220	13	41,8	N/A	808	253.030	189.773	3,2
France	4320	83	41,1	40,9	1807	109.176	9.502	0,5
Germany	1510	37	35,1	27,9	916	189.838	23.258	0,9
Finland	490	12	26,4	28,4	916	126.683	53.776	2,2
Sweden	762	11	19,4	23,2	506	175.909	25.394	1,8
Turkey	***450***	***10***	***14,7***	***10,5***	***400***	***240.984***	***32.667***	***1,5***
Portugal	611	13	13,8	11,6	497	189.000	22.581	1,1
Switzerland	424	7	13,3	11,6	130	302.273	31.368	1,9
Ireland	480	6	13,2	12,1	286	222.966	27.406	2,2
Denmark	155	5	11,8	N/A	539	115.882	76.258	2,4
Belgium	350	6	10	5,1	332	149.254	28.571	1,7
Italy	760	11	9,9	11	282	230.233	13.026	0,9
Netherland	810	11	9,8	10,1	281	169.310	12.123	0,9
Poland	160	4	6,6	N/A	233	173.158	41.125	1,6
Estonia	52	1	4,7	N/A	457	56.108	89.558	4,7
Norway	110	3	4,2	N/A	88	222.105	38.364	1,4
Austria	240	2	2,9	N/A	132	121.000	12.100	1,5
Bulgaria	52	2	2,9	N/A	163	77.027	54.808	1,4
Greece	52	2	2,1	1,5	99	116.667	40.385	1,1
Lithuannia	80	1	2	10,9	77	112.556	25.325	2
Luxembourg	80	1	1,6	0,3	59	94.118	20.000	1,6
Crotia	25	1	0,8	N/A	42	75.000	30.000	0,8
Serbia	25	1	0,7	0,7	28	108.333	26.000	0,7
Cyprus	39	1	0,6	N/A	14	310.000	15.897	0,6

#BAs : Number of Busines Angels

BANs: Number of Business Angels Networks

Table 8 presents a country wise comparison of number of angel investors, angel investor networks and some average investment indicators. As exhibited in the table, UK, France, Spain and Germany have higher number of business angels and angel networks. UK and France have 4,350 and 4,320 business angels, and 38 and 83 angel networks, repectively. Turkey has 450 business angels while having 10 anhel networks. Business angels investment amounts are about €84 million and €41 million in UK and France, respectively, while it is about €15 million in Turkey. The business angels in Turkey financed a total of 61 companies and created 400 new jobs. The average amount of investment per company is around €158,000 in UK while it is around €241,000 in Turkey. The average investmen amount per business angel is around €19,000 in UK while it is around €33,000. These figures show that Turkey has much less number of business angels compared to UK but business angels in Turkey employ higher amount of capital for their invetsments.

5. Conclusion

The practical contribution of this research may be to help policymakers promote and create good entrepreneurship policies and environment. Although weak legal protections and contract enforcement may force entrepreneurs and investors to have strong ties/relationships, it is not an institutional solution. Institutional rule based environment could extend the scale and scope of angel investors. The legal environment in Turkey for venture capital market is introduced with the national act of 2013. Since then the market has soared quickly. This is evitable in the number licensed angel investors, number of business angels and amount of angel investments. It is widely accepted in the literature that venture capital and business angels provide significant contribution in economic growth and technological advancement. Hence, the policymakers in Turkey ought to notify the importance of venture capital and provide a strong support for the enhancement of the ecosystem.

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