Informal Venture Capital in the Czech Republic: An Empirical Study

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Abstract: Business angel investments are considered to be the most important source of early-stage equity capital for small- and medium-sized enterprises in the US as well as in some other West European countries. In the Czech Republic, it is difficult to obtain any estimates of business angels’ activities. In order to encourage the development of the market, this explorative survey addresses filling the existing survey gap concerning the following characteristics of the Czech informal venture capital market: Who is a typical business angel in this market? What industries do the BAs invest in? What is their experience with partners, i.e. investee enterprises, universities, technology parks, business angels networks, venture capital funds etc.? What are their key motives for conducting venture capital investments? In many aspects, the findings of this study conform to the results of previous studies carried out within the conditions of developed markets. In other aspects, however, they show certain differences.

Key-Words: Venture Capital, Business Angels, Supporting Start-Ups, Central and Eastern Europe.

1 Introduction
Small- and medium-sized enterprises are the backbone of the EU economy and innovation; employing more than two-thirds of the workforce and generating more than half of its added value [17]. The emergence of new innovative enterprises is considered key to strengthening competitiveness in a knowledge-based economy.

When financing knowledge and technology transfer through the creation of spin-out companies from survey institutions, there is a ‘Valley of Death’ to be crossed. This term refers to a decline in the availability of financial resources for the development of innovative ideas during the survey and development stage of market implementation. During the various stages in creating a spin-out – such as proof of concept, protection of intellectual property, creation of the new company, market survey and take-off – it is no longer possible to make use of public resources to fund science and survey. From the perspective of standard corporate financing, business plans such as these are too risky or too small (the issue of shares and bonds, bank loans, formal private equity and venture capital). A lack of financial resources makes it difficult to set up new, technologically oriented companies and ultimately hinders the flexible adaptation of a national economy to world technological trends and, consequently, also hinders the growth of its competitiveness.

In advanced market economies, a lack of conventional sources of financing during this life stage of a company is, in addition to the various forms of state subsidies, covered by the use of formal and informal venture capital. The venture capital market, as a part of the private equity market, is primarily devoted to equity or equity-linked investments in young growth-oriented ventures. The venture capital market consists of two main segments: institutional venture capital (also called ‘formal venture capital’), and informal venture capital [10].

Venture and development capital is traditionally associated with the USA and the UK, from where private investment in various forms began spreading around the entire world.

Just as in other Central and Eastern European countries, private equity and venture capital investment in the Czech Republic did not appear until after 1990. Private equity and venture capital funds (representing formal venture capital) made investments worth €193 million in the Czech Republic in 2010 [4]. That is the equivalent of 0.13% relative to GDP (i.e. 42% of the EU average). However, it is difficult to obtain any estimates of business angel activity in the Czech Republic because, just as in other countries, there is no
published or comprehensive listing of informal investors.

Riding [19] highlights that business angel investments as ‘the single most important source of early-stage equity capital for small- and medium-sized enterprises’ in the US as well as in other countries.

It appears that it is thus necessary to implement projects that support the development of this strategy of corporate financing, because filling this identified gap will facilitate the availability of financial resources for the creation and development of technology businesses and thereby ultimately enhance the competitiveness of the economy of the Czech Republic.

2 Problem Formulation

The past two decades have witnessed a worldwide rise in the importance of funding early-stage entrepreneurial ventures through business angels. This segment of the informal venture capital market has been the subject of many empirical studies in advanced market economies [e.g. 1; 2; 3; 5; 6; 7; 8; 10; 11; 15; 13; 14; 19; 20; 21; 22; 23].

Under the conditions of emerging capital markets in Central and Eastern European countries, both theory and corporate practice grapple with an absence of empirical results.

This paper addresses the following issues connected with the Czech informal venture capital market: Who is a typical business angel in this market? What industries do BAs invest in? What is their experience with partners, i.e., investee firms, universities, technology parks, business angel networks, venture capital funds etc.? What are their key motives for conducting venture capital investments?

2.1 Survey Methodology and Data Sources

The purpose of this empirical survey is to gain a greater understanding of the Czech informal venture capital market. Therefore, the nature of this study is explorative. It relies on primary data that were collected using semi-structured interviews, i.e., it does not test a specific hypothesis. The authors explored a list of key issues to be covered. The main topics were adopted from a survey conducted by Stedler and Peters [20; 21], though personal interviews with business angels contributed to reshaping the questions.

Collecting a sample of business angels operating in the Czech Republic is a great challenge because there are no official statistics and business angels want to retain their anonymity. Therefore, only some experts’ estimations exist regarding the size and characteristics of the population. The authors of this study rely on such experts’ estimations and suppose there are not more than 10 business angels in the Czech informal venture capital market.

The obtained sample was collected during the time period from September 2011 to January 2012. The obtained data comprise 6 business angels. The sample has been collected asking mentors at StartupYard, South Moravian Innovation Centre and Technology Transfer Office at the Czech Technical University. The sample is clearly very small in comparison to most studies in the informal venture capital market conducted abroad. However, we should consider the small degree of development of the informal venture capital market in the Czech Republic and the small amount of existing knowledge about this market.

Most questions were open-ended. Open-ended questions allowed for the obtaining of extra information, e.g. individual opinions or comments on the subject, and may be a good basis for designing a quantitative-based survey on the Czech informal venture capital market in the future. In some cases, the questions were answered only partially. This was due either to the time-consuming nature of the interviews or by the sensitive nature of the questions.

The following main steps were undertaken to analyze the qualitative data: After reading through the responses, response categories for each surveyed part were developed. For example, with the question asking for respondents’ personal characteristics, the information was grouped into categories such as ‘region of operation’, ‘gender’, ‘the respondent’s current career’, ‘the respondent’s experience with investments in unquoted enterprises’, ‘the inspiration leading the respondent into venture capital investments’. By dividing the responses on content into categories, the trends in the data and the main issues raised by respondents could be highlighted. The following discussion explains the data analysis results in order to draw some specific issues existing in the Czech informal venture capital market. The results are also compared with the results of similar studies conducted under conditions of well-developed informal venture capital markets.

3 Empirical Findings

The following empirical findings are the basis for a discussion on the implications for future surveys.

1 Chodák (interview, Prague 9 November 2011).
3.1 Personal Characteristics
The sample of respondents represents business angels investors – exclusively men living or working in the Czech Republic. During the data collection process, it was not possible to contact the only woman, an investor, but the growing proportion of businesswomen and female entrepreneurs in the Czech Republic presupposes their existence.

In terms of age, BAs fall into two categories: the first category of respondents are those over the age of 50, and the second are aged 30-35 years if age. A private investor may thus be a relatively young person (30-35 years of age) who is able to offer his know-how despite having a short professional career. In this context it is really necessary to emphasize the fact that the ‘young’ investors are exclusively linked to the dynamically developing field of information and communication technologies.

All of the contacted BAs are economically active and work in corporate management, whether for their own or a foreign enterprise. Four of the respondents work in the field of information and telecommunications technology, one respondent is active in the field of Life Science and one respondent deals with trade and catering. Survey results suggest that BAs invest in sectors in which they have acquired some know-how during the course of their professional careers, usually in positions of company management, and also in the areas of design, survey and development, marketing, trade, logistics, financial management, commercial law and human resources. In terms of professional experience, a typical business angel is a manager (a general manager) with professional experience gained from having been in various positions of corporate management. It can be assumed that business angels play an important role not only as providers of venture capital, but also as providers of competences, e.g., 'value added' in the sense that they contribute their experience in addition to equity. The importance of the role of BAs with regard to the needs of start-up companies has been emphasized by studies such as EBAN [26]. Among other important findings is the fact that the majority of BAs in the Czech Republic are not, unlike in the US and other developed markets, ‘full time’ investors.

When contemplating private investments, BAs get inspired during the exercise of their profession both in the Czech Republic and abroad. While searching for investment opportunities (deal flow), an important role is played by contacts that BAs have made with domestic and foreign business partners and contacts established through social networks, blogs, and other forms of electronic communication. Survey results in this direction point out the inadequate functioning of institutionalized business angels networks and networking within the Czech Republic, which, within the conditions of developed markets, enable the necessary exchange of contacts and experience, as well as matchmaking innovative businesses with investors.²

3.2 Value of Investments and Investment preferences
BAs prefer investment projects in fields in which they have been successful as managers or owners in previous years and in which they have already built their own network of contacts. Thus, there is a correspondence between professional experience and the preferred field in terms of investment decisions. The BAs involved in this study have a greater tendency to focus their investment interests on dynamically developing business areas such as communications, computer and consumer electronics and life sciences.³

All of the interviewed investors consider the start-up stage to be the right time to implement capital injection; only two respondents have been interested in the past in a company going through the expansion stage. BAs do not support financing business in buyout (MBO/MBI), growth or bridge phases, which is in accordance with the definition of private capital. According to data provided by BVK [4], VC funds in the Czech Republic supported a total of 15 projects in 2010, of which seven businesses were going through the buyout stage, five companies were in the growth stage, one company in later stage venture, and only two projects in the start-up stage. It can thus be concluded that BAs and VC funds behave complementarily with regard to supporting company life stages.

BAs are by definition wealthy persons who, in order to diversify risk, invest part of their assets in risk and development projects (investments in unquoted companies). The results of the survey indicate that the share of private investments in the asset portfolios of BAs in the Czech Republic are

²Entities in the Czech Republic focused on the institutionalized matchmaking include Business Angels Czech and Business Angels Club Brno. The South Moravian Innovation Centre is also intensively active in activities regarding this field on the market.

³The dynamism of these business sectors in Europe and the Czech Republic have been confirmed by the EVCA Yearbook 2011/PEREP Analytics [25].
usually in the range of 10 to 30% (proportion of venture capital investments in the net worth); only one investor indicated a value higher than 50%. This share corresponds to the data published in a study by EBAN [26], according to which the proportion of investments by BAs in unquoted businesses without family connections is around 11%. The relatively high proportion of declared wealth in the form of shares in unquoted companies indicates strong investor confidence in the success of financed enterprises and their ability to correctly evaluate investment opportunity (experience-based due diligence).

To date, most investors have participated in the execution of 5 to 10 deals, during which time the value of the individual investments (investment per deal) range in the hundreds of thousands of Czech crowns rather than millions. That is less than shown by foreign survey, but it is necessary to take into account the fact that the low level of individual capital investment in the Czech Republic corresponds to the preferred field of business, which is the low-cost field of information and communication technologies. Stedler and Peters [20, 21] estimated an average deal size in Germany between €10,000 and €200,000. Riding (2008) reports that an average deal size in Canada was of $113,900 in 2005. According to the EBAN study [26], ‘BAs generally invest €25,000 to €250,000 in individual businesses – up to €400,000 in the UK’.

The BAs are in agreement that the roots of an investment’s success are in a business idea that is supported by a well thought-out business plan, the timing of the project with regard to favorable conditions on the corresponding market, and the implementation team.

3.3 Evaluating Partnerships
The BAs indicated that their relationship with the supported businesses was generally ‘good’ in cases when their exit took place within a time horizon of approximately 5 years and their investment was found to be successful (i.e. the return on their investment was ensured and the desired degree of appreciation of the capital investment was achieved). The BAs also point out the importance of the personal relationship between the managers of the supported businesses and the investors at each stage of the investment.

When evaluating the investors’ cooperation with other possible partners – such as universities, technology parks, business incubators, business angels networks, chambers of commerce, VC funds, public administrations and other partners – the views of the BAs significantly differ. Some investors consider cooperation with universities and business incubators to be desirable and beneficial, as ‘innovative ideas are born here’. The second group of investors, however, can see only other private investors as possible partners with whom it is possible to create an informal network and share contacts and services. VC funds (potential competitors) and public administrations (a sector placing obstacles) are perceived rather negatively. The results of the survey show that an emphasis is placed on the need to network in order to effectively manage cooperation with potential partners. Most investors are registered on the LinkedIn network.

3.4 Investors’ motivation for conducting informal venture capital projects
The motivation of BAs is both financial and non-financial in nature. The main motive is financial and is given by the degree of appreciation of the capital investment (Return on Investment). The prevailing non-financial motive is the effort of investors to assess their managerial experience. Some of the interviewed investors also consider it important to support and cultivate the business environment within the region through their activities and they see private investment as an opportunity to become members of the wider business community. Most of the investors see private investment partly as their hobby.

With one exception, the investors are not motivated by the desire to take great business risks; on the contrary, private investments are considered as a way to diversify the risk of the investor’s asset portfolio. None of the BAs are interested in a majority share of the capital stock of a supported business.

It can be concluded that the motives of the respondents toward private investment in their essential character corresponds to the motives mentioned, for example, by Stedler and Peters [20, 21]. Among the motives of greatest import are the investment’s profitability and the utilization of their experience for the development of the company. In accordance with the literature, it has also been found that BAs do not seek to acquire a majority share of the capital stock of the financed businesses.

4 Conclusion
This explorative study has examined the Czech market for informal investments. Under the conditions of the informal venture capital market in the Czech Republic, this study has been one of the first descriptive analyses of the personal
characteristics of informal investors, the nature of informal venture capital investments and the factors influencing investment activity on the informal venture capital market.

It was found that a typical business angel is a wealthy male general manager with professional and entrepreneurial experience and specialized know-how. Some findings are not consistent with previous descriptive survey [e.g. 5; 9]. Moreover, it was found that a typical business angel is not exceptionally middle-aged, i.e., a 35-65 year-old man or woman [26]. Another category of informal investors are young predominately male investors (aged 30-35 years) with entrepreneurial experience in information and communication technologies. In this respect, the results from the Czech market survey indicate agreement with the survey by Maula et al [15], according to which ‘attitudes, experience, and skills matter more than demographics such as income, age or education in explaining the propensity to make informal investments’.

Another aspect that distinguishes BAs in the Czech market from the traditional investors that are known, for example, from the USA, is that the vast majority of domestic BAs are not ‘full time’ investors.

Another point with which the survey results match the results provided by, e.g., the EBAN study [26] are issues of financial and non-financial motives of private investors and of preferred areas of business (industries).

The fundamental financial motive of BAs is to maximize the return on their investments. The key non-financial motivation of BAs is to contribute their expertise in business management and personal network of contacts in supporting the development of investee enterprises. BAs do not usually seek to acquire a majority equity stake in the financed enterprises. Private investment is also seen as a way to diversify investors' asset portfolios.

The results of the survey indicate that there is a correlation between a private investor's professional experience and the field in which they carry out the investment project. The focus of investment interest of the interviewed BAs, in most cases, are in dynamically developing fields of business (industries with a strong potential for entrepreneurial growth that offer the prospect of a very substantial return on investment) such as communications, computer and consumer electronics and life sciences.

The value of the individual investments (investment per deal) in the Czech Republic is at a lower level than provided by, for example, the EBAN study [26]. Conversely, the share of private investment in the asset portfolios of domestic BAs (10 to 30%) is, in principle, comparable with the results of this study.

The relationships between the investors and the financed enterprises are largely perceived as ‘good’, while respondents place an emphasis on the importance of the personal relationships between the managers of the supported by businesses and the investors at each life stage of the investment.

As far as being able to make generalizations about the aforementioned conclusions is concerned, it is necessary to point out that the survey results are based on the analysis of primary data collected from a very limited number of respondents. It is thus necessary to view the survey primarily as a starting point from which additional studies can be carried out with a greater number of respondents in areas which appear prospective on the basis of the survey results:

- mapping the BA market in the Czech Republic in terms of the number of investors, their personality profiles, the nature and the volume of investments;
- acquisition of projects (Deal Flow),
- criteria for evaluation of business plans (Due Diligence),
- the monitoring of projects, especially with regard to the control mechanisms used (Monitoring),
- opportunities to stimulate private investment by the state regarding the supply and demand of informal venture capital, etc.

Any survey results for individual areas may then be the subject of an international comparison, especially in the context of individual market regions within the CEE, or select small European economies.

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http://www.bvkap.de/privateequity.php/cat/154


