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The potential of angel investing in Entrepreneurship-Through-Acquisition

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Summary

While the investment activities of business angels are primarily associated with startups, they also invest to a notable extent in the entrepreneurial acquisition variant of company formation ("Entrepreneurship-through-acquisition" or ETA). However, these activities have not been specifically examined scientifically, and angels are not generally considered a typical resource for individuals seeking financing for the purchase of a small or medium-sized business. The findings of our study on angel investing suggest that the more knowledge angels possess about the various forms of ETA, the more inclined they are to invest in such transactions. Overall, our insights indicate that business angels represent a financing potential for business succession in the German SME sector.

Business angels and informal investors play a crucial role in financing entrepreneurial ventures. Previous empirical investigations have particularly focused on investments made by angels in early-stage startups. However, there is scant evidence that substantial investments from angels also flow into startups in later stages, established firms, as well as management buy-ins and buy-outs, or turnaround cases. Furthermore, Shane (2008) notes that angels tend to invest in more mature private companies to a significant extent. As an advantage of angel investments compared to financing through banks, one can mention the less bureaucratic examination process and the faster decision-making process. After all, angels invest their capital. Additionally, angels are considered investors willing to contribute their knowledge and network to the target companies. For a new entrepreneur, this can be helpful in managing a small or medium-sized business. On the downside, higher financing costs associated with angel investments can be mentioned, particularly differing significantly from debt capital costs.

The acquisition of an existing business presents an alternative entry point into entrepreneurship (Kent, 2022; Pinkwart et al., 2005). Entrepreneurs engaging in entrepreneurship through acquisition (ETA) acquire companies by purchasing the shares of the existing owners and assuming management control themselves (Kent, 2022). Therefore, the entrepreneurial process of opportunity recognition, evaluation, and exploitation differs from that associated with the establishment of a new business (Fueglistaller et al., 2016; Kent, 2022). ETA can take various forms, from management buy-outs to management buy-ins and search fund models. The latter two subtypes of ETA involve entrepreneurs acquiring shares in a company without prior involvement in its management. ETA, in general, is a less-explored topic, differing in various details from the research focus on business succession. Succession specifically pertains to family businesses, whereas ETA transactions can involve carve-outs or businesses no longer in family ownership. The question of how ETA opportunities are financed and who finances them has received little research attention thus far (Kent, 2022). For this reason, we examined the inclination of business angels from Western and Northern Europe (Sweden, The Netherlands, Germany, Austria, Switzerland) using an online survey, in which 94 angels participated.

Knowledge and investment inclination of angels

Most participants were already familiar with Management Buy-Ins (MBI) before this study, and there is a certain level of awareness about MBI within the business angel community. Overall, 17% of participants had already invested in MBI. Regional differences were observed, although they cannot be considered representative: while 29% of German respondents had made MBI investments, the figures were 18% in the Netherlands and only 5% in Sweden.

Considering that more than one-sixth of angels were involved in Buy-in investments, we recommend: a) that future research on angel investments should incorporate this MBI perspective, and b) that angel financing be considered as a potential funding source within the context of an MBI. In contrast, the majority of respondents are not familiar with Search Funds, which have been infrequently conducted in Europe and are still more of an American phenomenon.

Furthermore, based on linear simple regression, our results suggest that MBI investments could be viewed as a potential contribution to diversifying angels' portfolios. Should further studies establish a more robust connection, Buy-in entrepreneurs could use these insights to tailor their fundraising pitches and promote their MBI ambitions as a means of portfolio diversification to angels. Additionally, we advise MBI enthusiasts to educate business angels about MBI, including typical success rates and returns. According to our hypothesis testing, buy-in-specific knowledge is a crucial factor in openness to MBI investments and has a positive influence.

Angel investments, corporate transformation and risk

Our findings suggest that business angels can play a more significant role in supporting management buy-ins, especially in the context of business succession. In this regard, it is advisable to expand the tax and financing benefits that angels can utilize under the INVEST program to include succession investments. Particularly in small and medium-sized enterprises that are a few years away from a succession solution, the challenge of a lack of modernization coupled with an investment backlog has been observed. We suspect that business angels, who typically invest in dynamic, potentially disruptive startups, bring a certain expertise in transformation. Thus, they could serve as valuable sparring partners for the new management of small and medium-sized companies facing challenges such as organizational transformation or digital transformation.

The tax and financing benefits that angels receive for providing venture capital to young startups are mainly associated with the riskiness of these investments. It can be argued that MBI and search funds, compared to a family-internal or company-internal succession solution via a management buy-out (MBO), are significantly riskier, partly due to the issue of information asymmetries. While around 5% to 6% of companies fail in the context of an MBO, where internal employees or managers take over the company's leadership, these rates are notably higher in MBI (5% to 9%) and search funds (10%) (the ranges refer to different study results). Therefore, increased risks accompany investments in external business acquisitions.

Combining this discussion with available management or industry expertise and potentially faster and less compliance-laden financing, it emerges that business angels can provide a valuable financing contribution for small and medium-sized business acquisitions and successions — and are already doing so in practice. Given the importance of securing the broad entrepreneurial Mittelstand in Germany, we recommend further investigations. These should focus on how angel financing can be made more attractive as a complementary financing option in business succession. This could help strengthen the role of business angels as a valuable source of funding for small and medium-sized business acquisitions and successions – a role they already partly fulfil in practice.

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