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**CANADIAN INFORMAL INVESTORS:
TOWARDS A FRAMEWORK FOR POLICY INITIATIVES**

by
Patrizia E. Dal Cin, B.Comm (Honours)

**A thesis submitted to
the Faculty of Graduate Studies and Research
in partial fulfilment of
the requirements for the degree of

Master of Management Studies**

**School of Business
Carleton University
Ottawa, Ontario
May 17, 1993**

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ACCEPTANCE SHEET

**The undersigned hereby recommended to the Faculty of Graduate Studies
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Thesis Supervisor

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ABSTRACT

The purpose of this thesis is to describe the characteristics of the informal venture capital market. Information asymmetries make the informal market inefficient. Analysis of investors' reasons for rejecting projects indicates that the market is somewhat efficient once information asymmetries are overcome. The effectiveness of informal networks as communication channels provides evidence that markets are not dysfunctional. The investigation is performed at both national and regional levels, with conforming findings. Very high rejection rates among investors suggest that a perceived equity gap may be due to a lack of quality investment opportunities. Investors' motivations, expectations, and risk reduction strategies reveal that informal venture capital is intelligent, patient capital.

Wealth differences between investors and non-investors help explain why new entrants are unlikely to be motivated by tax incentives. As an inducement to increase their investing activity, investors' recommendations to tax incentives tend to focus on capital gains related issues.

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1. INTRODUCTION

Small- and medium-sized businesses (SMBs) have been a vital component of the economic engine of this country. 80% of new jobs created in Canada from 1978 to 1985 were by firms with fewer than 50 employees (Sahu, 1988). The Premier's Council of Ontario and the Ontario Chamber of Commerce have both provided evidence that new firms perceive that a lack of equity capital is a major obstacle to new firm development and job creation. This, in a sector which accounts for a majority of new job creation, demands investigation and remedial action.

Companies usually require expansion capital beyond that of their earnings in order to grow. Small, young companies often find it difficult to obtain financing from banks without collateral. The venture capital industry evolved in order to provide financing for new firm development and expansion. The attractions are the large gains accrued to investors when opportunities develop into successful companies. However, the industry is also known for its substantial levels of risk and its financing of failures.

The sources of venture capital include: professional venture capital firms, merchant banks, pension funds, large corporations (usually in the form of investments in joint ventures), venture capital divisions of banks, and private individuals. The Association of Canadian Venture Capital Companies (ACVCC) represents the institutional side of the industry, and provides information to interested parties on the activities of its

members¹. Private individuals do not form part of this association. As a result, they are part of a separate informal venture capital industry which is considerably less visible and structured. This marketplace has also been described as fragmented (Wetzel, 1986), in large part due to its local and personal characteristics and the absence of an identifiable, centralized arena for exchange.

Many SMBs do not have the profitability history, nor the asset base required to obtain loans from banks for expansion purposes. The more well known institutions of the venture capital industry typically do not undertake opportunities that require investments of under \$1 million. Often, the only recourse available to the founders of new companies requiring financing of under \$1 million is private individuals, also known as business angels, or informal investors. The study of this informal marketplace is the focus of this thesis.

Angels are known to be the catalysts for growth (Wetzel, 1981; Gaston and Bell, 1986; Short and Riding, 1987; Freer and Wetzel, 1990). Efforts to increase the number of angels through government policy have also been undertaken, for example, by the government of the United Kingdom (Harrison and Mason, 1991). Angels are known to invest their time as well as money in ventures (Wetzel, 1981) with the hope of nurturing them to a size and stage that alternative sources of financing may be provided by larger venture capital players. They may be considered the "front line"

¹ This promotional role of the ACVCC solicits business for its members while simultaneously providing a link for entrepreneurs to the professional venture capital industry.

of venture capital because they are the closest source of financing to the entrepreneur since they invest in earlier stage ventures.

The purpose of this thesis is to describe the private venture capital market in Canada. Analysis is executed at both the national and regional levels. A better understanding of the informal venture capital marketplace will benefit entrepreneurs, researchers and policy-makers alike. Entrepreneurs will gain valuable knowledge of the financing tiers, while simultaneously introducing them to a valuable, yet unfamiliar source of equity. Researchers will benefit from a study that reports national findings of the characteristics of the private venture capital market in Canada. By incorporating the characteristics of the marketplace into the recommendations, the thesis will provide policy-makers with initiatives that will be effective.

2. BACKGROUND

Angels perform many socially desirable functions. They invest in, and nurture small businesses with growth potential, thereby creating employment, increasing the tax base and raising the standard of living. In addition, they are perhaps the key to closing what is perceived to be an equity gap². Wetzel (1987) acknowledges that although there is no concrete evidence of a gap, perhaps gaps are "at least in the minds of entrepreneurs" (p.305). He goes on to say that gaps may be a function of inefficient markets. Informal markets are susceptible to inefficiency because sources of funds/opportunities are not fully and freely available to sellers/buyers of capital. In Canada, both the Premier's Council of Ontario and the Ontario Chamber of Commerce provide evidence to suggest that at least new firms perceive that there is a lack of equity. Ernst & Whinney (1985) also allude to the notion of a gap and the modification of the Small Business Development Corporation (SBDC) program to ameliorate the gap. Yet, the gap may exist, or be perceived to exist, only because the informal venture capital market does not have a centralized marketplace. However, informal networks could provide an alternative marketplace.

² An equity gap, or a capital market gap is a result of a market not in equilibrium. It is a shortage or absence of financing available for certain assets despite a fair return offered for risk assumed. The verification of the presence of a capital market gap is beyond the scope of this thesis. The existence of a gap will be assumed, however it may not be a "traditional" gap, where no financing is available to a certain sector. Rather, a gap could exist as a gap in communications or a dearth of alternative or viable opportunities.

Riding and Short (1987) report that angels have a sufficient deal flow. Together with the belief that new firms perceive a lack of equity, the perceived gap in the venture capital marketplace may be a result of a lack of quality investment opportunities rather than an inadequate supply of equity. Nonetheless, if there is indeed a shortage of equity, then government could intervene to offer incentives to individuals to enter the informal marketplace because it is estimated that only 1 in 20 potential angels are active in Canada (Short and Riding, 1988).

Previous research in the U.S. has only succeeded in documenting very superficial characteristics of informal investors. In Canada, the only published research (Short and Riding, 1987; 1988) is based on a small sample of investors and is limited to the Ottawa-Carleton region. It, too, documents only superficial characteristics. Little is known about informal investors' investing activity: motivations, referral sources, criteria for investments. This thesis seeks to inform public policy by identifying attributes of these and other characteristics using a large national study of investors and others. This exercise is necessary in order to evaluate effectively potential policy initiatives to ensure that they are compatible with marketplace.

3. PROBLEM STATEMENT

The primary objective of the thesis is to provide documented evidence regarding the characteristics of the informal marketplace in Canada. Evidence will be analyzed to assess possible reasons for an equity gap. Once the reason(s) for a gap is established, policy incentives to improve the informal marketplace will be proposed. Hence, policy recommendations will go beyond the tax system and be contingent on the reason for a gap. From informal investors' comments, which may be considered "expert opinion", the thesis will identify policy directives that may be used as an agenda for potential policy initiatives, with the intent of increasing the supply of equity available to SMBs.

4. LITERATURE REVIEW

4.1 Theoretical Review

The theories surrounding the informal market, and consequently private venture capital, are discussed next.

4.1.1 Stages of Financing

Freer and Wetzel's (1990) examination of the financing history of 284 new technology companies supports the following conclusions. Private individuals are more active than professional venture capital firms in the seed and start-up financing stage³. In the first-, second- and mezzanine stages of financing venture capital funds are more active than individuals. The authors also found that most entrepreneurs were forced to seek outside equity financing at the seed stage. They conclude that individual and professional venture capitalists play a complementary role in the financing of new ventures.

Similar findings have been reported in Canada. Jog and Schaller (1991) report that private⁴ sources of financing are more important than the securities market for SMBs.

³ For a discussion of stages of financing, please refer to Appendix B.

⁴ Private sources include: affiliate finance, banks, professional and private venture capitalists.

The risk associated with each stage of financing is directly related to the size and age of the company. Angels, despite (or a consequence of) their experience in early stage investments describe pre-start-ups and start-ups as most risky (Wetzel, 1981). Early stage and young firms follow, and finally established firms are perceived to be the least risky. Harrison & Mason (1991) used Wetzel's technique for measuring risk and found similar risk perceptions for U.K. investors. Freer and Wetzel (1990) concluded that since informal investors continue to invest in the earlier stages of new ventures, they exhibit less risk aversion, and more patience than their professional counterparts.

Ruhnka and Young (1987) found that venture capital firms in the U.S. expect, on average, an annual rate of return between 55-73% for seed and start-up financing and 35% for the later stages of development. The higher rates of return for the earlier stage investments reflect the demand for compensation for assuming additional risk; in other words, a risk premium.

Aside from risk, there is another reason for demanding a higher premium from companies in the early stages of development. Robinson (1987) reports that U.S. venture capital companies, on average, devote 31 person-days per year to each firm in a portfolio. Furthermore, Gorman and Sahlman (1989) reported that earlier stage investments undertaken by U.S. venture capital companies require more active involvement. Ruhnka and Young (1991) view participation in the management of the venture as a risk reduction strategy. Often angels sit on Boards of Directors in order

to provide a mentor role for the entrepreneur (Wetzel, 1983; Dal Cin, 1992). All evidence of early stage investments alludes to the notion that investing in early stage companies is anything but passive. Therefore, the high rate of return demanded is not simply a risk premium, but could in fact be partial compensation for the effort required to oversee the investment.

Sapienza (1992) found that venture capitalists provide value-added capital to the ventures they finance, regardless the stage of financing. Moreover, the more innovative the venture, the more beneficial the venture capitalist's involvement. This finding supports the belief that the technically oriented entrepreneur has a strong technical background but lacks management skills. Venture capitalists are able to complement the entrepreneurs skills and perform boundary-spanning functions⁵ (Gomez-Mejia *et al.*, 1990).

4.1.2 Capital Market Gap

In principle, SMBs may obtain financing from a number of sources:

- personal savings or savings from friends, family,
- informal investment markets,
- professional venture capital markets,
- chartered banks, and
- public equity markets.

⁵ Boundary-spanning functions include financing, marketing, and other activities that are apart from the technical aspects of a product, but are essential to the operations of a business.

The entrepreneur must search out external equity financing once the supply of funds from friends, family, and life savings has been exhausted. A bank loan is often unattainable because of a lack of collateral. Informal investment markets provide a viable alternative for such entrepreneurs.

Professional venture capital firms seldom undertake opportunities that require investments under \$1 million. Knight (1985) reported that "too small" was one of the most common reasons cited by professional venture capital companies for rejecting ventures presented to them. Small investments are less likely to have the potential to grow to provide the *dollar* return required to justify involvement by venture capitalists. The time, effort, and cost required to complete a due diligence process varies little with the size of the investment. Also, investments that need small amounts of financing are earlier stage investments and require more *patient* capital than venture capitalists are usually willing to provide. Mary Macdonald & Associates (ACVCC, 1992) report that only 11% of venture capital in the country was invested in start-up companies in 1991. They state that a preference for more mature companies is developing in the industry.

The cost of preparing a prospectus and the underwriting fee for public offerings is quite high (Smith, 1986) due to the fixed elements in the cost. Also, an additional cost is imposed because Canadian initial public offerings, on average, are underpriced (Jog and Riding, 1987). The Economic Council of Canada (1982) reports that issuing

costs are highest for SMBs because the cost of an issue is inversely related to the size of the issue and the characteristics of the issuing company. The listing requirements for the Toronto Stock Exchange are quite onerous (Riding, 1989). Thus, public financing is only a viable option for a very few successful SMBs. Often SMBs require mezzanine financing, usually from institutional venture capitalists, before a public offering becomes feasible.

The over-the-counter (OTC) market in Canada continues to be a problem for SMBs wishing to go public (*Canadian Business*, 1991). Although it may provide a stepping stone for companies not yet large enough to qualify for listing on the TSE, it provides most investors with a false sense of liquidity since most stocks are thinly traded. Thin trading seems to be the major defect in the OTC market.

It appears that banks, professional venture capital firms and public equity markets operate at mainly the high-end of the market. Moreover, institutions which have historically operated at the low end currently appear to be focusing on mezzanine financing, buyouts, and private placements. Even the average size of bank loans have increased significantly over the 1987-90 period (Haines *et al.*, 1991). Private venture capital, or the informal investment market has often been overlooked by entrepreneurs as a potential source of financing because as Wetzel (1983) put it, it is "virtually invisible". Yet, the pool of capital provided by informal investors is

estimated to be two or three times larger than that represented by the formal venture capital industry in the U.S. (*Financial Times*, 1992).

Since the traditional sources have moved to the higher-end of the market, and the informal investment market is not well known, there is a notion of a "capital market gap".

4.1.3 Market Efficiency

A capital market gap may very well exist because there may not be an efficient capital market on which investments can be traded. By definition, an efficient capital market consists of external (or pricing) efficiency and internal (or operational efficiency). There is external efficiency when the price of a security reflects all relevant information. This condition is necessary if "price" and "value" are to coincide. There is internal efficiency when securities are able to be traded with speed and at a relatively low cost. Together, these elements allow funds to be efficiently allocated to investments that are the most deserving, in other words the ones that yield the highest risk-adjusted rate of return.

In terms of the informal market, internal efficiency cannot be assumed because investments are not traded with ease. Often, an exit is impossible in the short-term and even over the longer term. Moreover, there are high costs associated with entry

and exit. Search costs, or due diligence, are required to enter a venture. Investors often only realize their return upon exit, incurring transfer of ownership costs.

Also, because of severe information asymmetry and lack of active trading, informal markets are not externally efficient. Yet, while informal markets are neither internally nor externally efficient, it cannot be concluded that the price demanded by angel investors is not fair or "correct". Entrepreneurs may claim that investors' demands are unreasonable. However, using preliminary data, Dal Cin (1992) reports that Canadian investors' rates of return are comparable to those of their U.S. counterparts.

Grossman and Stiglitz (1980) relate information asymmetries to market efficiency. They state that the efficiency of a market is contingent on the number of informed investors in the market. If the number of uninformed investors is large, then the price may not reflect the true value of the asset. Wetzel (1981) goes further to say that an efficient market requires fully informed investors *and* entrepreneurs. Asymmetries in the informal venture capital market may be symptomatic of a dysfunctional marketplace in that this market lacks a centralized clearing facility with regard to both information and trades.

4.1.4 Information Asymmetry

Akerlof's (1970) evaluation of the market for used cars illustrates how information asymmetry relates to market efficiency. He shows that in the presence of information asymmetry, the buyer of a good assumes that it is defective, since it would have otherwise already been sold. Leland and Pyle (1977) go further to say that information asymmetries may result in poorly performing markets. They explain that entrepreneurs possess "inside information". They know the quality of their project and their capabilities; in other words, the "true" value of their company^{*}. Potential investors must be wary of information communicated to them by entrepreneurs since there may be rewards for exaggerating positive qualities or not disclosing certain information. Since investors cannot distinguish between high and low quality investments (without investigating each opportunity), the market sets an "average" quality. If the average quality is set too high, entrepreneurs could introduce low quality projects to an uninformed market and make a profit. If the market assigns low average quality, then even high quality investments will not be financed because of the high cost of capital. They hypothesize that when substantial information asymmetries are present and the proportion of poor quality projects in relation to high quality projects is large, venture capital markets may fail to exist.

Gaston and Bell (1986) identified the primary problem of the informal marketplace as the inability of investors and entrepreneurs to locate and communicate with each

^{*} objectivity is assumed

other; in other words, lack of information transfer which results in information asymmetry.

In order to correctly assess a project's quality, and eliminate information asymmetries Leland and Pyle (1977) state that information transfer must occur and a due diligence process to verify an entrepreneur's information must be executed. Due diligence is a however, a costly exercise.

4.1.5 Search Costs and Lead Investors

Gorman and Sahlman (1989) define a lead investor in the professional venture capital industry as an investor who has invested at the seed or start-up phase⁷. They discovered that one of the primary roles of a lead investor is to help obtain additional financing when they decide to invest (to spread the risk), and in subsequent rounds of financing (to protect their initial investment). Their definition of a lead investor is at variance with that in the private venture capital market due to the differences between the private and professional venture capital industries. Private lead investors may or may not be involved in the initial stages. They are lead investors who actively back the venture with their own funds and who act as a focal point for assembling additional funds from other outside investors. Given the time horizon of venture capital, these individuals may or may not provide subsequent financing but are unlikely to have cashed out. If the lead investor has not provided subsequent

⁷ For a formal definition of a lead investor, see Appendix A.

refinancing, often the search for new sources will be taken on to protect the initial investment. Therefore both definitions are related.

In a venture capital market where all investors have positive search costs, only inferior investments will be offered by entrepreneurs; investors will eventually exit the market and choose to invest in risk-free assets (Chan, 1983). Given Chan's hypothesis, zero-cost investors are crucial to the integrity of the informal marketplace and its existence because they encourage investors to bring only their best projects to the market. Lead investors reduce information asymmetries by undertaking the due diligence process. They create zero-cost investors two ways. First, Lead investors may be regarded as zero-cost investors in Chan's context because of their ability to pass back information costs to the entrepreneur in the form of a higher return on their investment⁸. Lead investors also are the focal point for financing, introducing investors of their acquaintance to the venture, thereby offsetting the co-financiers due diligence costs, thus creating zero-cost investors. This improves the "allocation of resources in terms of the entrepreneurs' efforts and scale of projects" (Chan, p.1551). Therefore, in light of Chan's model, lead investors are the key to maintaining the integrity of the informal marketplace.

Leland and Pyle (1977) also infer that the market will be in equilibrium if there are no costs associated with information. Moreover, lead investors serve on the Board

⁸ I thank Professor Ashwani Srivastava for this argument.

of Directors or Advisors or participate in the management of the venture to ensure that their interests and those the entrepreneur are aligned⁹.

Akerlof (1970) cited institutions such as brand names to reduce quality uncertainty. Similarly, the alignment of a high profile angel will increase the reputation of the entrepreneur and the venture, thereby making the task of (re)financing easier. Therefore lead investors provide a useful service to co-investors as well as to entrepreneurs.

4.2 Empirical Evidence

This section reviews relevant empirical evidence on private venture capital markets and angels.

4.2.1 Profiles

Wetzel (1983) describes angels investors as wealthy, well educated individuals who provide patient money, often to small, technology-based firms, and who have experience in the start-up of new ventures. Short and Riding (1987; 1988) describe a typical Canadian angel to be a 50 year old male with a net worth of over \$1 million and an annual income over \$100,000. He is also well educated, and has experience in start-ups. In addition, he is typically a self-made success in an industry similar to

⁹ see Jensen and Meckling (1976) for discussion on agency theory.

the one in which he invests. With this experience the angel is able to impart valuable management know-how so that the entrepreneur may better manage the company.

4.2.2 Non-financial Returns

May Kay Sullivan (1991) uses cluster analysis to identify three types of investors: "rational economic", "risk managing", and "responsive". The rational economic investor's motives are primarily financial, he is the most risk adverse of the three, and has the shortest holding period. The risk managing investor considers both financial and non-financial motives and uses risk-reducing strategies such as diversification across industries, holding both debt and equity, and investing as part of a group. The responsive investor is the least interested of the three in financial returns and considers societally-beneficial motivations more important than the other two types of investors.

Wetzel (1983) also mentioned that non-financial returns are associated with informal investments. Tymes and Krasner (1983) asked informal investors to substitute non-monetary incentives for financial returns. The most frequent substitutes were: contribution to technology, aid to the entrepreneur and urban renewal. Similarly, Riding (1992) found that informal investors are not solely motivated by financial returns. Rather he found that informal investors are primarily motivated by their need for achievement. This need is satisfied in two ways: through financial gain and the excitement of participating in the creation of a new venture. All previous

findings, however, are based on anecdotal evidence or on small, geographically-limited samples. The suspicions about the importance of non-financial factors remain to be documented in a sample of sufficient size to permit generalizations.

4.2.3 Investment Activity

4.2.3.1 Rejection Rates

Angel investing is characterized by very high rejection rates. Angels in the U.K. invest in 5.7% of all investment opportunities they receive (Harrison and Mason, 1991). Dal Cin (1992) found similar results for investors in Southern Ontario, only 2.6% of investments were financed. More notably, she provides evidence that experience influences the decision making process of informal investors. Typically, older investors will have gained valuable investing experience. Her findings also showed that the number of investments undertaken may be a function of the number of opportunities presented to investors.

4.2.3.2 Geographical Description

Since angel investing has an active component to it, angels often invest "close to home". Wetzel (1983) found that 75% of firms financed by his sample were located within 300 miles of the investor. Riding and Short's (1987) investigation of the Ottawa area investors found that more than 85% of investments were located within 50 miles of the investor. It is possible, however, that these findings are attributable to the geographic isolation of such areas as Ottawa, Boston or San Francisco. Yet,

the geographic proximity may be a consequence of the active component of informal investing. The physical closeness allows an investor easier access to the company for monitoring purposes.

The proximity phenomenon is not exclusive to informal investment portfolios, but also form part of professional venture capital companies' investment preferences (ACVCC, 1992). Furthermore, Sapienza (1992) found a positive correlation between communication and value of venture capitalist's involvement.

4.2.3.3 Holding Period

Wetzel (1983) found that the median expected holding period for angel investors in the New England area was 5 to 7 years. Dal Cin (1992) reports that Southern Ontario angels, on average, expect to hold their investments for 5.9 years. See Table 1 for a summary of research findings on this issue.

Short (1987) reported that 80% of informal investors she interviewed expect to realize their return on investment in the form of a capital gain. Similar results were reported of informal investors in California (Tymes and Krasner, 1983). Given that the company must be nurtured, these results are not surprising. A long time horizon is required to allow the company to grow and develop into an opportunity where an exit is provided by a professional venture capital company or an IPO.

4.2.4 Informal Networks

Wetzel (1983; 1986) illustrates that in the absence of a formal marketplace for informal investments, informal networking will be used to gather sufficient funds to finance new ventures. Tymes and Krasner (1983) support the existence of informal networks by reporting that 78% of informal investors prefer to participate as co-investors; and other informal investors were mentioned by 68% of respondents as preferred partners. Haar *et al.* (1988) explain that co-investors are introduced for two reasons: to share risk and to act as an informal jury to determine the quality of the venture. In addition, co-investors also provide additional human capital (which means more knowledge, experience and contacts) to the business.

Informal networks are composed of friends and business associates (Riding and Short, 1988; Haar *et al.*, 1988). The lead investor concept promotes the notion that although informal networks may be described as being composed of friends and business associates, they are primarily related as co-investors. Wetzel (1983) also described informal networks as imperfect channels for communication. Although they are a substitute for a formal marketplace, they are not efficient and as a result the market is fragmented.

Table 1 has been constructed to provide a concise summary of some salient aspects of the literature findings.

Table 1: Summary of Literature Findings

Region	New England (Wetzel, 1983)	California (Tymes and Kraemer, 1983)	Sunbelt Region (Gaston and Bell, 1986)	Ottawa- Carleton (Short, 1987)	East Coast (Haar <i>et al.</i> , 1988)	U.K. (Harrison and Mason, 1991)
Criteria						
Size of Investment	\$US 50,000	\$US 100- 250,000	\$US 73,500	\$C 109,000	\$US 130,000	£100,000
Holding Period	5-7 years	5-7 years	3-4 years	5 years	< 5 years	3-5 years
Sector	High Tech	High Tech	Mfg, Finance, Insurance, Real Estate	High Tech	Mfg - High Tech	n.a.
Geographic Location	58% w.i. 50 mi.	41% w.i. 50 mi.	w.i. 50 mi.	44% w.i. 50 mi.	58% w.i. 50 mi.	n.a.
Annual Income	n.a.	n.a.	\$US 70,000	\$C 150,000	\$US 100- 250,000	£25,000
Net Worth	n.a.	n.a.	\$US 750,000	\$C 1,000,000+	few millionaires	£250,000*
E (return)	20% p.a.**	50% p.a.**	20% p.a.**	31.6% p.a.**	1-4 times	5 times

* excludes principal residence

** denotes compound annual return

5. RESEARCH QUESTIONS AND METHODOLOGY

Consistent with the primary objective of the study, the characteristics of the informal venture capital marketplace in Canada are investigated. A series of research questions were formulated in order to establish a precise description of the informal venture capital market. These have been derived from the literature in order to compare Canadian data with similar studies elsewhere.

The data was provided by a database that had been created as a result of a study conducted by the School of Business on private venture capital in Canada. The intent of the study was to inform public policy on the salient characteristics of informal investors. The inception of the study and the task of gathering financing were made possible through the efforts of Professors Duxbury, Haines and Riding of the School of Business and Robert Safrata of Canadian New Ventures Ltd.

The data gathering phase commenced March 1991 and was completed in December 1992, using both personal interviews and mailed questionnaires (see Appendix C for questionnaire). Informal investors from every province (with the exception of Manitoba and Saskatchewan) form the sample. An overall response rate of 42.3% was achieved for the entire sample. This rate is considerably better than that achieved by Wetzel in New England (1.3%), Tymes and Krasner in California (6%) and Haar *et al.* in the Eastern U.S. (4.3%).

Table 2 provides a breakdown of the respondents in the database. Responses from the 279 angels across Canada will provide the framework for analysis. Their responses will establish the characteristics of the supply-side of the informal marketplace. Non-investor sample will also be used for some the analysis.

Table 2: Database of Respondents

Type of Respondent	Number in Database
Non-Angel Investor	95
Angel Investor	279
Entrepreneur	23
Professional Venture Capitalist	14

5.1 Market Integrity

In light of Chan's (1983) model, the market's integrity¹⁰ will be maintained if there are no-cost investors in the marketplace. As argued earlier, in the informal venture capital market, lead investors serve the role of no-cost investor. An investigation to determine whether lead investors exist in such a market is required.

Proposition 1: Lead investors exist among the angel investor population in Canada.

Proposition 1 was tested using responses from Q32b: "Do you introduce other potential investors to entrepreneurs requiring financing?" A positive response to this question is not sufficient to correctly identify lead investors. For example, investors may introduce other investors only after they have been introduced to the venture by

¹⁰ Market's integrity will be violated if all investors exit the market because only low quality investments are offered. Such a market will fail to function.

another (lead) investor through syndication. Since lead investors execute a due diligence process they will also serve on a Board of Directors or Advisors, or actively participate in the venture to protect their investment and consequently their reputation as a lead investor. To ensure that lead investors are correctly identified only those who respond affirmatively to Q32b and Q42a or b: "Do you expect personal representation on: (a) a formal Board of Directors; (b) a Board of Advisors; or Q43: "Do you expect to participate directly in the business as an operating principal?" will be considered lead investors.

5.2 Market Efficiency

The informal marketplace is not efficient (for a definition of an efficient market, please refer to the discussion in Section 3.1.iii). If markets were efficient, then investors would only reject opportunities based on price. Hence, if investors use non-financial aspects as important determinants of invest/reject decisions, this will be evidence of inefficiency in the marketplace. This is tested through Proposition 2.

Proposition 2: Informal investors consider non-financial aspects of potential investments as important determinants of invest/reject decisions.

Responses from Q40 "Please indicate the extent to which you agree or disagree with [(14) statements regarding risk capital investing]" will be used to test Proposition 2. Factor analysis was employed to associate statements with potential underlying

motivating factors". The results obtained after the varimax rotation are used because it attempts to group variables in a more interpretable pattern than the pre-rotation results. Pre-rotation results simply identify relationships but it is difficult to identify meaningful factors based on these results. Often the variables and factors do not appear correlated in any interpretable pattern (Norusis, 1989).

Similarly, under the efficient market hypothesis, price reflects all relevant information. If markets were efficient then the most common reason why they declined to invest would be an unsatisfactory risk/return ratio, which is defined by price. If any other reason is found to be the most popular, then one may conclude that price does not reflect all relevant information. Proposition 3 will test this hypothesis.

Proposition 3: Price is not the exclusive reason informal investors reject opportunities presented to them¹¹.

Q38 will provide the data to test Proposition 3. Investors were asked to indicate the most common reasons, among 5 listed reasons, why they declined to invest in opportunities that were presented to them.

¹¹ Factor analysis is a statistical technique used to identify a relatively small number of factors among a larger set of variables. It attempts to measure concepts that are difficult to define using a single variable measure. For example, "athletic ability" may not be measured directly, but can be expressed as a function of agility, coordination, speed and strength which are objectively measurable qualities.

¹² Proposition 3 differs from Proposition 2 in that it analyzes reasons for rejection whereas Proposition 2 analyzes reasons why investments are undertaken. For example, an opportunity may receive financing because it featured an environmentally friendly gimmick which motivated the investor to invest. However, an opportunity will not necessarily be rejected because it does not offer such a feature.

5.3 Market Functionality

In the absence of a formal centralized clearing facility for both information and trades, the informal venture capital market may be dysfunctional. However, given evidence of a functioning market, it is likely that local informal networks offer a viable alternative to a formal centralized clearing facility. A test for their existence is required. Informal networks exist, and are effective communication channels if:

- **investors introduce other investors to opportunities they review, regardless of the decision whether or not to invest**

Q32b "Do you introduce other potential investors to entrepreneurs requiring financing?" and Q32c "When you choose not to invest in an opportunity, do you sometimes refer the entrepreneur or intermediary to another potential investor of your acquaintance?" are used in the analysis.

- **investors cite any referral source more often than personal active search as the most useful source of opportunities**

Q32a, which is a rating (on a 5-point scale) of personal active search as a method of generating new investment opportunities provides the data for this test.

- **other individual investors are the most frequent co-investors**

Q25 and Q29 are in the analysis. Q25 provides the number of investments over a 5 year period. Q29 gives details of co-financiers for the investments listed in Q25.

- **number of investments will vary with investment flow** (That is, the overall investment rate will be lower for those investors who undertake more investments. For example, investors who are well connected in the market, or have many linkages to the informal market, will have more investments presented to them and consequently invest in more opportunities. Investment flow will be derived from the size of an investor's portfolio and overall investment rate.)

Q25 and Q34 which details investors' rejection rates will be used to calculate the overall investment rate. The investment flow is the quotient of the overall investment rate for each investment-intensity category divided by the mid-point of each intensity category. Investment-intensity categories were derived using a histogram of the number of investments over a 5-year period for each angel respondent. The data shows that the first investment-intensity category is 0-2 investments, it is called low-intensity and has 76 respondents. Medium-intensity is 3-5 investments (89 respondents), and high-intensity is 6 or more investments over a 5-year period (61 respondents).

5.3.1 Geographic Scope

The informal marketplace has been described as local. Results obtained from the respondents across Canada of the geographic location of their investments will determine whether the informal marketplace is also local in Canada. There is consensus in the literature that the majority of investments are located within 50

miles of the investor (recall Table 1). This, combined with reportings of the networks being made up of friends and business associates, would infer that informal networks and geographic proximity of investments to the investor are related issues.

Proposition 4: There is a positive correlation between the ratio of investments located within 50 miles of the investor to total investments and the rating of personal active search as a source of new venture opportunities.

Proposition 5: There is a positive correlation between the ratio of investments co-financed with other individual investors to total investments and the investor's rating of business associates and friends as referral sources.

Proposition 6: There is a negative correlation between the ratio of investments co-financed with other individual investors to total investments and the rating of personal active search as a source of new venture opportunities.

Figure 1 illustrates how Propositions 4, 5 and 6 assess the geographic scope of informal networks.

Figure 1: Propositions 4, 5 and 6

Business associates and friends have local and personal attributes. The affirmation of Proposition 4 would suggest that referral sources are a good source of co-investors. The affirmation of Proposition 5 infers that local investments are a result of personal active search. Proposition 6 would infer that co-investors are the source of investments when personal active search is not undertaken. Together, propositions 4, and 5 offer evidence to suggest that informal investment markets are local. In addition, if the market is indeed local, investors will have resided in their municipality for a relatively long period in order to build links into the informal network. The determination of this characteristic is necessary for policy development and to determine whether regional analysis is warranted. If marketplaces are local then

there may be regional disparities. An analysis of informal markets by region will be performed to determine whether regions differ and how they differ.

The geographic scope of the informal market is necessary to evaluate the extent of informal networks to communicate investment opportunities. Conclusions about the geographic description of the informal marketplace have distinct policy implications. A local marketplace would indicate that the marketplace may only be functional locally. Similarly, policy incentives must be formulated with this attribute in mind. Therefore, recommendations to the provincial and federal levels of government would include recommendations for municipal-level implementation.

Together, the affirmation of Propositions 4, 5 and 6 would indicate that markets are personal (i.e. informal networks exist and are local in nature). Directives aimed at making the market more functional must consider this attribute of the market.

Details of angels' new venture investments over a 5 year period were extracted from Q25 (total number of investments), Q28 (geographic dispersion of investments) and Q29 (frequency and types of co-financiers). These responses were correlated with Q31 which asks investor respondents to rate how often various sources were used to generate opportunities on a 5-point scale.

5.4 Other Characteristics

5.4.1 Rate of Return

Equity investments in SMBs clearly have an element of risk associated with the investment. As compensation for assuming this risk, investors demand a risk premium. Since angel investing is characterized by the financing of start-up and young companies, the risk associated with early stage investments is considerably higher than later stages. Ruhnka and Young (1987) found that venture capital firms in the United States expect, on average, an annual rate of return between 55-73% for seed and start-up financing, and 35% for the later stages of development. Plummer (1987) also documented discount rates used by U.S. venture capital firms average between 41-75% for early stage ventures. Wetzel (1981) recorded that American angel investors demand an average rate of return of 50% for seed and start-up firms, yet only 22.5% for exit stage investments. Table 1 lists reported angels' expected rates of returns between 20-50% (compound annual rates of return).

Robust markets are necessary to ensure that buyers and sellers of capital have a choice among a variety of opportunities. The availability of a plethora of investments offering all levels of risk make it clear that sellers have a choice. However it is not clear whether buyers of capital are price takers as a result of a possible insufficient supply of capital. Investors expected rates of return will aid in determining whether investors are demanding too high a premium for risk capital investments. In addition, the rate of return will provide a useful comparison with results obtained elsewhere.

Expected annual rate of return is calculated using data from Q41 "How large a financial return (after taxes) do you expected on your risk-capital investments? (ERETURN) % over n years." The equation was as follows:

$$(1+(ERETURN/100))^{(1/n)}-1$$

5.4.2 Risk Reduction Techniques

Venture capital is considered among the most risky capital so investors will demand a risk premium for their investments and also adopt risk reduction strategies. Ruhnka and Young (1991) outline some other commonly used risk reduction strategies employed by venture capital firms. One is a long-term hold strategy so that the geometric average of compound returns from the winners will offset the losers in the portfolio. The average holding period will also verify that investor respondents are indeed referring to their informal investments. In addition, this characteristic has particular implications for policy recommendations. Q41 asks investors "How long do you expect to hold your investment before cashing out?"

Another way of reducing risk is by becoming part of the Board of Directors or Advisors. Participation in the venture will increase the amount of control an investor has over his/her investment. Q42a or b: "Do you expect personal representation on: (a) a formal Board of Directors; (b) a Board of Advisors; or Q43: "Do you expect to participate directly in the business as an operating principal?" provides data for evidence for the popularity of this risk reduction strategy.

An investor will also protect his/her investment in the investee firm by placing operating covenants on the entrepreneur. These covenants often take the form of periodic reports, authorization of cash disbursements over a preset amount, control over salaries, dividends and control of the financial structure of the firm. They ensure that the entrepreneur is acting in the best interest of the company, rather than his/her own behalf. Q46 "Do you negotiate operating covenants [for the deals you enter into]?" was used in the analysis.

There are legal means for protecting an investor's (and entrepreneur's) rights which takes the form of a formal shareholder's agreement. This document provides investors with the legal rights to ownership of the company based on the amount of equity financing. Q44 "Do you insist on a formal shareholder's agreement [for the deals you enter into]?" was used to test this risk reduction strategy.

Often, investors will hold both debt and equity positions in the investee firm. This may also be considered a risk reduction strategy. Equity guarantees the investor a share in the profits if the investment is a winner, but debt will guarantee some form of compensation if it is a loser. Q45 "Are your risk-capital investments structured in the form (a) straight equity (b) debt only (c) combination of debt and equity?" provided the data for the analysis.

Finally there is diversification. Diversification is one of the most common methods of reducing risk. There are two ways a new venture investor may diversify. Specific to new venture investing, angels may diversify their investments across industries. Q27 asked respondents to list their investments under industry categories. This was used to calculate the mean number of industries an investor invests across. The second way to diversify is in terms of an entire investment portfolio. Investors will want to invest in other types of investments in order to protect themselves from risk. Q30 asks "[Approximately what percentage] of your assets is represented by your risk capital investments in young or start-up firm in young companies?" and Q24 "Do you invest any of your personal funds in the following [7 investment alternatives]."

5.4.3 Rejection Rates

Other investing characteristics will be reported so that comparisons with the current literature may be made. Specifically, investment rates will be reported. Very high rejection rates may offer reasons why a gap is perceived. Q34 prompts investors to state rejection rates at certain points of their decision making process. A cumulative average will calculate an investor's rejection rate.

5.4.4 Size of Investment

The distribution of the size of investments must be explored since certain provisions have been made under the private placement exemption in hope of capturing informal investment activity and companies wishing to go public. The \$150,000

private placement exemption is of particular significance. This exemption was created so that SMBs could more easily obtain access to the TSE. However, such provisions could present barriers to investment and could impose rigidity in the marketplace. Data from Q26 which categorizes respondents investments by size was used in the analysis.

5.5 Role of Government

5.5.1 Federal Level

If a gap is the product of a lack equity capital, government could close the gap and conceivably increase employment by offering tax incentives to investors so that new entrants would enter the market, thereby increasing the supply of available capital and simultaneously reduce the cost of equity to entrepreneurs. Therefore, *inter alia*, this thesis will evaluate the present lifetime capital gains exemption as an incentive to informal investing. Capital gains are associated with informal investments because the return on investment is most often in the form of a capital gain upon exit. Evaluation of the current capital gains exemption as an effective incentive to SMB-investing involves reporting the responses to Q33(b): "Did the capital gains exemption encourage you to undertake informal investment activity?"

Those who answered that the incentive did encourage them were separated from those who answered that the incentive did not encourage them to undertake informal investing. Those who answered affirmatively are referred to as Investor Group 1.

Since the incentive was effective for them their responses to tax reform were to be considered appropriate for increasing investment activity of informal investors currently in the market.

Those investors that were not attracted to the market by the incentive are referred to as Investor Group 2. The responses of this group were to be considered appropriate for attracting new entrants to the market. Group 2 should reflect how best to encourage non-angel investors to undertake informal investments because, just as the capital gains exemption did not encourage this group, it would seem that the current incentives were not effective for non-angel investors either. *t*-tests identified whether any major differences exist between non-angels and Investor Group 2 that would make tax reform ineffective.

Demographic variables were employed to test whether differences exist between non-investors and Investor Group 2. The following variables were employed for the analysis: Age (Q2), Self employed (Q11), Educational background (Q15), Hours worked per week (Q18), Years in municipality (Q20), Nature of past business experience (Q21b), Present job description (Q21c), Income (Q22) and Personal assets and Net worth (Q23).

If no differences were found the responses of Group 2 would have been considered policy recommendations for attracting new capital to the market. Otherwise, the

investor groups were collapsed and their recommendations were considered appropriate for increasing current angels' investing patterns. Before the investor groups were collapsed, the same demographic variables that were used to determine differences between Investor Group 2 and non-investors, determined whether differences between the investor groups would disallow the groups to be collapsed.

Significant differences between Investor Group 2 and non-investors were found, so investigation of the reason(s) why non-angel investors do not undertake angel investing was executed. This consisted of analysing responses to Q24b. This helped to inform public policy why more capital is not being attracted to this segment of the market. Also, non-investors' perceptions of the aspects of risk capital investing were analyzed and compared with angel investor responses (Q51).

The first policy incentive that was analyzed is an increase in the current capital gains exemption (Q33bii). The responses of Investor Groups 1 and 2 were reported.

Given the disadvantage of close-ended questions, an analysis of the open-ended question "Can you suggest tax incentives which you would like to see enacted?" (Q33d) would produce more accurate, detailed opinions. Most respondents took the time to complete this section. These responses would provide a more precise indication of what angel investors seek in the way of tax incentives. Given that these

investors are knowledgeable in the field of new venture investing, their suggestions may be considered expert opinion. An investigation of this question follows.

Again the responses were aggregated according to investor group affiliation. The methodology consisted of a thematic evaluation of qualitative data collected from angel respondents.

Two data analysis procedures were employed. The first consisted of categorizing the transcribed open-ended responses under broad topics, then again into more specific topics until the responses could be grouped into fairly descriptive, and precise incentives. To avoid researcher-specific biases when interpreting qualitative data, a second researcher categorized the data in the same fashion. Any discrepancies between the interpretations of the two researchers were settled by a third opinion. All three researchers were informed in the area of policy incentives, taxation and private venture capital. The incentives are reported by investor group.

The second data analysis procedure segmented the data according to the characteristics of the individual investor respondent regardless of group affiliation. Specifically, the incentives were grouped according to the investor's age, since past studies have found older investors have shown that their decision-making process is more insightful (Dal Cin, 1992). This was done in hope of capturing the most "expert" opinion so that the recommended incentives would address and reward

intelligent, patient¹³ capital with the hope of increasing this investment activity. The data was segmented according to the age. Age categories were: 35 and under, 36 to 50, 51 to 65, and 66 and over (as used by Dal Cin, 1992).

If no differences between Investor Group 2 and non-investors were found, the following illustration outlines the analysis of policy recommendations:

Q33(b): The Federal government has provided an exemption from income taxes on the first \$100,000 of capital gains income. (i) Did this exemption encourage you to undertake informal investment activity?	
If Yes: "Investor Group 1"	If No: "Investor Group 2"
(ii) Would you be more likely to undertake [more] informal investment activity if this exemption were increased?	
<u>Investor Group 1</u> Policies are considered to be effective at increasing the investment activity of current market players	<u>Investor Group 2</u> Policies are considered to be effective at attracting new entrants ("new capital") to the market
(c) Can you suggest tax incentives which you would like to see enacted?	
<u>Investor Group 1</u> Policies are considered to be effective at increasing the investment activity of current market players.	<u>Investor Group 2</u> Policies are considered to be effective at attracting new entrants to the market.

¹³ "Intelligent, patient capital" refers to an investor who (executes a due diligence process and) invests in anticipation of financial gains over the long term.

5.5.2 Provincial Level

Ontario will be the focus of provincial incentives since the TSE is located in Ontario and it is the largest public equity market in Canada. Currently, the most prominent incentive offered to informal investing and financing for SMBs is the Small Business Development Corporation (SBDC) program. Knight and Ferguson (1984) in their evaluation of the program identified a major problem. SBDCs have often made only one investment. They found that SBDCs were established with the intent of investing in one particular investment. This is contrary to the intent of the SBDC program. The program was established to have SBDCs continually monitor and evaluate new opportunities. The authors speculate that the program has failed in this aspect is because individual SBDCs do not promote themselves. SBDCs prefer to have investments referred to them by someone who would pre-screen investments.

The use of the SBDC program by angels was reported. Recommendations to the program are made in light of the use of informal networks and geographical findings.

6. FINDINGS AND ANALYSIS

6.1 Market Integrity

Proposition 1: Lead investors exist among the angel investor population in Canada.

Support is found for Proposition 1: 83.8% of respondent investors have at some point in their investing experience assumed the lead investor role. The affirmation of Proposition 1 indicates that the integrity of the Canadian informal market place is intact: both good and bad investments may be found.

6.2 Market Efficiency

Proposition 2: Informal investors consider non-financial aspects of potential investments as important determinants of invest/reject decisions.

Table 3 contains the mean rating of each statement of motivation and the percent of respondents that strongly agreed (7-rating). Note that financial returns have the fourth highest mean rating and is rated a 7 by only 27% of respondents.

Table 3: Ratings of Statements of Motivations

Statement of Motivation	Mean Rating n=268	% of Respondents Rated 7
A. I expect large financial returns	5.38	27
B. I value my participation with the individuals involved	5.08	18
C. I understand the nature of the particular business opportunity	5.50	25
D. It is important to me to be part of creating something	4.82	20
E. I've had previous experience in this kind of business	4.13	8
F. I have confidence in the business's principals	6.22	53
G. I value the sense of excitement associated with my involvement	4.51	15
H. My research indicated the opportunity has potential	5.48	26
I. I value the recommendations about the business made by people whose judgement I respect	4.90	15
J. The business is the "be-all and end-all" of the principals financial future	3.91	7
K. It is more fun than gambling	3.47	13
L. I have confidence in my ability to manage the risks	5.35	24
M. My gut-feeling regarding possible investments is dependable	4.63	13
N. I am lucky in such endeavours	3.02	3

Factor analysis was employed to associate statements with potential underlying motivating factors. Table 4 illustrates the groupings and factor loadings after the varimax rotation.

Table 4: Varimax Rotation Results of Factor Loadings

Statement	Factor 1 "Affiliation"	Factor 2 "Chance"	Factor 3 "Comfort"	Factor 4 "Financial"
B	.7618			
D	.7295			
G	.7290			
N		.7757		
M		.6914		
K		.6493		
J		.4949		.4582
L		< .45		
H			.7027	
C			.6994	
E			.5926	
I			.4502	
F				.7675
A				.7303

Factor analysis was able to discern four general motivations for informal investing: affiliation, chance, comfort¹⁴ and financial. The first factor, affiliation, describes how investors agree that active participation, the sense of being part of creating something and the related excitement are part of informal investing. The sense of gambling, luck, intuition, risk, and principal's financial involvement are related because they are all statements that allude to the notion of a "quick and dirty" method of evaluating investment opportunities. As ACVCC (1992) explains, the most obvious indicator of management's commitment to the project is the financial commitment of the founder

¹⁴ Comfort is really not a motivation, but the variable statements that contribute to this factor all indicate some sort of due diligence, or investigation process that the investor undertakes for informal investments.

(follows agency theory). Since there is no formal investigation process, these statements contribute to the chance factor. Factor 3, the comfort factor, relates understanding, experience, research and opinions of others. Compared to the chance factor, factor 3 may be considered "an educated guess" as to the success of an investment opportunity. The financial motivation factor, factor 4, is governed by an investor's perceived financial gain, and his/her perception of the entrepreneur's ability (and slightly by the entrepreneur's invested interest).

Those variables (statements) that had factor loadings above .55 were grouped into four general motivations. Cronbach-Alphas were computed to confirm the association of the variables that constructed the factors. This internal consistency technique was selected because the variables used a Likert 7-point scale. Results may be found in Table 5.

Table 5: Reliability of Scales for Motivations

Motivation	Contributing Variables	Cronbach α	Mean Score n=268
Factor 1 Affiliation	B D G	.7228	4.753
Factor 2 Chance	N M K	.6565	3.714
Factor 3 Comfort	H C E	.4754	5.076
Factor 4 Financial	F A	.5232 ^a	5.740

^aAs an alternative measure of association, a one-tailed t-test showed a significant (99%) positive correlation was observed between variable statements A and F.

Although the financial and comfort¹⁵ factors have the highest mean scores, the affiliation factor cannot be ignored since the mean score is slightly higher than neutral, tending to the agree-side of the scale. The chance factor is not a strong motivation since its mean score is slightly towards the disagree-side of the scale.

Essentially these results indicate that there are 3 factors that prompt investment activity: financial, risk amelioration and affiliation. Investors do primarily undertake informal investments for financial gain and they undertake a careful investigation process to assist them in deciding whether or not to invest. Although the primary motivation is financial, investors also consider group interaction and excitement of creation an important attribute to informal investing. Some investors acknowledge that luck and intuition are contributing factors to an investment's success, but most agree that it does not influence their decision to invest.

Proposition 3: Price is not the exclusive reason informal investors reject opportunities presented to them.

The results are found in Table 6.

¹⁵ The low Cronbach- α value would indicate that the comfort factor may be a composite of 1 or more factors.

Table 6: Most Common Reasons for Rejecting New Venture Investments

Reason:	% Agree
A. Unfamiliar with technology or nature of business	48.5
B. Market potential insufficient	43.8
C. Lack of confidence in management	80.0
D. Unsatisfactory risk/return ratio	61.9
E. Inadequate or unsatisfactory business plan	41.5
F. Other	23.3

Price is defined by the risk/return ratio. Results show that price is not the exclusive reason informal investors reject opportunities; moreover, it is not even the most popular response¹⁶. Therefore we may conclude that the market for informal investments is inefficient.

¹⁶ Since investors were able to select multiple reasons for rejecting the opportunities they have reviewed in the past, results may not reflect the single most common reason for rejection. Perhaps if investors were asked to choose the one most frequent reason for not investing, results would be different.

The database of responses indicated that 26 investors listed only 1 (most common) reason for rejecting. Again price was not the most popular response; and again, the principal-related response was the most popular.

Table 6i: The Most Common Reason for Rejecting New Venture Investments by Respondents Who Listed Only One Reason

Reason	% Agree
A. Unfamiliar with technology or nature of business	19.2
B. Market potential insufficient	7.7
C. Lack of confidence in management	38.5
D. Unsatisfactory risk/return ratio	23.1
E. Inadequate or unsatisfactory business plan	-
F. Other	11.5

However, this may be considered a characteristic of the market. In traditional finance theory, risk is defined as systematic risk. Yet these results indicate that investors also consider unsystematic risk very important. The largest component of unsystematic, or firm-specific, risk is the entrepreneur(s) or management. For example, in the absence of a board of directors and shareholders, owners of private companies remain the managers. Management of publicly traded companies may be replaced more easily than management of private companies since there is a separation between owners (shareholders) and managers. When angels invest in private companies they invest with the knowledge that management cannot be replaced (or only with great difficulty). Essentially, they invest in the entrepreneurs (owners and managers of the company) because the quality of management has direct impact on the success of the venture, or the return on investment. Factor analysis performed in the preceding section showed that investors' perceive financial returns to be associated with their confidence with the entrepreneur's ability.

Therefore, it may be argued that markets have external efficiency because investors' invest/reject decisions reflect their acknowledgement of all risk. Yet, in any market, including the informal market, price should incorporate all risk. Total risk should include the unsystematic component since results show that it is a large part of the total risk. However, risk assessment is a problem in the face of information asymmetry. It is information asymmetry that makes informal markets inefficient. For example, equilibrium price cannot be reached by traditional supply and demand, but

rather through negotiations between investor and entrepreneur. Consequently, price is very subjective because it is not only a function of the opportunity's quality (entrepreneur's and product's) but also of what the angel has to offer to the business in terms of management skills, and boundary spanning functions.

6.3 Market Functionality

In the absence of a formal centralized clearing facility, informal markets may fail to function. As a substitute of a formal clearing facility, informal networks act as communication channels that disseminate information and gather financing. Informal networks were said to exist if:

- **investors introduce other investors to opportunities they review, regardless of the decision whether or not to invest**

Finding: 72.4% of respondents say they introduce other investors they know to investments they undertake. Similarly, 70.6% of the investors who responded said that they refer the entrepreneur to another investor of their acquaintance even when they choose not invest (usually anonymously).

- **investors cite any referral source more often than personal active search as the most useful source of opportunities**

Finding: Business associates and friends were named by 57% of respondent as the most useful source for generating investment leads. In fact, only 29.3% of

respondents stated that active personal search was their most useful source for generating investment opportunities. Similarly, business associates received the highest mean rating for frequency of use.

- **other individual investors are the most frequent co-investors**

Finding: Of the investments undertaken by the sample of angel investors, 75% were co-financed by other individual investors. In fact, the next frequent co-investor type were professional venture capital firms. However, only 8.8% of investments included professional venture capitalists as co-investors (see Table 7).

Table 7: Percent of Investments Co-financed, by Type of Co-financiers*

Other individuals	75.0%
Venture capital firms	8.8%
Public economic development agencies (ie.FBDBs)	5.2%
SBDCs	2.7%
Other	8.8%

* Totals may not equal 100% since different co-financiers may be included in financing the same venture.

- **number of investments will vary with investment flow**

Finding: There does not seem to be any indication that the number of investments undertaken is a function of investment flow (see Table 8).

Table 8: Mean Rejection Rates by Investment Intensive Categories and Decision Making Moments

Investment Intensity	Overall Investment Rate	Approximate Investment Flow
Low (0-2) n=76	1.29%	78
Medium (3-5) n=89	3.31%	121
High (>5) n=61	2.71%	89

If the main shortcoming of informal markets were a lack of information flow, then the more exposure an investor has to investments, the more connections within the informal market. The more connections, the greater the information flow, and therefore the number of investments would vary with investment flow. If the number of investments undertaken were a function of investment flow then high intensity investors would be exposed to more investments than medium intensity investors. Results indicate that information is obviously not the only impediment to investing in new ventures. However, these results may not provide sufficient evidence to make such a conclusion because investment flow, as defined by the questionnaire, was defined by the number of investments an investor undertook during the 5-year period prior to responding the questionnaire. This period may or may not reflect an angel's informal investment experience or investment flow. In addition, wealth is an obvious determinant of investment activity.

In conclusion, informal networks exist in Canada. Furthermore, findings would suggest that they are effective at gathering financing and disseminating information.

6.3.1 Geographic Scope

Table 9: Geographic Distribution of Investments

Distance of Investment	Number	%age of Total
Within 10 miles of home or office	522	39.2
Beyond 10 miles but within 50 miles	211	15.9
Beyond 50 miles but within 300 miles	187	14.1
Beyond 300 miles of home or office	411	30.9
Total	1331	100

Consistent with other findings, Canadian angels tend to invest close to home: 55.1% of the 1331 investments cited by respondents were within 50 miles of their home or office; 39.2% were within 10 miles (see Table 9). Yet it is interesting that nearly 31% of investments are located so far from the investor. This would indicate that angels prefer to invest close to home, but will not rule out a distant opportunity if it has merits. Propositions 4, 5 and 6 test connections within and between informal markets and networks and the boundaries that they span.

Proposition 4: There is a positive correlation between the ratio of investments located within 50 miles of the investor to total investments and the rating of personal active search as a source of new venture opportunities.

Finding: Proposition 4 is confirmed. A positive correlation¹⁷ exists and is significant at the 95% level. This would indicate that investors actively search for investments close to home (see correlation chart).

¹⁷ Note that for the Canadian sample, because of its size, parametric 1-tailed correlations were used for Propositions 4, 5, and 6.

Proposition 5: There is a positive correlation between the ratio of investments co-financed with other individual investors to total investments and the investor's rating of business associates and friends as referral sources.

Finding: Proposition 5 is confirmed.

Both ratings of the importance of friends and business associates were positively correlated with the

proportion of investments that were co-financed with other individual investors. Correlations were significant at 90% (friends) and 99% (business associates) levels (see correlation chart).

Table 10: Correlation Results of Canadian Data

Correlation Results		
	Proportion of inv located w i 50 miles	Proportion of inv co-financed w other angels
Rating of personal active search	1184 ^a (252) ^b P = 030 ^c	- 2710 (252) P = 000
Rating of business associates	- 0222 (262) P = 361	1601 (261) P = 005
Rating of friends	- 0377 (240) P = 280	0968 (239) P = 068

^a Correlation coefficient

^b Number of cases

^c 1-tailed significance

Proposition 6: There is a negative correlation between the ratio of investments co-financed with other individual investors to total investments and the rating of personal active search as a source of new venture opportunities.

Finding: Proposition 6 is confirmed. A significant (99%) negative correlation is observed. Therefore one may conclude that an investor will hear of an investment

from a referral source rather than personal active search¹⁸ when the investment is located at a distance (see correlation chart). This finding is consistent with Riding and Short (1988) and Haar *et al.*, (1988), who report that informal networks are composed of friends and business associates.

The conclusions drawn from the affirmation of all three propositions about the geographic description of the informal networks and marketplaces are as follows:

- informal investment markets tend to be local. When investments are made close to home, they are discovered by investors rather than referred to by friends and business associates.
- when investments are not close to home they tend to be referred to investors by friends and business associates. Therefore, informal markets are very personal.

Together, the findings indicate that informal markets are **personal and local**. Links within informal networks are geographically clustered, however they are not limited to physical, geographic boundaries. There are linkages between informal networks and they originate and develop from personal connections. Figure 2 is a schematic of how informal networks disseminate information.

¹⁸ Ambiguity surrounds the definition of "personal active search". It may include an investor actively searching through newspapers, initiating contact with an entrepreneur, or promoting him/herself as an angel. In general, personal active search will be considered anything but an opportunity generated from a known referral source. It will include the instances when an entrepreneur initiates contact with the investor if the investor is unaware that he/she was referred by another investor.

Figure 2: Schematic of Informal Network Links Between Geographic Centres

6.4 Other Characteristics

6.4.1 Rate of Return

The mean expected annual rate of return for the sample of informal investors was 23.79% (after taxes)¹⁹. To obtain a pre-tax equivalent, certain assumptions are made. First, since informal investors earn on average more than \$150,000²⁰ annually, a 51% marginal tax bracket is assumed. Second, since returns on informal

¹⁹ Note that if the capital gains exemption were still valid for any particular investor, and the investment's capital gains were within the allowable expense, then after-tax rate would equal the pre-tax rate of 23.79%.

²⁰ 69% of respondents who offered information about their annual income said they earned over \$100,000; 45% of them earned over \$150,000; and 53% had a net worth of over \$1 million.

investments are typically in the form of a capital gain, capital gains tax rules will apply. Currently 75% of capital gains are taxed at the individual's personal tax rate, assuming that the individual has exhausted his/her capital gains exemption allowance. Accordingly, the pre-tax rate of return is 37.61%. This figure is consistent with the ranges reported in Table 1. Therefore, there does not seem to be evidence of angel's demanding excessive returns because of a possible equity gap. Therefore, this may be considered inconsistent with the premise that an equity gap exists.

6.4.2 Risk Reduction Techniques

The use of a long-term hold strategy as a risk reduction strategy was adopted by many investors. The average number of years investors in this research expect to hold on to their investments before cashing out is 6.35 years. Furthermore, this confirms the notion that angels provide *patient* capital.

Becoming part of the Board of Directors or Advisors is another way of reducing risk. Of the participants in this research, 89.5% of the respondents said they expect to serve on a Board of Directors or Advisors when they invest in a private company. Moreover, 33.4% participate directly in a business as an operating principal. Again, this study provides empirical evidence that angels provide more than equity financing to SMBs. Ruhnka and Young's (1991) analysis of risk reduction strategies suggest that the motivation for involvement in investee companies is more than purely altruistic.

It was found that 62% of respondents stated that they had negotiated operating covenants in the deals they had made in the past. This provides evidence to suggest that investors prefer to have control over the new ventures they undertake.

Contrary to their name, informal investors do draw up formal agreements: 89.4% of those surveyed insist on a formal shareholder's agreement for their investments. Furthermore, 72% structure their deals to include both equity and debt positions, which indicates the popularity of these two risk reduction strategies.

Diversification is one of the most common methods of reducing risk. Within their new venture portfolios, Canadian investor respondents were found to invest, on average, in two (2.59) different industries. From an investment portfolio perspective, angels diversify across investment alternatives. Table 11 illustrates the popularity of this diversification method. Furthermore, the investors invest only 21%, on average, of their assets in young or start-up companies.

Table 11: Portfolio Analysis of Angels

Investment Alternatives	% of Angels Who Invest
Stock Market	73.3
Mutual Funds	45.5
Bonds	49.8
GICs and the like	52.3
Real Estate (other than principal residence)	67.9
Coins, Stamps, Art and the like	29.2
Other	8.7

6.4.3 Size of Investment

The Ontario Securities Act (OSA) states that a company wanting to become listed must file a prospectus with the Ontario Securities Commission (OSC) unless an exemption is available. As stated in Section 4.1.2 the cost of preparing a prospectus for public offering is very expensive. The private placement exemption, also known as the \$150,000 exemption is one of the most popular exemptions. The qualifications for the exemption requires that each investor invests a minimum of \$150,000²¹ in the company wishing to go public. The entrepreneur applying for this exemption may search for investors one of two ways. One, if the placement is not advertised in the media, the entrepreneur is only required to disclose a term sheet which discloses the salient terms of the securities offered for sale. Two, if the private placement is advertised in the media, an offering memorandum is required. The cost of an offering memorandum is considerably less, \$15,000 to \$40,000²², then a prospectus, \$200,000 to \$400,000 (Ernst & Whinney, 1985).

An offering memorandum as described by the OSA is:

"A document purporting to describe the business and affairs of an issuer that is being prepared primarily for delivery to and review by prospective investors so as to assist those investors to make an investment decision"

²¹ \$150,000 investment need not be limited to an equity position. The investor may hold debt or a combination thereof.

²² Blake, Cassels & Graydon, Venture Capital Seminar, Ottawa, 1992.

Often, an offering memorandum is required regardless the route chosen by the entrepreneur because investors require information about the company which is usually not found in a term sheet.

Table 12: Size Distribution of Investments

Size of Investment	Number	% of Total
Less than \$10,000	221	16.38
\$10,000 - \$24,999	205	15.20
\$25,000 - \$49,999	204	15.12
\$50,000 - \$99,999	200	14.83
\$100,000 - \$249,999	278	20.61
\$250,000 and over	241	17.87
Total	1349	100

Table 12 shows that the distribution of angel investments would indicate that at least 61.5%, but as high as 82% of informal investments undertaken by angel respondents show that the private placement exemption will not facilitate access to a public equities market. In addition, the exemption prohibits creating syndicates or corporations for the purpose of permitting groups of individuals to purchase shares less than the minimum required investment of \$150,000. Therefore, although this exemption is the most popular, it does not seem to be a viable alternative for most SMBs.

The reason for this is obvious. Angel investing is risky capital investing. The majority of investors want to maintain a relatively "safe" portfolio (see Table 13). Half, 50.1%, of respondents invest a maximum of 10% of their assets in young or start-up

companies. Given the 2-6-2 rule (2 successes, 6 living dead, 2 failures) for new venture investing, some feel that they should only invest as much as they can afford to lose. Assuming the sample reflects the population of informal investors, only millionaires can afford to invest in new ventures when the minimum investment required is \$150,000.

Table 13: Percentage of Assets Invested in Young and Start-up Companies

Percentage	No. of Investors	Percentage of Total
under 5%	69	25.8%
5% - 10%	65	24.3%
11 - 25%	65	24.3%
26% - 50%	34	12.7%
more than 50%	34	12.7%

6.5 Regional Analysis

Canada is a broad and diverse country. Although aggregate Canadian findings seem to conform with the literature on informal investment markets, a regional analysis is warranted since half the investor respondents were from Ontario. Generalizations made thus far may be as a result of this. Moreover, inferences made about a country cannot be stated without looking at its components. The sample will be segmented by geographical location, into 4 regions: Eastern Canada, Quebec, Ontario, and Western Canada.

6.5.1 Market Integrity

Proposition 1: Lead investors exist among the angel investor population in Canada.

Table 14: Proportion of Lead Investors, by Region

Region	Sample Size of Informal Investors	Proportion of Lead Investors
Canada	279	83.8%
Eastern Canada	58	75.9%
Quebec	19	78.9%
Ontario	162	88.1%
Western Canada	40	80.0%

Table 14 shows that Proposition 1 is found to hold true in all regions of Canada. The affirmation of Propositions 1 would indicate that the integrity of the Canadian informal market place is intact: both good and bad investments may be found.

6.5.2 Market Efficiency

Proposition 2: Informal investors consider non-financial returns as important for the investments they decide to undertake.

Canadian investors are very much alike. There is a conformity in responses concerning possible motivations. Table 15 contains the mean rating of each statement of motivation by region.

Table 15: Ratings of Statements of Motivations

Statement of Motivation	Mean Ratings				
	Canada n=268	Eastern Canada n=55	Quebec n=18	Ontario n=155	Western Canada n=40
A. I expect large financial returns	5.38	4.93	5.56	5.50	5.46
B. I value my participation with the individuals involved	5.08	4.93	5.56	5.00	5.15
C. I understand the nature of the particular business opportunity	5.50	5.31	5.61	5.60	5.33
D. It is important to me to be part of creating something	4.82	4.84	4.94	4.80	4.82
E. I've had previous experience in this kind of business	4.13	4.66	3.28	3.99	4.32
F. I have confidence in the business's principals	6.22	5.96	6.47	6.29	6.23
G. I value the sense of excitement associated with my involvement	4.51	4.84	4.22	4.39	4.69
H. My research indicated the opportunity has potential	5.48	5.56	5.28	5.45	5.61
I. I value the recommendations about the business made by people whose judgement I respect	4.90	5.26	4.59	4.74	5.18
J. The business is the "be-all and end-all" of the principals financial future	3.91	3.70	4.53	3.85	4.18
K. It is more fun than gambling	3.47	3.53	3.65	3.43	3.47
L. I have confidence in my ability to manage the risks	5.35	5.36	5.50	5.33	5.33
M. My gut-feeling regarding possible investments is dependable	4.63	4.67	4.94	4.68	4.23
N. I am lucky in such endeavours	3.02	3.09	3.11	3.02	2.84

Table 16 provides more decisive evidence that Canadian informal investors are alike. The table shows the correlation results of the mean ratings between regions after the means have been ranked within regions. All correlations are statistically significant at the 99% level.

Table 16: Correlations of Means Ratings of Motivation Statements Between Regions

Region	Eastern Canada n=55	Quebec n=18	Ontario n=155	Western Canada n=40
Eastern Canada	1			
Quebec	.8080	1		
Ontario	.8926	.9559	1	
Western Canada	.9490	.8276	.9381	1

Factor analysis was performed on each region to determine if non-financial motivations were considered important by investors in each region. Table 17 is a summary of the underlying motivations and their mean ratings. Note that no results are available for Quebec as a result of the small sample size. Appendix D contains a comprehensive mathematical explanation of how the table was constructed.

Table 17: Summary of Motivations and Mean Scores, by Region

Region	Canada	Eastern Canada	Ontario	Western Canada
Motivation				
Excitement		3.985		4.099
Comfort	5.076	5.394	5.015	
Camaraderie		5.444		5.679
Experience		4.982		5.101
Financial	5.740	4.927	5.882	5.118
Affiliation	4.753		4.760	
Chance	3.714		3.718	
Instincts				3.526

Table 17 illustrates that non-financial motivations exist, and are considered important by investors in all regions. It is particularly interesting how similar the motivations

are between regions. Therefore despite how diverse the country's landscape is, angel investors are very similar.

Proposition 3: Price is not the exclusive reason informal investors reject opportunities presented to them.

The results are found in Table 18. They are consistent across all regions. A lack of confidence in management is the most common reason for rejecting opportunities by all investors in all regions.

Table 18: Most Common Reasons for Rejecting New Venture Investments

Reason	Canada n=260	Eastern Canada n=51	Quebec n=18	Ontario n=153	Western Canada n=38
	Percentages				
A. Unfamiliar with technology or nature of business	48.5	47.1	44.4	47.1	57.9
B. Market potential insufficient	43.8	54.9	55.6	56.2	57.9
C. Lack of confidence in management	80.0	76.5	77.8	81.0	81.6
D. Unsatisfactory risk/return ratio	61.9	58.8	44.4	63.4	68.4
E. Inadequate or unsatisfactory business plan	41.5	35.3	27.8	45.8	39.5
F. Other	23.3	16.0	27.8	22.4	35.1

6.5.3 Market Functionality

Informal networks were said to exist if:

- investors introduce other investors to opportunities they review, regardless of the decision whether or not to invest (See Table 19, Introduce and Refer results)

- investors cite any referral source more often than personal active search as the most useful source of opportunities (see Table 19)

Table 19: Regional Analysis of Informal Network Findings

	Canada n=269	Eastern Canada n=56	Quebec n=18	Ontario n=155	Western Canada n=40
Introduce	72.4%	55.2%	81.3%	76.6%	55.0%
Refer	70.6%	67.9%	70.6%	71.7%	77.5%
Business Associates & Friends	57.0%	46.4%	61.1%	61.0%	70.0%
Personal Active Search	29.3%	44.6%	22.2%	25.5%	25.0%

- other individual investors are the most frequent co-investors (see Table 20)

Table 20: Percent of Deals Co-financed, by Type Co-financier*

Type of Co-Financier	Canada	Eastern Canada	Quebec	Ontario	Western Canada
Other individuals	75.0	71.1	90.3	78.6	73.1
Venture capital firms	8.8	9.5	4.2	10.1	7.1
Public economic development agencies (ie FBDBs)	5.2	13.9	1.4	3.2	5.7
SBDCs	2.7	2.0	-	4.0	0.1
Other**	8.8	3.5	4.2	8.3	16.2

*Totals may not equal 100% since different co-financiers may be included in financing the same venture

**Other co-financiers included pension funds and companies (through joint-ventures)

- number of investments will vary with investment flow

Finding: There does not seem to be any indication that the number of investments undertaken is a function of investment flow since overall investment rates do not decrease as investment intensity increases (see Table 21). Therefore, it is not clear whether the number of investments undertaken is a function of investment flow.

Table 21: Mean Overall Investment Rates by Region

Region		Canada n=234	Eastern Canada n=39	Quebec n=14	Ontario n=142	Western Canada n=38
Group						
Sample		2.38%	4.49%	0.99%	1.57%	3.76%
Investment Intensity	Low (0-2)	1.29% n=76	2.99% n=11	- n=5	1.21% n=47	1.26% n=11
	Medium (3-5)	3.31% n=89	5.24% n=24	6.25% n=4	2.13% n=62	4.56% n=12
	High (>5)	2.71% n=61	5.33% n=7	2.63% n=6	1.18% n=33	4.91% n=15

Informal networks do exist in all regions. Regional analysis uncovered that generalizations may be made about informal networks because results are homogenous across regions.

6.5.3.1 Geographic Scope

Table 22 exhibits that all regions of Canada show that angels tend to invest close to home. This is consistent with findings from the aggregate Canadian sample and other studies (recall Table 1).

Table 22: Geographic Distribution of Investments

Distance of Investment	Canada	Eastern Canada	Quebec	Ontario	Western Canada
Within 10 miles of home or office	39.2%	52.8%	47.7%	35.4%	36.5%
Beyond 10 miles but within 50 miles	15.9%	8.5%	2.3%	18.4%	18.2%
Beyond 50 miles but within 300 miles	14.1%	14.6%	18.6%	14.1%	12.0%
Beyond 300 miles of home or office	30.9%	24.1%	31.4%	31.9%	33.2%

Proposition 4: There is a positive correlation between the ratio of investments located within 50 miles of the investor to total investments and the rating of personal active search as a source of new venture opportunities.

Finding: Proposition 4 is confirmed for only the Quebec region (95%). Other regions did not conclude significant findings, however a positive correlation was viewed for all regions. Using nonparametric correlations (since sample sizes are relatively small for the regional analysis) Eastern Canada, in addition to Quebec shows a significantly (90%) positive correlation (see correlation tables in Appendix E).

Proposition 5: There is a positive correlation between the ratio of investments co-financed with other individual investors to total investments and the investor's rating of business associates and friends as referral sources.

Finding: Proposition 5 is confirmed for Eastern Canada, and Ontario (see correlation tables in Appendix E for significance levels). Both ratings of the importance of friends and business associates were positively correlated with the proportion of investments that were co-financed with other individual investors.

Proposition 6: There is a negative correlation between the ratio of investments co-financed with other individual investors to total investments and the rating of personal active search as a source of new venture opportunities.

Finding: Proposition 6 was confirmed for Eastern Canada, Quebec and Ontario regions (see correlation tables in Appendix E for significance levels).

Regional analysis uncovered that informal networks do exist in Western Canada, yet they are not effective. None of the propositions (4, 5, nor 6), which intended to measure the effectiveness informal networks, were affirmed. Wetzel hypothesized that in the absence of a formal marketplace informal networks are communication channels used to disseminate information and gather funds to finance new ventures. Interestingly enough, formal marketplaces are prevalent in Alberta and British Columbia (where the western sample was drawn). The Alberta Penny Stock Exchange and the Vancouver Stock Exchange are very speculative exchanges listing small, new companies (usually resource oriented). With this knowledge, although Propositions 4, 5 and 6 are refuted, it provides evidence to support Wetzel's hypothesis that informal networks are a substitute for formal marketplaces.

Regional analysis illustrated that although slight differences between regions are present, essentially the Canadian marketplace is homogeneous and operates much like those in other countries.

6.5.4 Other Characteristics

A regional analysis of investor demands and investing habits illustrate that Canadian investors primarily behave the same way, however some interesting differences were observed (see Table 23). Similarities include the participation component of informal investing by most investors in all regions either through representation on a Board of Directors or a Board of Advisors. Risk reduction strategies such as drafting a

shareholder's agreement, holding both debt and equity positions in the company and investing across industries were consistent across all regions.

Table 23: Investor Demands, by Region

	Canada n=257	Eastern Canada n=51	Quebec n=17	Ontario n=150	Western Canada n=39
	% of respondents who agree				
Representation on Board	89.5	84.3	88.2	93.3	82.1
Participate in Operations	33.4	40.7	38.9	31.8	28.9
Place Covenants	61.7	63.6	33.3	67.8	48.7
Shareholder's Agreement	89.4	92.6	88.9	91.6	76.9
Hold debt and equity	72.1	63.0	50.0	77.5	74.4
	Averages				
E(Return)p.a	23.79% (26.65)	17.79% (16.59)	24.11% (12.08)	24.82% (27.87)	26.34% (33.79)
E(Holding Period)	6.38 yrs (3.20)	7.22 yrs (3.80)	7.00 yrs (3.12)	6.30 yrs (2.89)	5.57 yrs (3.53)
Portfolio of Industry	2.59	2.47	2.21	2.65	2.73
No. of Inf. Inv. over 5 yr period	4.84	3.69	4.84	4.70	7.07
Inv. Size ('000s \$)	113.74 (112.21)	91.70 (98.89)	116.80 (137.82)	119.08 (108.73)	123.49 (129.14)
Stake ('000s \$)	636.32 (1230.09)	360.53 (500.70)	906.18 (1892.89)	631.67 (1079.24)	919.06 (1879.73)

() brackets contain standard deviations

Differences singled out Eastern Canadian investors. Specifically, their average investment and average stake in informal investments were smaller; along with a lower mean expected annual rate of return. This finding is not surprising considering Eastern Canada has some of the poorer areas in the country.

The existence of formal marketplaces for venture capital investments in Western Canada has profound impact on investor's average investment and stake and number of investments undertaken during the 5 year period. Specifically, these averages were higher than other regions. Similarly, the expected holding period was the lowest in the country, reflecting the ability to cash out relatively sooner than if a formal exchange were not present, and reinvest gains into other new ventures.

Although the expected annual rate of return for Western Canadian angels is the highest, it is not different in absolute terms. Note that holding period affects the expected annual rate of return because returns are usually realized in the form of a capital gain. The annual rate of return is compounded, and thereby affected by the holding period. For example, the average expected total return by Eastern Canada investors is 326% over the mean 7.22 year holding period, whereas the average expected total return by Western Canada sample is 368% over a 5.57 year holding period. Therefore, overall expected rates of return, in absolute terms, (therefore growth rate prior to exit) are very similar among Canadian investors.

Quebec too has a relatively high average stake, yet a long holding period. This investing attribute may be a consequence of the Quebec Stock Savings Plan (QSSP). Investors holding stock of companies listed on the Montreal Stock Exchange (MSE) are given significant tax credits, permitting they hold their stock for a minimum of 2 years. This incentive has had an obvious impact their investing habits.

6.6 Role of Government

6.6.1 Federal Level

One of the study's intents was to evaluate the effectiveness of the capital gains exemption as an incentive to investing in SMBs. Responses to Q33b "Did [the \$100,000 capital gains] exemption encourage you to undertake informal investment activity?" segmented the investor sample. Of the 220²³ respondents who answered both questions regarding the tax incentives (Q33bi and ii), 69 (31.4%) admitted that the exemption encouraged them to undertake informal investing. This group was referred to as Investor Group 1. Again, their opinions on tax reform was considered appropriate for increasing the investment activity of those investors currently in the market. The remaining 151 (68.6%) stated that the exemption did not influence their decision to take on informal investing activity. They were called Investor Group 2.

The opinions of Investor Group 2 were considered appropriate for attracting new entrants to the market because just as the current incentive was not effective for this group, it has also failed to encourage non-investors. Nonetheless, before such a presumption of similarity is made, there must be verification that Investor Group 2 resembles the non-investor group. Otherwise the investor groups will be collapsed. *t*-tests were employed to determine if there are differences between the two groups.

²³ Analysis of federal incentives will not include responses from Newfoundland angels because the Newfoundland version of the questionnaire did not include these two questions.

Table 24: Results of Demographic Differences Between Investors and Non-Investors

H₀: There are no differences between Investor Groups 1 and 2 and Non-investors

H_a: There are differences between Investor Groups 1 and 2 and Non-investors

Variable Name	Description	Means		
		Investor Group 1 n=68	Investor Group 2 n=151	Non-investor Group n=75
Age	Age Category	2.318	2.318**	2.096**
Semp	Self Employed	.773	.88***	.576***
Educ	Level of Education	4.642	4.874*	4.495*
Whour	Work Hours (/wk)	50.730	49.955	49.511
Mtime	Length of Time in Municipality (yrs)	26.940	28.676***	20.581***
Nature of Past Business Experience				
Exp1	Senior Mgmt of a Large Corporation	.149**	.275***	.097***
Exp2	Senior Mgmt of a Med-sized Business (\$25-100 M annual sales)	.224	.269***	.065***
Exp3	Senior Mgmt of a Small Business (\$500,000-25 M annual sales)	.433	.456**	.312**
Exp4	Middle Management	.149	.216	.194
Exp5	Professional	.343	.342	.344
Exp6	Other	.075	.102	.075
Present Job Description				
Wtype1	Managerial	.530	.616**	.462**
Wtype2	Professional	.349	.417	.441
Wtype3	Administrative	.106	.079	.108
Wtype4	Clerical	.000	.007	.000
Wtype5	Craft	.000	.000	.022
Wtype6	Service	.061	.060	.054
Wtype7	Retired	.045	.060	.022
Wtype8	Other	.030	.067	.043
Inc	Income ('000s)	109	121***	75***
Assets	Personal Assets ('000s)	1,090	1,290***	390***
Nworth	Personal Net Worth ('000s)	740	960***	240***

* denotes statistically significant differences between Investor Group 2 and Non-investors, and between Investor Groups 1 and 2 and Non-investors at the 90% level, ** at the 95% level, *** at the 99% level

* denotes statistically significant differences between Investor Group 1 and 2 at the 90% level, ** at the 95% level, *** at the 99% level

Table 24 contains the names and a brief description of the variables that were used in the analysis. The significance readings are based on 2-tailed significance reading. (Note all variables are either dichotomous or categorized except Whour and Mtime.)

Those demographic variables that are significantly different between groups have noteworthy impact on the proposed tax initiatives. Both parametric and non-parametric statistical tests were employed to discern differences between Investor Group 2 and non-investors (results were identical). On average, more angels are self employed than non-investors. Angels also tend to have more business experience than non-investors. Specifically, angels have had experience as the senior management level of small, medium and large corporations. In addition, more angels currently have managerial or professional responsibilities than the non-investors sample²⁴. This background has particular relevance for new venture investing because it is this critical experience/knowledge that the angel investor possesses which benefits the new company. Wetzel (1983) and Riding and Short (1988) profiled angels as individuals who have had success in growing their own businesses and who wish to continue being involved with new ventures, but not as founders. These results support their generalizations of angels.

²⁴ Note that age was also a significant variable. Non-investors were typically younger, which may indicate why angels have more business experience. However, in general, with regard to experience, results concur with Wetzel (1983) and Riding and Short (1988)

Other differences, which are equally relevant, are the wealth variables. On average, angels are wealthier than non-investors: they have higher incomes, higher personal assets and net worth.

Together, these findings would indicate that perhaps the reasons why non-investors are not angel investors is because they:

- should not be since they do not possess the necessary knowledge needed to properly advise the entrepreneur(s); and
- they do not have the financial means to afford to undertake such risky investment practices²⁵.

These differences are so significant that suggestions made by Investor Group 2 to increasing new venture investing may not have any relevance to non-investors. Table 25 is a summary of reasons why non-investors do not invest in new ventures. It offers evidence to support the statements made above.

²⁵ It should be noted that an ideal non-investor sample would have been one that would have resemble investors' demographic characteristics more closely. Therefore, recommendations made by both Investor Groups 1 and 2 may attract new entrants who have high incomes and can afford to invest in risky capital ventures but who have not be attracted to the market given current incentives (in addition to increasing the activity of current market players).

Table 25: Reasons Why Non-investors Do Not Invest in Small Businesses

Reasons	% in Agreement n = 72
Lack of suitable opportunities	30.6
Lack of information about such investments	22.2
Too much risk involved	33.3
Too much capital required	31.9
Other*	26.4

*Other reasons given included: conflict of interest, not interested, no time.

Furthermore, Table 26 illustrates that the risk tolerance of non-investors is considerably less than Investor Group 2. Both groups do find risk a disincentive to investing, yet it seems to affect non-investors more (95% significant difference). Note that statistically significant differences indicate that tax considerations are less a consideration to non-investors than Investor Group 2. No statistically significant differences between aspects of risk capital investing were found between Investor Groups 1 and 2. When investor groups were collapsed and compared to non-investors, risk continued to be considered a greater disincentive by non-investors than investors (99% significance; see Table 26). This follows Freidman and Savage's (1948) finding that higher income earners (wealthier people in general) have diminishing marginal utility of money and consequently they are less risk adverse.

Table 26: Aspects of Risk Capital Investing

Aspect	Non-Investors n = 78	Investor Group 1 n = 64	Investor Group 2 n = 151
Few opportunities	2.59	2.72	2.65
Tax considerations	3.11††‡ **	3.64††‡	3.43†† **
Risky	2.25††‡‡‡	2.42††‡‡‡	2.62††
Lack of liquidity	2.46	2.36	2.44
Investment required is often too high	2.47	2.34	2.43
Time required to search for deals	2.58	2.63	2.59
Time required to manage the company	2.45	2.51	2.31

†† 95% significant difference between all investors and non-investors

‡ 90% significant difference between Investor Group 2 and non-investors; †† 95% significance; ‡‡‡ 99% significance

** 95% significant difference between Investor Group 1 and non-investors

No significant demographic differences²⁶ were observed between Investor Groups 1 and 2. In light of these findings, suggestions made by Investor Group 2 will be compared to Investor Group 1 because there may be no differences among suggestions between the two investor groups. Analysis will commence with opinions on a proposed increase in the capital gains exemption.

Within Investor Group 1, 65 of the 69 investors (94%) stated that they felt an increase in the exemption will increase their investment activity. Similarly, the majority, 56%, of Investor Group 2 agreed that an increase in the exemption will affect their investment habits. However, this number should be interpreted with caution because people would have a tendency of responding affirmatively since it is

²⁶ Although Investor Group 2 had more experience in senior management positions in large corporations (significant 95%) this finding is not enough to disallow the groups to be collapsed.

beneficial to ask for more as opposed to nothing. An investigation of the open-ended question will offer more accurate recommendations for tax reform and determine whether Investor Groups 1 and 2 differ.

The database contains 221 angels outside Newfoundland. Of those angels, 196 made 257 suggestions or comments on tax reform regarding new venture investing. To compile the data into a useful form, categories were formed. Only those categories that contained frequencies of 2 or more are reported. Thus, 249 usable suggestions were sorted into categories. Table 27 is a compilation of the suggestions made by both investor groups. Note that there does not seem to be much difference between their views on how to increase informal investing activity. Therefore, responses will be considered most appropriate for increasing the activity of investors currently in the marketplace and other high income earners who can afford to enter the market.

Table 27: Frequency of Tax Suggestions Made, by Investor Groups 1 and 2

Tax Suggestions	Frequency		
	Investor Group 1 n=69	Investor Group 2 n=151	Total n=220
Corporate Taxes	17	35	52
Capital Gains Related	22	29	51
Personal Tax Related	7	26	33
Write-off Losses	8	20	28
More Government Involvement	15	19	34
Less Government Involvement	7	10	17
Simplification of Tax System	2	10	12
Indexing Returns (Gains)	2	3	5
Deductions	0	3	3
Minimum Holding Period	4	3	7
Employee Related	2	2	4

The category with the highest frequency of suggestions was corporate tax related. Specific recommendations were concerning tax holidays for a specified number of years (ie. 3) for new businesses, further reduced tax rates for small businesses, and accelerated capital cost allowances for assets in SMBs. These recommendations are interesting because they do not affect the individual's tax liability. Rather, they impact the probability of success of the new venture. Reduced corporate taxes for large corporations was also mentioned. This would help the private investor locate large corporations as co-investors. Macdonald (1991) outlines the elements of strategic support that a large corporation would provide: capital infusion, improved credibility, rapid market penetration, economical, high quality manufacturing and R&D support. For example, a large corporation as a co-investor would not only

provide financing, but an asset base for the new organization. This infrastructure would save the new SMB from dispensing of precious resources for these necessary disbursements. Moreover, large corporations often provide an exit for individual investors.

Specific capital gains related incentives such as a reduction in the capital gains tax to no capital gains tax were among the most frequently mentioned incentives in this category. Capital gains-related incentives are very relevant to angel investing since returns are usually in the form of a capital gain upon exit. Respondents comments allude to the belief that taxing the gain takes money that would normally have been re-invested in other new ventures out of circulation. As stated earlier, Wetzel (1983) describes angels as former founders of successful companies. The success of their venture allows them to buy into participation of other new ventures. Canadian angel investors have similar backgrounds, 48.5% of those interviewed have experience as senior management of a small business.

Hatsopoulos (1989) stated that capital gains is crucial to international competitiveness. He explains that in a high-wage country such as the U.S. (or Canada), the key to being competitive is being innovative and investing in long term investments. For the Canadian situation, Doyle (1990) also argued that the Department of Finance's taxation policies should encourage risk taking.

Somewhat related to capital gains is the minimum holding period category and indexing returns. Specific incentives mentioned no capital gains on investments that are held for a minimum number of years (3 - 5 were mentioned). This incentive would reward patient and intelligent capital. Since long term investments are subject to inflation, indexing returns will differentiate between a return due to inflation and a true gain. The result will be a truer calculation of a capital "gain".

Personal tax issues included lowering personal taxes, lowering the marginal tax rate for the higher tax brackets, and allowing interest from a mortgage to be tax deductible. The reasoning behind decreasing personal tax rates is that private investors invest personal income in new ventures. Moreover, it is almost exclusively the high income earners that undertake these types of investments. Again, decreasing their tax liability will increase the supply of capital available for investment.

Currently capital losses may only be claimed against capital gains. In total, 28 investors made suggestions to change this tax policy. Suggested amendments to this policy would allow capital losses to be claimed against personal income. This would make new venture investing less risky because a loss would be less expensive. This change would protect investors against down-side risk²⁷.

²⁷ An allowable business investment loss (BIL) currently exists in the tax system. However, the desire for such a tax provision was mentioned with such frequency that one must conclude that either: (1) the definition of "small business corporation" that qualifies investments for this loss is too narrow; or (2) angels are not aware of certain tax provisions.

Somewhat related to cumulative net investment loss tax rule, search costs incurred cannot be claimed as a deduction unless the investment is undertaken. This rule makes it more expensive to undertake this sort of investment activity. Moreover, this legislation may impede the formation of an efficient market. Information asymmetry has been found to be the major obstacle to an efficient informal market (recall Section 6.2). Due diligence reduces information asymmetry, but it is a costly exercise. This tax legislation further increases the expense.

More government involvement generally meant front-end tax incentives. Examples given were tax credits in the range of 20-50%. This type of incentive would make risk financing more attractive by increasing returns.

Less government involvement generally referred to the cancelation of front-end incentives. An investor's quote will explain the reasoning behind these comments "No tax driven incentives, raises the wrong kind of money." Comments such as these are a reminder that angels are not primarily motivated by financial returns, especially those based solely from tax relief. An investment should be made on its merits, not its tax incentives. Another comment was "Government should not try to give incentives... distorts the system." Less government involvement also included comments that referred to a desire for stability in tax laws. Since angel investing is patient capital and when the tax environment is very unstable, some investors

explained that their return is virtually tax dependent. An example is the numerous changes to the capital gains tax rate and exemption²⁸.

Investors also commented that a simplification of the tax structure would affect their investing pattern. Simple taxation rules would make it easier for investors to evaluate opportunities and would also lessen the administrative burden on small companies.

Employee related refers to no taxes on stock options bought by employees of an SMB. This not only encourages employee performance, but provides SMBs with an alternative source of financing: its employees. It also makes it easier for employees to create wealth and gain new venture investing experience. This, in turn will provide them with the opportunity to invest in other SMBs as angel investors.

²⁸ At this point it is worth mentioning the concerns raised in Q50 of the questionnaire as a result of the Ontario government's attempt to pass Bill C-70 in the Spring of 1991. This Bill would have made members of Boards of Directors personally liable for employees wages in the event of a bankruptcy. Angels sit on Boards to impart their expertise with the intent of increasing the likelihood of success of the company. This function is economically beneficial and should not be discouraged. Although the Bill was not passed, it drove many angels out of the market and hindered others from entering the market. This is one example of the, at times, adverse investment climate angels must endure.

Table 28: Frequency of Tax Suggestions Made by Investors, Segmented by Age

	<35 n=50	36-50 n=113	51-65 n=96	>65 n=17
	Frequency			
Corporate Taxes	9	20	20	3
Capital Gains Related	8	17	22	4
Personal Tax Related	3	11	14	4
Write-off Losses	7	13	7	1
More Government Involvement	6	15	12	-
Less Government Involvement	3	5	9	-
Simplification of Tax System	4	3	5	-
Indexing Returns (Gains)	-	-	4	1
Deductions	2	1	-	-
Minimum Holding Period	1	-	5	-
Employee Related	1	4	1	-

Segmented by age, differences in the opinion for the direction of incentives becomes more focused (see Table 28). Specifically, a change in the tax treatment of capital gains that would make a successful venture more lucrative is recommended. Similarly, tax reform that would make it easier for SMBs to succeed increases the likelihood of enjoying positive returns on investment.

6.6.2 Provincial Level

6.6.2.1 Recommendations to SBDC

In light of geographical findings, any government efforts directed at helping entrepreneurs obtain financing should be executed at the municipal level. (See specific recommendations for municipal government activity in the following section.)

Specifically for Ontario, the following modification to the SBDC program is recommended. That, the names of SBDCs be distributed to local Boards of Trade to assist them with the task of assembling an investor base to whom to present local opportunities. This will make the market more efficient because it will increase the number of known investors to municipal governments involved in economic development. By providing the names of SBDC participants to local Boards of Trade, the SBDC will be introduced to a continuous flow of investments. This may increase the likelihood of more than one investment being financed by the established SBDC, as was the intent of the program.

In addition, findings would indicate that angel investors are not using the SBDC program. Table 7 shows that only 2.7% of investments undertake used an SBDC or were co-financed with one. Therefore, a thorough review of the program and its participants is warranted.

6.6.3 Municipal-Level Involvement

As reported earlier in the findings of Proposition 3, the main reason investors give for rejecting investments presented to them is a lack of confidence in management. It is in the best interest of the municipality to undertake activities that promote economic development. New businesses employ area residents, expand the tax base and attract other new businesses, to name a few societally beneficial spillovers.

Moreover, the regions which the new business settles in is the first have these benefits accrued to them.

Krentzman and Samaras (1960), realizing the economic importance of new venture creation, were concerned about the high failure rates among new businesses. They advocate the use of outsiders by small firms to assist in preparing business plans, and securing financing. Since the municipality directly benefits from new venture creation, it should become involved with assisting entrepreneurs. Efforts at the municipal level should concentrate on informing entrepreneurs on the details of running their own business and assisting them to prepare a presentation to investors.

Chrisman *et al.* (1987) surveyed entrepreneurial businesses that were served by regional economic development offices over a 3 year period prior to establishing their businesses. Comparing sales and employment tax revenues, with the cost of running the pre-venture counselling, results indicate that a return²⁹ of \$3.77 was realized for every dollar spent in one area and \$1.50 for another area. These results may be a very conservative estimate of the economic benefits generated by this type of counselling because only a 14% response rate was obtained. Yet, telephone listings verified that 75-80% of the firms that obtained pre-venture counselling still existed. Further evidence of the success of this program is that respondents rated the counselling they received very high (4 on a 6-point scale).

²⁹ return is defined here in terms of new tax revenues

2 OF 2

PM-1 3 1/2" x 4" PHOTOGRAPHIC MICROCOPY TARGET
NBS 1010a ANSI/ISO #2 EQUIVALENT

7. DISCUSSION

7.1 Evaluation of Reasons for a Capital Market Gap

The Problem Statement explained that an investigation of the informal market and supply of private venture capital would surface evidence for the existence of an equity gap. It is however unclear if the gap does indeed exist and if it does, its nature and origin.

At the very least, a gap would imply an inefficient allocation of resources. Yet, the long term effects of such a state could have detrimental effects for Canada's competitiveness in an international context. More importantly, investigation of a gap is required prior to recommendations for tax incentives.

Based on the elements of a market, there are three possible explanations for a capital market gap. They are outlined below as well as the which tests provided the evidence for determination of each reason's soundness.

- a dysfunctional marketplace where investors are not informed about investment opportunities available to them, and entrepreneurs do not know of possible financing alternatives

Theories of venture capital markets disintegrating are advanced because of a lack of information transfer and positive search costs. Proof of lead investors presence eliminates this as a possible reason for an equity gap.

- an insufficient supply of capital available for investment opportunities;

Typically this reason is offered by entrepreneurs. To estimate the supply of capital available for investment opportunities, demographic data that was compiled from respondents was used. Since 69% of those respondents who offered information about their annual incomes said they had annual incomes over \$100,000 and 98% of angel respondents were male. These characteristics will establish an estimate for determining the underlying population for informal investing³⁰. Revenue Canada (1992) reports that approximately 200,000 males filed 1990 tax returns reporting taxable incomes of \$100,000 in Canada. If only half of those individuals were to invest in one new venture (mean of \$100,000 per investment), then \$10 billion is available for risky ventures. Therefore, it is doubtful that there is an insufficient supply of capital.

- a lack of suitable opportunities for investors;

Where suitable is defined as an opportunity that has a sufficient return to risk ratio and other attractive features that allow to compete with alternative investments. This is the most likely reason why a capital market gap is perceived. Very high rejection rates reflected in the overall investment rates shown in Table 8, coupled with a lack of confidence in management cited as the most common reason for rejecting investment opportunities supports this hypothesis. These results would indicate that entrepreneurs themselves are the reason why their projects are not being financed.

³⁰ Similar methodology was used by Short (1987).

7.2 Formal versus Informal Marketplaces

Wetzel (1983; 1986) contended that in the New England area, in the absence of a formal marketplace informal networks are communication channels used to disseminate information and gather funds to finance new ventures. Evidence brought forth regarding Canadian informal networks would support that informal networks are serving the same function. Furthermore, it may be argued that informal networks form and operate their own "marketplace". Yet, informal marketplaces are susceptible to inefficiencies because sources of funds/opportunities are not fully and freely available to sellers/buyers of capital.

Geographical analysis revealed that data that would allow a comparison between formal marketplaces and informal networks. The advantages a formal marketplace has over informal networks are:

- since companies are public, more information about them is available, therefore formal markets may be more efficient than their informal counterparts
- able to attract more capital because accessible to more sources
- investors are able to invest in more, different new ventures (Table 23)
- investors are able to (re)invest more often in new ventures because expected holding periods are shorter (Table 23)
- investors that sit on Boards of public companies are more "visible" than informal investors

The disadvantages are specific to a formal marketplace that specializes in listing small, risky ventures. Recent problems experienced by the VSE feature the disadvantages of a formal marketplace over informal markets:

- fraudulent announcements made by companies listed as pressure from shareholders mount on management (*Vancouver Sun*,b; *Fortune Magazine*)
- few players make the market, therefore opportunity for abuses (*Vancouver Sun*,b)
- few players, therefore there may be an artificial sense of liquidity

While it remains unclear whether formal marketplaces are better than informal ones, the two will always co-exist. Evidence of this is partially brought forward by Wetzel (1987). In his article he estimates the supply of private venture capital to be at least twice as much as that managed by professional venture capitalists. Meanwhile, the U.S. has one the most active over the counter markets in the world, NASDAQ. Over the counter markets, and small public exchanges specializing in small company listing facilitate access to public financing earlier than traditional, larger exchanges. However, there will always be a pre-listing stage.

7.3 COIN

The evidence brought forward about the geographical nature of informal investing and the effectiveness of informal networks has significant impact on the role of

government. Past efforts to have more new ventures funded have included the introduction and financial support of a matching service, introduced as Computerized Ontario Investment Network, and later changed to Canadian Opportunities Investment Network (COIN). COIN sought to mate investment opportunities with investors by providing a listing service for entrepreneurs and a database of investments for investors. Blatt and Riding (1992) listed the following reasons for its failure:

- COIN only provided a listing service. As a result, investors were still required to incur the costs of a due diligence process.
- Investors may not need COIN, Riding and Short (1987) reported that investors were content with the number of opportunities that were presented to them.
- Informal investments tend to be located near the investors with a consortium of personal contacts. COIN was centralized in Toronto and listed opportunities nationwide; it did not deal with the local and personal elements of informal investments.
- For a fee, investors are allowed to see the opportunities listed in COIN's database, then if they are interested, they initiate contact with the investor. Under these circumstances, the investor becomes the one in search of an investment. This method of introduction results in investors losing their bargaining power.

Of those investors surveyed, 54% had never heard of COIN. Among the investors who had heard of COIN, only 24% had tried it and when asked whether they would use it again: 61% stated that they would not.

This thesis revealed that the present informal market is functional, yet somewhat inefficient due to information asymmetry. Since COIN did not address the local and personal elements of the current market it was effectively introducing an alternative marketplace. The marketplace it was proposing required that both investors and entrepreneurs pay a fee to participate. According to Chan (1983), when all investors incur positive search costs, entrepreneurs will introduce only inferior projects. In addition, in the presence of an established marketplace, COIN's market was in competition for investors and entrepreneurs. Since the existing market was more established, lower cost, more functional, and had more participants, COIN's market failed.

8. CONCLUSIONS

This thesis found that although informal markets are inefficient, they are not dysfunctional. Evidence brought forth regarding Canadian informal networks would support that informal networks are communication channels used to disseminate information and gather funds to finance new ventures. Furthermore, it may be argued that informal networks form and operate their own "marketplace" mainly within geographic boundaries. These two findings suggest that the solution to efficient informal markets is to increase the number of market players because information dissemination is contingent on developed networks.

The geographical description of the marketplace enhances our knowledge of informal networks. The Canadian market may be better described as small clusters of informal markets, with occasional linkages between these marketplaces formed through friendships and business interactions, often initiated through co-financing arrangements.

Together, the geographical and informal network evidence would suggest that any government initiative should be administered at the municipal level. Currently, Boards of Trade and Economic Development Corporations are in the best position to introduce local opportunities to local investors. Continued municipal support of these entities is recommended since economic benefits are most felt at this level.

The regional analysis concluded that Canadian angel investors are very much alike, there is not much variation between regions. Also, Canadian angel investors resemble angel investors in other areas of the U.S. and the U.K.

The best way the federal government could encourage SMB investing is by modifying capital gains tax. It may do this two ways:

- reducing capital gains tax so that successful ventures become more lucrative and more is available to be reinvested in other new ventures
- widen the definition of "small business corporation" so that more angel investments would qualify for the Business Investment Loss provision in the tax system (This would allow capital losses to be claimed against other income, thereby making losses less expensive thereby protect investors from down-side risk.)

These measures will make risky investments more attractive, and less risky. This may steer some additional capital into informal investments, which will further develop networks and make the market more efficient.

There is evidence to support the notion that the perceived equity gap is due to a lack of suitable opportunities for investors. Angel responses indicate that a lack of confidence in management is the most common reason for rejecting opportunities that were presented to them. Investors perceive financial returns as a function of an entrepreneur's ability. In addition, the alarmingly high rejection rates indicates that

entrepreneurs are not presenting quality investment opportunities. The recommended course of action is education which should be administered at the municipal level.

9. LIMITATIONS

Analysis of angel investors' viewpoints on tax incentives would indeed provide expert opinion on ways to increase angel investing. However, angels cannot claim to be expert policy-makers. There are always trade-offs, abuses, and no guarantees of success no matter how sophisticated the econometric models. This thesis only hopes to provide an initial step towards the formulation of incentives to informal investing.

Another limitation of study is that new policy formulation that may increase the number of angels may not increase the supply of equity to SMBs. Angel investors will continue to invest in only those businesses that they perceive to have growth potential. Those small businesses that have the potential to be profitable, but not grow to become public, may not be undertaken by angels, regardless of the number of known angels. The equity gap may still exist for those companies even if angels increase in number. The fact is, that alternative investments will always compete for equity, and equity is a scarce resource. SMB investments must always have a risk premium because they do represent a risky investment.

APPENDIX A: Working Definitions

Business Angels

are also known as angels, private venture capitalists, informal investors. They are individuals, aside from the entrepreneurs or their family and friends, who invest their own funds in private companies. They are very similar to professional venture capitalists, but they tend to invest in earlier stages of new ventures and have longer time horizons.

Capital Market Gap

is a result of a market not in equilibrium. It is a shortage or absence of financing available for certain assets despite a fair return offered for risk assumed.

Due Diligence

is an investigative process undertaken by investors which entails gathering information about the prospective company, its management, products, market, and competitors.

Informal Investment

is a financial position in a private company. The investment may take the form of debt or equity, or quasi-equity.

Lead Investors

are individuals who introduce other investors to the opportunity after the decision to invest has been made. The lead investor usually completes a due diligence process before an investment is made. If a lead investor has decided to invest in a project, the entrepreneur's task of obtaining the required capital is made considerably easier since the lead investor often assumes part of the responsibility and has the appropriate contacts to guide the venture up the growth curve.

Non-Angel Investor

is defined as a person who does not invest in informal investments. This person may or may not invest in any financial instruments.

Professional Venture Capital Companies

are also known as professional venture capitalists, and institutional investors. They are entities that assume equity or equity-type positions in private companies. They actively participate in the management of the companies they invest in often with the intent of developing the company to the point where an initial public offering (IPO) is possible. Investments are expected to be relatively long-term (3 to 8 years; ACVCC, 1992).

Venture Capital

is risk capital invested in (or loaned to) a company by an outside investor. Often the investment is not secured by assets, but the investment is undertaken in anticipation of financial returns, i.e. returns commensurate with the risk assumed. Often returns are realized in the form of a capital gain upon exit.

APPENDIX B: Stages of Financing

A successful new venture entails periods of growth, various rounds of financing, changes in strategic intent, changes in management skills, and different levels of risk. The stage of development is relevant to both the entrepreneur and investor. The following stages have been defined by Mary Macdonald & Associates (ACVCC, 1992):

Seed Financing is required to prove a concept. It is typically used for developing a prototype.

Start-up Financing is provided for product development and test marketing.

First-stage Financing is required when the company has started to sell its product(s), but requires additional funds to start full commercial production and sales.

Second-stage Financing is normally initial expansion capital for companies that are not yet profitable or profitable enough to finance growth opportunities.

Mezzanine Financing (also known as Third-Stage) is required for companies that have major growth opportunities but profits are not large enough to finance the capital requirement of expanded production facilities, or marketing expenditures. Often, it takes the form of debt or convertible debt.

Leveraged Buyout Financing is provided to outsiders or management to buyout the investors. Debt instruments are used because the company is profitable and is able to afford interest charges and may make use of an interest tax shield.

The classic story of a successful venture commences when an entrepreneur(s) has an idea for a product³¹ and builds a prototype with savings, and "love money" (that of family and friends). The prototype is functional but more funds are required for fine tuning the product and test marketing to determine if there is indeed a market for the product. At this point the entrepreneur has exhausted the supply of love money, and (additional) loans from the local banks may or may not be attainable. The founder(s) cannot afford the cost a prospectus for a public offering, nor is it a viable option since the company is still relatively small. Similarly, a professional venture capital firm considers the company either too small or too early stage. This is when an angel enters. A business angel may provide the much needed capital and often the business sense the entrepreneur requires at this stage. The angel hopes to see the company grow to a stage where either a professional venture capital company will offer an exit, or an IPO is a viable option. If growth is achieved, a professional venture capital company will typically be in the next round of financing. Professional venture capitalists are in the business of growing companies with the intent of taking the company public. For this reason a professional venture capitalist will typically assume a controlling interest and assign a management team to the new venture.

³¹ or service

APPENDIX C: Questionnaire

SECTION 1. BACKGROUND INFORMATION

The following questions are designed to provide a brief bibliographical profile of respondents. Remember that all information is strictly confidential and that only aggregate data will be published. We very much appreciate your participation in this research.

1. (a) What is your sex? 1.(b) Which city, province do you reside in?
a. Male b. Female _____
2. What is your age? _____ YEARS
3. What is your present marital status?
a. Married or living with a significant other (hereafter referred to as "spouse")
b. Divorced - skip to Q.8
c. Separated - skip to Q.8
d. Never married - skip to Q.10
e. Widowed - skip to Q.8
4. What is your spouse's age? _____ YEARS
5. Does your spouse work for pay?
a. No (please skip to Q.8)
b. Yes
6. How many hours a week does your spouse work on his/her job? _____ HOURS
7. Which of the following descriptions best describes most of the work your spouse does? (Please circle one)
a. Managerial
b. Professional
c. Administrative
d. Clerical
e. Craft
f. Service
g. Other (please specify) _____
8. Do you have any children?
a. YES _____ CHILDREN
b. NO - skip to Q.10
9. Please answer the following questions concerning your children.

	<u>AGE</u>	<u>SEX</u>	<u>LIVING AT HOME</u>
		(please circle)	(please circle)
CHILD #1	___ YEARS	M F	NO YES
CHILD #2	___ YEARS	M F	NO YES
CHILD #3	___ YEARS	M F	NO YES
CHILD #4	___ YEARS	M F	NO YES
CHILD #5	___ YEARS	M F	NO YES
CHILD #6	___ YEARS	M F	NO YES
10. Do you have any dependants other than your spouse or children living with you?
a. No
b. Yes (Please specify) _____ lives with me
11. Are you self employed? a. Yes - skip to Q.14 b. No
12. How long have you worked for YOUR PRESENT EMPLOYER? _____ YEARS
13. How long have you had YOUR PRESENT JOB? _____ YEARS

14. How many individuals report to you directly? _____ PEOPLE
15. Please circle the letter which BEST describes:
- | YOUR
Educational Background | YOUR SPOUSE'S
Educational Background |
|---------------------------------|---|
| a. High School or less | a. No spouse |
| b. Courses at Community College | b. High School or less |
| c. Community College | c. Courses at Community College |
| d. Some university | d. Community Colleges |
| e. A university degree | e. Some university |
| f. Post Graduate Degree(s) | f. A university degree |
| | g. Post Graduate Degree(s) |
16. Have you ever been involved at the top management level (as director or officer) in the start up of a new venture?
a. YES b. NO
17. If YES, have you been employed in a similar business prior to this start-up?
a. NO b. YES (please specify) _____
18. How many hours a week do you spend working? _____ HOURS
19. What is the population of the municipality where YOU presently reside?
a. Under 10,000
b. 10,000 to 100,000
c. 100,001 to 250,000
d. 250,001 to 500,000
e. Over 500,000
20. How long have you lived in this municipality? _____ YEARS
21. (a) How many different salaried jobs have you held since you left school? _____ JOBS
(b) What is the nature of your past business experience:
i) senior management of a large corporation?
ii) senior management of a medium-sized business (\$25-\$100 million annual sales)?
iii) senior management of a small business (\$500,000-\$25 million annual sales)?
iv) middle management
v) professional
vi) other _____
(c) What best describes most of the work you do?
i) managerial
ii) professional
iii) administrative
iv) clerical
v) craft
vi) service
vii) retired
viii) other _____
22. Please circle the category which BEST describes, for the current year, before taxes:
YOUR INCOME	YOUR SPOUSE'S INCOME
a. less than \$35,000	a. no spouse
b. \$ 35,000 - \$ 49,999	b. less than \$ 35,000
c. \$ 50,000 - \$ 64,999	c. \$ 35,000 - \$ 49,999
d. \$ 65,000 - \$ 74,999	d. \$ 50,000 - \$ 64,999
e. \$ 75,000 - \$ 99,999	e. \$ 65,000 - \$ 74,999
f. \$100,000 - \$149,999	f. \$ 75,000 - \$ 99,999
g. \$150,000 and over	g. \$100,000 - \$149,999
	h. \$150,000 and over

23. Please circle the category which BEST describes:

Total Personal Assets

- a. less than \$ 50,000
- b. \$ 50,000 - \$ 74,999
- c. \$ 75,000 - \$ 99,999
- d. \$100,000 - \$149,999
- e. \$150,000 - \$299,999
- f. \$300,000 - \$499,999
- g. \$500,000 - \$999,999
- h. \$1,000,000 and over

Personal Net Worth

(Personal assets less liabilities)

- a. negative or zero
- b. less than \$ 50,000
- c. \$ 50,000 - \$ 74,999
- d. \$ 75,000 - \$ 99,999
- e. \$100,000 - \$149,999
- f. \$150,000 - \$299,999
- g. \$300,000 - \$499,999
- h. \$500,000 - \$999,999
- i. \$1,000,000 and over

24 (a) Do you invest any of your personal funds in the following? Circle as many as apply.

- i) the stock market
- ii) mutual funds
- iii) bonds
- iv) GIC's and the like
- v) real estate, other than principal residence
- vi) coins, stamps, art and the like
- vii) directly in small business
- viii) other (please specify) _____

(b) If you do not invest directly in small business, is there a particular reason? Circle as many as apply. (If you do invest directly in small business, please skip to 24(c))

- i) lack of suitable opportunities
- ii) lack of information about such investments
- iii) too much risk involved
- iv) too much capital required
- v) other (please specify) _____

THANK YOU, PLEASE SKIP TO Q.51

*****If you answered "no" to each and every item listed in 24(a), please skip to Question 51. Otherwise, please continue.*****

(c) Approximately what percentage of your annual income derives from these risk capital investments?

- i) less than 2%
- ii) 2% to 10%
- iii) 11% to 25%
- iv) 26% to 50%
- v) more than 50%

*****If you answered "no" to (vi) in 24(a), please skip to question 51. If you do or have invested directly in small business, please continue.*****

SECTION 2: INVESTMENT PROFILE

The following questions are designed to measure the extent and nature of past risk capital investments in young or start-up firms. For purposes of this questionnaire, risk capital is defined as equity or equity-type capital for young or start-up companies.

25. Within the past five years, how many risk capital investments have you made?

_____ investments in Canada

_____ investments outside Canada

26. Of the investments reported in Q.25, how many fell in the following categories which represent the amount(s) of funds personally committed by you?

	NUMBER
a. under \$10,000	_____
b. \$ 10,000 - \$ 24,999	_____
c. \$ 25,000 - \$ 49,999	_____
d. \$ 50,000 - \$ 99,999	_____
e. \$100,000 - \$249,999	_____
f. \$250,000 and over - please specify the appropriate amount for each investment	
i. \$ _____	ii. \$ _____
iii. \$ _____	

27. Of the investments reported in Q.25, how many fell in each of the following categories?

	NUMBER
a. Retail	_____
b. Wholesale trade	_____
c. Manufacturing-High Technology products	_____
d. Manufacturing-Industrial products	_____
e. Manufacturing-Consumer products	_____
f. Service	_____
g. Construction	_____
h. Finance/Banking/Insurance	_____
i. Transportation	_____
j. Natural Resources	_____
k. Real Estate	_____
l. Other (please specify) _____	_____

28. Of the investments reported in Q.25, how many fell in each of the following geographic categories?

	NUMBER OF CASES
a. within 10 miles of your home or office	_____
b. beyond 10 miles but within 50 miles	_____
c. beyond 50 miles but within 300 miles	_____
d. beyond 300 miles	_____

29. Of the investments reported in Q.25, in how many cases did the total risk capital financing involve other types of investors besides yourself who also put up risk capital?

	NUMBER OF CASES
a. other individuals	_____
b. venture capital firms	_____
c. public economic development agencies (ie FBDB)	_____
d. Small Business Development Corporations	_____
e. other (please specify) _____	_____

30. Consider the total assets of your immediate family. What percentage of these assets is represented by your risk capital investments in young or start-up firms? Please circle.

- a. under 5%
- b. 5% - 10%
- c. 11% - 25%
- d. 26% - 50%
- e. more than 50%

- 31 Below is a list of ways in which you might have learned about risk capital investment opportunities that you have considered during the last five years. Please indicate how often each source has been used by circling the appropriate number below.

	NOT OFTEN			VERY OFTEN	
	1	2	3	4	5
a. Active personal search.....	1	2	3	4	5
b. Accountants or lawyers.....	1	2	3	4	5
c. Business associates.....	1	2	3	4	5
d. Friends.....	1	2	3	4	5
e. Family.....	1	2	3	4	5
f. COIN*	1	2	3	4	5
g. Canadian New Ventures (VentureLink).....	1	2	3	4	5
h. FBDB**	1	2	3	4	5
i. Entrepreneurship shows and fairs.....	1	2	3	4	5
j. Profit (formerly Small Business Magazine).....	1	2	3	4	5
k. Other magazines or newspapers.....	1	2	3	4	5
l. Other (please specify).....	1	2	3	4	5

* Computerized Ontario Investment Network

** Federal Business Development Bank

32. (a) Which of the above sources have been the most useful for generating leads or risk capital investment opportunities that you have seriously considered? _____
- (b) Do you introduce other potential investors to entrepreneurs requiring financing?
- a. Yes b. No
- (c) When you choose not to invest in a particular investment opportunity, do you sometimes refer the entrepreneur or intermediary to another potential investor of your acquaintance?
- a. Yes b. No
33. (a) Have you ever used COIN?
- a. Yes b. No c. Not familiar with COIN
- If YES, would you use COIN again?
- a. Yes b. No
- (b) The Federal gov't has provided an exemption from income taxes on the first \$100,000 of capital gains income.
- (i) Did this exemption encourage you to undertake informal investment activity?
- a. Yes b. No
- (ii) Would you be more likely to undertake informal investment activity if this exemption were increased?
- a. Yes b. No
- (c) Can you suggest tax incentives which you would like to see enacted? Please describe.

SECTION 3. INVESTMENT DECISION MAKING

This section asks questions about what prompts you to invest and about how you make decisions about particular investments.

Figure 1 is a schematic of what could happen during the process of making decision about whether or not to invest in a particular proposal. Please refer to it when answering questions 34 to 39.

34. a. Out of the every 100 opportunities, what percent do you reject at time 0? _____ PERCENT
- b. What is the most frequent reason for such a rejection?
- _____ REASON
- c. Out of the original 100 opportunities, what percent do you reject at time 1? _____ PERCENT
- d. What is the most frequent reason for such a rejection?
- _____ REASON
- e. Out of the original 100 opportunities, what percent do you reject at time 2? _____ PERCENT
- f. What is the most frequent reason for such a rejection?
- _____ REASON
- g. Out of the original 100 opportunities, what percent do you reject at time 3? _____ PERCENT
- h. What is the most frequent reason for such a rejection?
- _____ REASON

35. Please recall Figure 1. Below is a list of things that you may consider at Time 0 when deciding whether to proceed to Time 1. Please evaluate how important each of these are to your decision by circling the appropriate number on the scale below.

	NOT IMPORTANT			MODERATELY IMPORTANT			VERY IMPORTANT
potential of industry.....	1	2	3	4	5	6	7
potential of product or idea.....	1	2	3	4	5	6	7
having a business plan.....	1	2	3	4	5	6	7
realism of business projections.....	1	2	3	4	5	6	7
opinions of your colleagues about the opportunity.....	1	2	3	4	5	6	7
background of the principals.....	1	2	3	4	5	6	7
fit with your own background.....	1	2	3	4	5	6	7
perceived financial rewards.....	1	2	3	4	5	6	7
other.....	1	2	3	4	5	6	7

36. Please recall Figure 1. Below is a list of things that you may consider at Time 1 when deciding whether to proceed to Time 2. Please evaluate how important each of these are to your decision by circling the appropriate number on the scale below.

	NOT IMPORTANT			MODERATELY IMPORTANT			VERY IMPORTANT
potential of industry.....	1	2	3	4	5	6	7
potential of product or idea.....	1	2	3	4	5	6	7
having a business plan.....	1	2	3	4	5	6	7
realism of business projections.....	1	2	3	4	5	6	7
opinions of your colleagues about the opportunity.....	1	2	3	4	5	6	7
background of the principals.....	1	2	3	4	5	6	7
fit with your own background.....	1	2	3	4	5	6	7
fit with other investments.....	1	2	3	4	5	6	7
perceived financial rewards.....	1	2	3	4	5	6	7
other.....	1	2	3	4	5	6	7

37. Please recall Figure 1. Below is a list of things that you may consider at Time 2 when deciding whether to proceed to Time 3. Please evaluate how important each of these are to your decision by circling the appropriate number on the scale below.

	NOT IMPORTANT			MODERATELY IMPORTANT			VERY IMPORTANT
potential of industry.....	1	2	3	4	5	6	7
potential of product or idea.....	1	2	3	4	5	6	7
having a business plan.....	1	2	3	4	5	6	7
realism of business projections.....	1	2	3	4	5	6	7
opinions of your colleagues about the opportunity.....	1	2	3	4	5	6	7
background of the principals.....	1	2	3	4	5	6	7
fit with your own background.....	1	2	3	4	5	6	7
fit with other investments.....	1	2	3	4	5	6	7
perceived financial rewards.....	1	2	3	4	5	6	7
other.....	1	2	3	4	5	6	7

38. Think of investment opportunities you have rejected. What were the most common reason(s) why you declined to invest? (Circle one or more as appropriate)

- unfamiliar with the technology or the nature of the investment
- market potential insufficient
- lack of confidence in management
- unsatisfactory risk/return ratio
- inadequate or unsatisfactory business plan
- other (please specify) _____

39. Is Figure 1 an adequate description of the investment decision making process you use?

- a. Yes
b. No, (please explain) _____

40. Please indicate the extent to which you agree or disagree with each of the following statements by circling the appropriate response below.

I decide to invest directly in a business opportunity because:

	Strongly Disagree			Neither Agree nor Disagree			Strongly Agree
	1	2	3	4	5	6	7
I expect large financial returns.....	1	2	3	4	5	6	7
I value my participation with the individuals involved.....	1	2	3	4	5	6	7
I understand the nature of the particular business opportunity.....	1	2	3	4	5	6	7
It is important to me to be a part of creating something.....	1	2	3	4	5	6	7
I've had previous experience in this kind of business.....	1	2	3	4	5	6	7
I have confidence in the business's principals.....	1	2	3	4	5	6	7
I value the sense of excitement associated with my involvement.....	1	2	3	4	5	6	7
My research indicated the opportunity has potential.....	1	2	3	4	5	6	7
I value the recommendations about the business made by people whose judgement I respect.....	1	2	3	4	5	6	7
The business is the "be-all and end-all" of the principals financial future.....	1	2	3	4	5	6	7
It is more fun than gambling.....	1	2	3	4	5	6	7
I have confidence in my ability to manage the risks.....	1	2	3	4	5	6	7
My gut-feeling regarding possible investments is dependable.....	1	2	3	4	5	6	7
I am lucky in such endeavours.....	1	2	3	4	5	6	7

Can you please specify other reasons why you invest?

41. How large a financial return (after taxes) do you expect on your risk-capital investments? _____ % over _____ years How long do you expect to hold your investment before cashing out? _____ years

42. Do you expect personal representation on:

- a. a formal Board of Directors b. a Board of Advisors

43. Do you expect to participate directly in the business as an operating principal, i.e., financial officer, sales & marketing, engineering?

- a. Yes b. No

44. Do you insist on a formal shareholder's agreement?

- a. Yes b. No

45. Are your risk-capital investments structured in the form of:
 a. straight equity b. debt only c. a combination of debt and equity

46. Do you negotiate operating covenants?
 a. Yes b. No

If YES, which of the following have you asked for in past investments?

- a. minimum debt/equity ratio
 b. maximum salaries/dividend payouts
 c. minimum working capital ratio
 d. others (please specify) _____

47. Do you prefer a silent role in the company?
 a. Yes b. No

48. Do you object to people knowing about your investment in a given company?
 a. Yes b. No

49. How would you characterize the availability of investment opportunities in which you would seriously be interested?
 a. plentiful b. adequate c. scarce

50. Compared with five years ago, is it getting easier for you to find high-quality investment opportunities?

YES

NO

- (a) More good companies are forced to seek equity.

- (a) Tougher economy

- (b) More investment exchanges/
databases/publications

- (b) Competitive marketplace

- (c) Quality of management is improving

- (c) Quality of management is declining

- (d) Involvement of other investors is increasing,
reducing exposure

- (d) Entrepreneur's unwillingness to give up equity,
accept investors' conditions

- (e) Other _____

- (e) Other _____

51. Please rate the following aspects of risk capital investment according to whether they encourage or discourage you from investing.

	Major Disincentive		Neutral	Major Incentive	
	1	2	3	4	5
few opportunities.....	1	2	3	4	5
tax considerations.....	1	2	3	4	5
risky.....	1	2	3	4	5
lack of liquidity.....	1	2	3	4	5
investment required is often too high.....	1	2	3	4	5
time required to search for deals.....	1	2	3	4	5
time required to manage the company.....	1	2	3	4	5
other.....	1	2	3	4	5

SECTION 4: PERSONALITY, MOTIVATIONS AND NEEDS

52. Please indicate the extent to which you agree with each of the following statements

	Strongly Disagree			Neither Agree Nor Disagree			Strongly Agree
	1	2	3	4	5	6	7
Like plenty of excitement going on around me.....	1	2	3	4	5	6	7
Nearly always have a quick answer when people talk to me.....	1	2	3	4	5	6	7
Like practical jokes.....	1	2	3	4	5	6	7
Am rather lively.....	1	2	3	4	5	6	7
Like doing things where you have to act quickly....	1	2	3	4	5	6	7
Like getting a party going.....	1	2	3	4	5	6	7
When making new friends, I usually make the first move.....	1	2	3	4	5	6	7
Like telling jokes or funny stories to your friends..	1	2	3	4	5	6	7
Am usually happy and cheerful.....	1	2	3	4	5	6	7
Like mixing with people.....	1	2	3	4	5	6	7
Sometimes get so restless that I cannot sit in a chair long.....	1	2	3	4	5	6	7
Usually like letting myself go and enjoying myself at a party.....	1	2	3	4	5	6	7
Like going out a lot.....	1	2	3	4	5	6	7
Think that other people think of me as being very lively.....	1	2	3	4	5	6	7
Usually feel sure I can do the things I have to	1	2	3	4	5	6	7
Say the things you are thinking quickly.....	1	2	3	4	5	6	7
Usually feel if things go badly they will work out right in the end.....	1	2	3	4	5	6	7
Am slow and unhurried in the way I move.....	1	2	3	4	5	6	7
Often long for exciting things to happen.....	1	2	3	4	5	6	7
Very much enjoy talking to people.....	1	2	3	4	5	6	7
53. I do my best work when my assignments are fairly difficult.....	1	2	3	4	5	6	7
I try very hard to improve on my past performance.....	1	2	3	4	5	6	7
I take moderate risks and stick my neck out to get ahead..	1	2	3	4	5	6	7
I try to perform better than my colleagues.....	1	2	3	4	5	6	7
I try to avoid any added responsibilities	1	2	3	4	5	6	7
When I have a choice, I try to work in a group instead of by myself.....	1	2	3	4	5	6	7
I pay a good deal of attention to the feelings of others at work.....	1	2	3	4	5	6	7
I find myself talking to those around me about non-business related matters.....	1	2	3	4	5	6	7
I prefer to do my own work and let others do theirs ...	1	2	3	4	5	6	7
I express my disagreements with others openly.....	1	2	3	4	5	6	7

	Strongly Disagree				Neither Agree Nor Disagree				Strongly Agree
In my work, I try to be my own boss.....	1	2	3	4	5	6	7		
I go my own way, regardless of the opinion of others..	1	2	3	4	5	6	7		
I disregard rules and regulations that hamper my personal freedom.....	1	2	3	4	5	6	7		
I try my best to work alone on a job.....	1	2	3	4	5	6	7		
I consider myself a "team player".....	1	2	3	4	5	6	7		
I seek an active role in the leadership of a group...	1	2	3	4	5	6	7		
I find myself organizing and directing the activities of others.....	1	2	3	4	5	6	7		
I strive to gain more control over the events around me.....	1	2	3	4	5	6	7		
I strive to be "in command" when I am working in a group.....	1	2	3	4	5	6	7		
I avoid trying to influence those around me to see things my way.....	1	2	3	4	5	6	7		
When I do my work well, it gives me a feeling of accomplishment.....	1	2	3	4	5	6	7		
When I perform my work well, it contributes to my personal growth and development.....	1	2	3	4	5	6	7		
I feel a great sense of personal satisfaction when I do my work well.....	1	2	3	4	5	6	7		
Doing my work well increases my feeling of self-esteem.....	1	2	3	4	5	6	7		
What I do is more important to me than the money I earn.....	1	2	3	4	5	6	7		
I would be happy if I didn't have to work at all.....	1	2	3	4	5	6	7		
My main interest is to get enough money to do the other things I want to do.....	1	2	3	4	5	6	7		

55. Please indicate how satisfied you are with:

	VERY DISSATISFIED			NEUTRAL			VERY SATISFIED
Your work in general.....	1	2	3	4	5	6	7
The performance of your investments (if any).....	1	2	3	4	5	6	7
Your pay.....	1	2	3	4	5	6	7
The number of hours you work.....	1	2	3	4	5	6	7
The schedule of your working hours.....	1	2	3	4	5	6	7

SECTION 5: STRESS AND COPING

The questions in this scale ask you about your feelings and thoughts during the last month. In each case, you will be asked to indicate how often you felt or thought a certain way. Although some of the questions are similar, there are differences between them and you should treat each one as a separate question.

<i>In the last month how often have you:</i>	NEVER		SOMETIMES			ALWAYS	
been upset because something happened unexpectedly?.....	1	2	3	4	5	6	7
felt that you were unable to control important things in your life?.....	1	2	3	4	5	6	7
felt nervous or "stressed"?.....	1	2	3	4	5	6	7
dealt successfully with irritating life hassles?.....	1	2	3	4	5	6	7
felt that you were coping effectively with important changes that were occurring in your life?.....	1	2	3	4	5	6	7
felt confident about your ability to handle your personal problems?.....	1	2	3	4	5	6	7
felt that things were going your way?.....	1	2	3	4	5	6	7
found that you could not cope?.....	1	2	3	4	5	6	7
been able to control irritations in your life?.....	1	2	3	4	5	6	7
felt you were on top of things?.....	1	2	3	4	5	6	7
been angered because of things that happened that were outside of your control?.....	1	2	3	4	5	6	7
found yourself thinking about things that you had accomplished?.....	1	2	3	4	5	6	7
been able to control the way you spent your time?.....	1	2	3	4	5	6	7
felt difficulties were piling up so high that you could not overcome them?.....	1	2	3	4	5	6	7
felt anxious about the performance of your investment(s)?.....	1	2	3	4	5	6	7

57. How frequently do you use the following strategies to cope with stress?

	NEVER		SOMETIMES			ALWAYS	
I work harder than usual.....	1	2	3	4	5	6	7
I just try to forget about it.....	1	2	3	4	5	6	7
I find some activity to take my mind off things, like going to a movie or playing some sports.....	1	2	3	4	5	6	7
I go shopping.....	1	2	3	4	5	6	7
I have an alcoholic drink.....	1	2	3	4	5	6	7
I take a tranquilizer.....	1	2	3	4	5	6	7
I take some other kind of medicine.....	1	2	3	4	5	6	7
I smoke more often.....	1	2	3	4	5	6	7
I talk things over with my spouse.....	1	2	3	4	5	6	7
I talk things over with my friends.....	1	2	3	4	5	6	7
I talk things over with my colleagues at work.....	1	2	3	4	5	6	7
I talk things over with my supervisor at work.....	1	2	3	4	5	6	7
I participate in some organized groups or clubs in order to get social support.....	1	2	3	4	5	6	7
I try to get away from everyone.....	1	2	3	4	5	6	7
I engage in some religious activity, such as going to church, saying a prayer, or meditating.....	1	2	3	4	5	6	7
I seek professional help, such as a counsellor or therapist.....	1	2	3	4	5	6	7
I actively seek new investment opportunities.....	1	2	3	4	5	6	7

THANK YOU FOR YOUR PARTICIPATION

APPENDIX D: Regional Analysis

Appendix D contains a regional analysis that takes the same form as the analysis performed on the aggregate sample.

Factor analysis was performed on each region to determine if non-financial motivations were considered important by investors in each region. Again, the results obtained after the varimax rotation are used because it attempts to group variables in a more interpretable pattern (Norusi's, 1989). Table 1A illustrates the groupings and factor loadings for Eastern Canada.

Table 1A: Varimax Rotation of Factor Loadings for Eastern Canada Sample

Statement	Factor 1 "Excitement"	Factor 2 "Comfort"	Factor 3 "Camaraderie"	Factor 4 "Experience"	Factor 5 "Financial"
K	.7946				
G	.7629				
D	.6289				
N	.5820				
J	.5534				
I		.8374			
H		.7147			
L		.6036			
B			.7781		
F			.6521		
M			<.55		
C				.8440	
E				.6157	
A					.8642

Eastern Canadian investors demonstrated slightly different motivations compared to the aggregate sample for informal investing: excitement, comfort, camaraderie, experience and financial. Factor 1, the excitement factor consists of statement variables such the excitement associated with gambling, personal involvement, creating and an element of luck, coupled with the knowledge that the principals are gambling with their futures since they have everything invested in the venture. The comfort factor includes the undertaking of research and seeking opinions of others while assessing the risks involved. Factor 3, the camaraderie factor, reveals the necessity of a good working relationship between investor and entrepreneur and an investor's confidence in the principals. Experience best describes Factor 4 which includes variable statements such as an understanding of the particular opportunity with previous experience in the field. Factor 5 is a single factor statement of financial returns.

Those variables (statements) that had factor loadings above .55 were grouped into four general motivations. Cronbach-Alphas were computed to confirm the association of the variables that constructed the factors. This internal consistency technique was selected because the variables used a Likert 7-point scale. Results may be found in Table 2A.

Table 2A: Reliability of Scales for Motivations for Eastern Canada Sample

Motivation	Contributing Variables	Cronbach α	Mean Score n=54
Factor 1 Excitement	K G D N J	.7115	3.985
Factor 2 Comfort	I H L	.6275	5.394
Factor 3 Camaraderie	B F	.4379 ^a	5.444
Factor 4 Experience	C E	.6555 ^b	4.982
Factor 5 ^c Financial	A	-	4.927

^aA positive and significant (95%, parametric; 99%, nonparametric) correlation was observed between statements B and F.

^bA positive and significant (99%, parametric and nonparametric) correlation was observed between statements C and E.

^cTo compare Eastern Canada results with Canadian results, a one tailed t-test showed a significant (95%, parametric; 90% nonparametric) positive correlation was observed between variable statements A and F.

The mean ratings in Table 2A reveal that the excitement factor is not a very motivating factor for Eastern Canadian investors; they are essentially neutral to this aspect of informal investing. Due diligence is undertaken by this region's investors; most agree that they seek opinions of others, do research and assess risks as part of their decision making process. On average, investors in this area agree that camaraderie is an important aspect of informal investment activity. Experience and financial motivations were also considered somewhat important by angels in the Atlantic provinces.

Factor analysis revealed 5 motivations for the Quebec sample, however, varimax failed to converge the factors in an interpretable fashion. However, to compare the sample effectively with the rest of Canada, statements A and F were not significantly

correlated. Yet, financial returns may be still be associated with investors's confidence in the business' principals since the significance test is affected by the very small sample size ($n=18$).

Table 3A: Factor Loadings for Ontario Sample

Statement	Factor 1 "Affiliation"	Factor 2 "Chance"	Factor 3 "Comfort"	Factor 4 "Financial"
B	.7579			
D	.7209			
G	.8214			
N		.7179		
M		.6383		
J		.5611		
K		.6693		
L		< .55		
H			.5661	
C			.7300	
E			.7352	
I			< .55	
F				.7012
A				.6461

Consistent with the Canadian results, Ontario investors demonstrated the same 4 underlying motivations for informal investing: affiliation, chance, comfort and financial (see Table 3A).

Those variables (statements) that had factor loadings above .55 were grouped into four general motivations. Cronbach-Alphas were computed to confirm the association of the variables that constructed the factors. This internal consistency

technique was selected because the variables used a Likert 7-point scale. Results may be found in Table 4A.

Table 4A: Reliability of Scales for Motivations for Ontario Sample

Motivation	Contributing Variables	Cronbach α	Mean Score n=155
Factor 1 Affiliation	B D G	.7607	4.760
Factor 2 Chance	N M K J	.6471	3.718
Factor 3 Comfort	H C E	.4684	5.015
Factor 4 Financial	F A	.3767*	5.882

*As an alternative measure of association, a one-tailed t-test showed a significant (99%, parametric and nonparametric) positive correlation was observed between variable statements A and F.

Results obtained for the Ontario sample indicate that underlying motivations and contributing variable statements are identical to Canadian findings. However, the financial factor is rated somewhat higher than the entire Canadian sample.

Table 5A: Factor Loadings for Western Canada Sample

Statement	Factor 1 "Instincts"	Factor 2 "Excitement"	Factor 3 "Experience"	Factor 4 "Camaraderie"	Factor 5 "Financial"
N	.8293				
H	.7802				
I	<.55				
K		.8466			
G		.7882			
J		.5779			
H			.6749		
C			.6651		
E			.5953		
L			<.55		
B				.8428	
F				.7247	
A					.8578
D					-.6724

Western Canadian investors demonstrated slightly different motivations compared to the entire sample, yet they were very similar to those of Eastern Canada (see Table 5A). Instincts, excitement, experience, camaraderie, and financial motivations were uncovered. Factor 1, the instinct factor, consists of statement variables that describe the excitement associated with gut-feeling, and luck. The excitement factor is composed of the notion of gambling, the excitement associated with personal involvement and the idea that the principals are gambling with their futures when they have everything invested in the venture. Factor 4, the experience factor, associates research, understanding and previous experience. Factor 4 illustrates the correlation between participation with the principals and the investor's confidence in

the principals. Western Canadian investors view a negative correlation between financial returns and the importance of creating something.

Those variables (statements) that had factor loadings above .55 were grouped into four general motivations. Cronbach-Alphas were computed to confirm the association of the variables that constructed the factors. This internal consistency technique was selected because the variables used a Likert 7-point scale. Results may be found in Table 6A.

Table 6A: Reliability of Scales for Motivations for Western Canada Sample

Motivation	Contributing Variables	Cronbach α	Mean Score n = 40
Factor 1 Instincts	N M	.8492 ^a	3.526
Factor 2 Excitement	K G J	.6954	4.099
Factor 3 Experience	H C E L	.5557 ^b	5.101
Factor 4 Camaraderie	B F	.2659 ^c	5.679
Factor 5 ^d Financial	A D	-.11468	5.118

^aA positive and significant (99%, parametric and nonparametric) correlation was observed between statements N and M.

^bA positive and significant (95%, nonparametric; not significant, parametric) was observed between statements B and F.

^cA negative and significant (99%, parametric and nonparametric) correlation was observed between statements A and D.

^dTo compare Western Canada results with Canadian results, a one tailed t-test showed an insignificant (parametric and nonparametric tests) positive correlation was observed between variable statements A and F.

APPENDIX E: Correlation Results

Correlation Results for Canadian Sample

	Proportion of inv. located w.i. 50 miles	Proportion of inv. co- financed w. other angels
Rating of personal active search	.1184 ^a (252) ^b P = .030 ^c	-.2710 (252) P = .000
Rating of business associates	-.0222 (262) P = .361	.1601 (261) P = .005
Rating of friends	-.0377 (240) P = .280	.0968 (239) P = .068

^a Correlation coefficient

^b Number of cases

^c 1-tailed significance

Correlation Results for Eastern Canada Sample

	Proportion of inv. located w.i. 50 miles	Proportion of inv. co- financed w. other angels
Rating of personal active search	.1516 (54) P = .137	-.2690 (54) P = .025
Rating of business associates	.1933 (56) P = .077	.2380 (56) P = .039
Rating of friends	-.0899 (49) P = .269	.0786 (49) P = .296

Correlation Results for Quebec Sample

	Proportion of inv. located w.i. 50 miles	Proportion of inv. co- financed w. other angels
Rating of personal active search	.4581 (17) P = .032	-.6111 (17) P = .005
Rating of business associates	.1911 (18) P = .224	.1399 (18) P = .290
Rating of friends	-.5064 (18) P = .016	.1487 (18) P = .278

Correlation Results for Ontario Sample

	Proportion of inv. located w.i. 50 miles	Proportion of inv. co- financed w. other angels
Rating of personal active search	.1034 (144) P = .109	-.2460 (144) P = .001
Rating of business associates	-.0134 (149) P = .435	.1927 (148) P = .009
Rating of friends	-.0044 (137) P = .480	.1221 (136) P = .078

Correlation Results for Western Canada Sample

	Proportion of inv. located w.i. 50 miles	Proportion of inv. co- financed w. other angels
Rating of personal active search	.0467 (37) P = .392	-.1317 (37) P = .219
Rating of business associates	-.2741 (39) P = .046	-.0424 (39) P = .219
Rating of friends	.1448 (36) P = .166	.0576 (36) P = .369

**Correlation Results for Canadian Sample
(Nonparametric)**

	Proportion of inv. located w.i. 50 miles	Proportion of inv. co- financed w. other angels
Rating of personal active search	.1120 ^a (252) ^b P = .038 ^c	-.3058 (252) P = .000
Rating of business associates	-.0251 (262) P = .343	.1465 (261) P = .009
Rating of friends	-.0240 (240) P = .356	.0704 (239) P = .139

^a Correlation coefficient

^b Number of cases

^c 1-tailed significance

**Correlation Results for Eastern Canada Sample
(Nonparametric)**

	Proportion of inv. located w.i. 50 miles	Proportion of inv. co- financed w. other angels
Rating of personal active search	.1942 (54) P = .080	-.2609 (54) P = .028
Rating of business associates	.2156 (56) P = .055	.2042 (56) P = .066
Rating of friends	-.0889 (49) P = .272	.0245 (49) P = .434

**Correlation Results for Quebec Sample
(Nonparametric)**

	Proportion of inv. located w.i. 50 miles	Proportion of inv. co- financed w. other angels
Rating of personal active search	.4170 (17) P = .048	-.4950 (17) P = .022
Rating of business associates	-.2369 (18) P = .172	.0604 (18) P = .406
Rating of friends	-.5393 (18) P = .010	-.0324 (18) P = .449

**Correlation Results for Ontario Sample
(Nonparametric)**

	Proportion of inv. located w.i. 50 miles	Proportion of inv. co- financed w. other angels
Rating of personal active search	.0854 (144) P=.154	-.3210 (144) P=.000
Rating of business associates	-.0206 (149) P=.401	.2024 (148) P=.007
Rating of friends	-.0085 (137) P=.461	.1441 (136) P=.047

**Correlation Results for Western Canada Sample
(Nonparametric)**

	Proportion of inv. located w.i. 50 miles	Proportion of inv. co- financed w. other angels
Rating of personal active search	.0363 (37) P=.415	-.1705 (37) P=.157
Rating of business associates	-.3018 (39) P=.031	-.0466 (39) P=.389
Rating of friends	.1615 (36) P=.173	.0001 (36) P=.500

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