

A TECHNICAL NOTE ON ANGEL INVESTING IN EMERGING MARKETS

The following note discusses the practice of angel investing particularly its meaning and suitability to emerging markets. The text below is adapted from a chapter in *An Executive Briefing on Angel Investing in Latin America*, published by the Batten Institute at the Darden Graduate School of Business Administration at the University of Virginia. This note, like the book chapter, focuses on angel investing in Latin America, but the discussion and the relationships presented are relevant and perfectly suitable to discussions of early-stage finance and entrepreneurship in all emerging economies. Additionally, the note focuses on the role of angel investors and venture capitalists on entrepreneurial activity and economic development.

What Is Angel Investing?

To be sure, the classification of investing activities has never been suited to sharp distinctions. In an age of rapid innovation in financial services and highly sophisticated securities, there is no stable line between equity and debt or between traditional and investment banking. And so it is for angel investing. In the United States, where angel investing is mature and widely practiced, the differences between angels and venture capitalists are usually obvious. But in emerging markets, where the entire investing ecosystem is typically underdeveloped, the boundaries between angels, venture capitalists, and serial entrepreneurs are porous and incomplete. This note discusses early-stage investing activities that are similar and in some cases identical to what would be classified in the United States as angel investing; however, this note also covers a broader set of investing activities than would be covered in an account of angel investing in the United States or other mature markets. The inclusion of borderline angel-investing activities reflects the realities of a developing investing environment that has not yet produced large groups of angels. In addition, the study of a broad set of early-stage investors who face similar challenges expands our understanding of the challenges angels face in emerging markets and the practices that can be used to overcome them.

Angels are most often defined as close cousins to venture capitalists (VCs), but they also closely resemble serial entrepreneurs and similar hybrid investment groups. Though there are many differences among classes of investment groups, most early- to midstage financiers can be

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distinguished by five criteria: the source of capital, the stage of participation, the recipients of capital, the resources provided, and the presence of professional investment managers.

Angels are generally defined as nonprofessional investors who invest their own capital and provide mentoring and hands-on business acumen to third-party, early-stage firms. Like most early- to mid-stage financiers, angels take equity positions and require some degree of managerial control over the venture. For angels, the investment of “soft capital,” the guidance, advice, and access to networks, is as important to the venture as the investment of money, or “hard capital.”

VCs are similar to angels in that they invest in third-party firms, but they usually do not invest their own capital, are staffed by professional investment managers, invest in later stages (midstage or pre-IPO), and offer mostly hard capital. VCs monitor and protect their investments through various control mechanisms but do not typically provide the mentoring and hands-on assistance that characterize angels.

Finally, serial entrepreneurs and all who develop ventures for themselves and close associates are similar to the U.S. definition of angels but distinct in important ways. Like angels, serial entrepreneurs are mostly nonprofessional investors who invest personal funds and offer hands-on mentoring to early-stage firms—but not to true third parties. Such investors typically invest in projects they will own or that will be owned by family members. As a result, this class of investing remains a step away from true financial intermediation.

In part, local institutions—economic, legal, and social—determine the organizational forms through which capital is directed from investors to entrepreneurs. As the paragraphs below describe, the fit between local institutions and angel investing offers promising possibilities for the future of entrepreneurship and seed-stage finance in emerging markets.

Institutions Matter: Angel Investing and Market Development in Latin America

In the last decade, economists and finance scholars have substantially advanced our understanding of the link between basic institutions and financial market development. Through large-scale historical studies, researchers have shown how the rule of law, the efficacy of courts, and the security of property rights underpin all financial arrangements, from the simplest to the most complex. What is now clear is that the health of a nation’s financial system is a direct reflection of the quality of its economic institutions. Those institutions, including the central bank and stock market and the formal and informal systems of laws and property rights, set the “rules of the game” for local firms. When they work well, local institutions make it easier for entrepreneurs to start firms, raise capital, write contracts and compete with established firms. When they don’t work well, local institutions work like a trap, holding back entrepreneurship and keeping firms from competing at home or abroad. Though institutions affect all firms in an economy, they are particularly important for new, local firms. Unlike multinationals, local firms cannot easily raise capital abroad or base their contracts in foreign legal systems. Thus, local

firms are truly bound by local economic institutions. So are their nation's hopes for economic growth and rising living standards.

At root, investing and lending are social relationships based on the ability of the contracting parties to reach an arrangement they believe will benefit them both. In simple investing relationships where parties are well known to each other and their actions are easily observed, the parties may reach a suitable agreement without heavy reliance on the law and the government. Handshake deals, IOUs, and oral contracts are common where parties have longstanding relationships, risks are relative low, and the terms of financing are straightforward. More commonly, investing relationships are undertaken between relative strangers whose employ contractual arrangements in order to economize on the heavy costs of monitoring. Generally, the larger, riskier, and more complex the financing arrangement, the more heavily it relies upon the efficacy and predictability of local institutions. The heavy reliance on institutions also applies to standardized lending and investing arrangements undertaken through or directly supported by securities markets. Financial arrangements of this type, which is absolutely standard in highly developed economies, include mortgage-based and home-equity lending through commercial banks, automobile loans and a wide variety of loans that used stocks and bonds as collateral. Where economic institutions enable easy financial contracting through the law, capital wends its way to all corners of the economy through a rich and vibrant financial ecosystem.

The financial market of the United States epitomizes the largely impersonal system of financing that efficiently and somewhat mysteriously allocates capital throughout an economy. In terms of size, liquidity and capital costs, the U.S. system is unmatched. Its size and history have contributed to a large and longstanding supply of capital from internal and external sources. But what truly makes the U.S. financial system operate so effectively is a deep and stable legal system and a host of financial institutions that monitor firms, regulate transactions, and widely disseminate a vast array of financially relevant information. Many of the economic institutions that support financial arrangements in the United States work so well that they seem unremarkable or even invisible to most observers. Nevertheless, the system would quickly stumble and fall were seemingly mundane standards and laws removed. The cumulative knowledge embodied in accounting codes such as the GAAP, SEC regulations, the management of credit histories, and all forms of property laws contributes mightily to the stability and efficiency of the U.S. financial system. Unfortunately, like Rome, such a financial system isn't built in a day or even in a decade. In the United States and elsewhere, the development of effective economic institutions and a sound financial ecosystem is regrettably, but understandably, a slow, deliberate process.

The importance of economic institutions in general and a strong financial system in particular raises important questions all those interested in the economic prospects in Latin America. Does the inherently long-term process of building financial markets mean that faster economic growth in Latin America is years away? Will faster economic growth in the region come only after economic institutions are fully developed or will their development and faster growth go hand in hand? Those questions are too large to fully address here but, surprisingly,

this is the context in which we should reflect upon the meaning and prospects for angel investing in Latin America. Like any other investors angel investors (“angels”) seek investment opportunities and are willing to put capital at risk. But angels are unlike more familiar classes of investors (e.g., venture capitalists, investment bankers) in ways that make them well suited for success in Latin America and that highlight the complex relationship between institutions, entrepreneurship and economic growth.

Angel Investing and Economic Institutions

Perhaps the easiest way to emphasize the relationship between angels and economic institutions is to compare angels with venture capitalists (VCs), their closest investor cousins. Whereas the majority of angel investors are easily distinguished from VCs, some of the largest and most sophisticated angel investors are nearly identical to VCs. Here we use the term angels to refer to the most common class of angel investors, which are neither as large nor as formally structured as the typical VC. Angels and VCs are similar in their general goals and the skills they possess, but Angels are distinct from VCs in numerous ways that are central to the likelihood of their success in Latin America.

First and perhaps most important, angels typically supply the capital that they invest whereas VCs mostly invest capital on behalf of others, usually pension funds, institutional investors, and corporations. One might be tempted to argue that capital is capital and that it is the size and terms of financing that differentiate angels and VCs. But make no mistake the difference in funding sources is critical. Unlike the capital providers to VCs, angels typically remain very close to their money. Angels play an active role in selecting and monitoring the investments they make and are active in the firm they invest in. By contrast, VCs more commonly operate as financial intermediaries who undertake a similar set of investment-related activities, but do so for capital providers who remain uninvolved in the investments. For VCs, the reliance on third parties to fund their investments has many advantages. The main advantage is that VCs can draw upon an almost unlimited pool of capital that they can deploy virtually anywhere they see fit. Being open to a wide pool of capital economizes on the costs of raising funds, lowers required returns and thus, offers higher expected margins for VCs.

But coaxing funds from financially sophisticated investors who can select among a multitude of investment alternatives is not easy. Because they entrust their capital to others, institutional investors, pension funds, and corporations require financing arrangements and assurances that permit them to receive high returns without being directly involved in the investments or the firms themselves. The typical capital provider to a VC relies upon a reasonably accurate and timely flow of verifiable financial information on the VCs investments. That is, VCs must invest where monitoring can be undertaken efficiently and without hands-on involvement by their capital providers. Furthermore, these capital providers, who themselves are often investing on behalf of others, are strongly tied to achieving market rates of return in a relatively short time period. VCs’ capital providers are not particularly patient investors. They allocate their capital judiciously and readily liquidate their positions if sufficiently high risk-

adjusted returns do not materialize. All of those points imply that VCs, because of their source of financing, rely heavily on the financial market institutions that support third-party monitoring and, no less directly, on the legal system and the efficacy of securities laws. By making accounting firms, banks, investment banking firms and attorneys legally liable for faulty or biased information, a nation's legal system provides strong incentives for providers of those market-supporting activities. An effective and efficient legal system promotes trust in the firms and market institutions that make VC investing possible.

To satisfy their sophisticated investors, VCs include contractual terms in their standard funding contracts that give the VC cash flow rights, voting rights, and board rights over the firms they invest in. Why all three? Each is a way to manage the complex set of contingencies that influence the risks of the VCs investment. The use of various mechanisms of control also reflects the inherent incompleteness of the contracting environment. VCs also rely heavily upon the use of financial securities, such as convertible preferred stock, to manage the firms in which they invest. Those securities largely determine managerial control and also serve to incentivize certain actions for firms, such as retaining the involvement of the founders and meeting financial targets. The complexity of the typical financing arrangements used by VCs underscores the sensitivity of VC financing to local financial institutions. To be successful, the typical VC financing arrangement requires a highly effective judiciary (to handle legal disputes and ensure the value of contracts); investor protection and property rights (to reduce the need to pursue legal action); financial market reporting and disclosure institutions (to help monitor investments for themselves and their investors); financially sophisticated securities laws (to handle state-contingent securities); robustness and trading activity on financial markets (for exit) and; institutions that promote and allow local firms to be traded via ADRs or go public on larger foreign markets.

Like VCs, angels benefit from strong institutions; but the investment form, or perhaps "technology," used by angel investors internalizes many of the institutions of finance that are critical to more formal and sophisticated investment forms. Because angels more typically invest and manage their own rather than other people's money, they are less directly dependent on the institutions that support more complex forms of finance. Angels monitor firms for their own sake and so avoid the need to produce regular performance information that is verifiable to distant investors. Although angels certainly need timely financial information for themselves, they don't have the same level of reporting burden as VCs and don't make as heavy use of the formal reporting infrastructure.

Another important element of the angel investing technology is that it tends to fund and invest more locally than other sources of finance. Angels like to be close to the firms they invest in and this has many benefits, particularly in challenging environments. Staying close means investing in firms that can be monitored easily, visited regularly, and assisted through the social connections that angel investors bring. Closeness, in many ways, is an effective substitute for more formal monitoring requirements and strict contracting terms. Angels often operate as mentors and under more flexible terms than VCs. That is a good thing, because newer firms in challenging institutional environments would probably be pushed out of the market if burdened

with the need to meet the more onerous demands of VCs. Angels' preference for investing locally also makes them more patient investors. They are less drawn to the prospect for speculative gains from passive investing and so tend to accept a less stringent timeline and hurdle rate than VCs do.

Exit

In many ways, angel investors are better suited to challenging and less developed institutional environments than are VCs. But what about the critical issue of exit? Like all investors, angels expect to realize a return at some point. But here too, angels seem to be better able to manage the challenges of a weaker institutional infrastructure. Unlike VCs, angels don't rely upon IPOs as traditional forms of exit and so they are not as directly dependent on the health of local equity markets. Equity markets, particularly those for IPOs, are relatively young and weak in Latin America and this is a serious challenge for local VCs. Of course, because angels often exit to VCs their prospects are indirectly, but quite seriously, affected by the health of local equity markets. It's true that angel investing adapts relatively well even where institutions are weak, but there is no escape from the deficiencies of the local institutional environment. Angel investing and early-stage VC finance is unlikely to grow quickly without reasonable improvements in the exit prospects for early-stage investors.

Prospects

What does all this mean for the prospects of angels in Latin America? Do the institutional challenges that limit the prospects for VCs and equity markets also prevent successes for angels? Must angels and VCs arrive on the scene at the same time, or will one necessarily precede the other? The short answer to all of these questions is that it remains to be seen. Timing and causation in the development of a financial ecosystem are complex issues. What seems to be clear is that angel groups are forming throughout Latin America and are working diligently to adapt to a challenging environment. Academics, governments, and certainly potential angels have much to learn from those groups, including how existing angels are likely to fare going forward in Latin America.

The Institutional Environment in Latin America

The past quarter-century has brought turbulence and tremendous change in the nations of Latin America, but their economies have grown stronger and have begun to focus sharply on the microeconomics determinants of growth. For most, the contemporary economic history of Latin American begins in the 1980s, called the "lost decade" because it brought the debt crisis and stagnating living standards. After a painful decade of macroeconomic instability and renegotiations, the 1990s brought widespread opening to a rapidly globalizing world. The regions two largest economies, Brazil and Mexico, engaged in large-scale restructuring and

privatization that Chile had begun years earlier. Across the region, nations lowered tariffs and investment barriers and formed regional trading agreements to encourage deeper cross-border commercial relationships.

By the mid-1990s, the region began to show signs of progress and growth, but a spate of currency crises beginning in the middle of the decade decimated small businesses and turned back the clock on growth. Mexico's currency crisis in 1994–95 and the Asian Crisis that engulfed Brazil in 1997 stopped the forward momentum of a decade of tremendous change. Other, smaller but no less important setbacks followed but eventually the painful economic restructuring began to pay off. Economic shocks that would've have crippled the region in prior years didn't, and that simple fact was a sure sign of progress. At long last, much of the region had acquired the stability and resilience it had worked so hard to achieve.

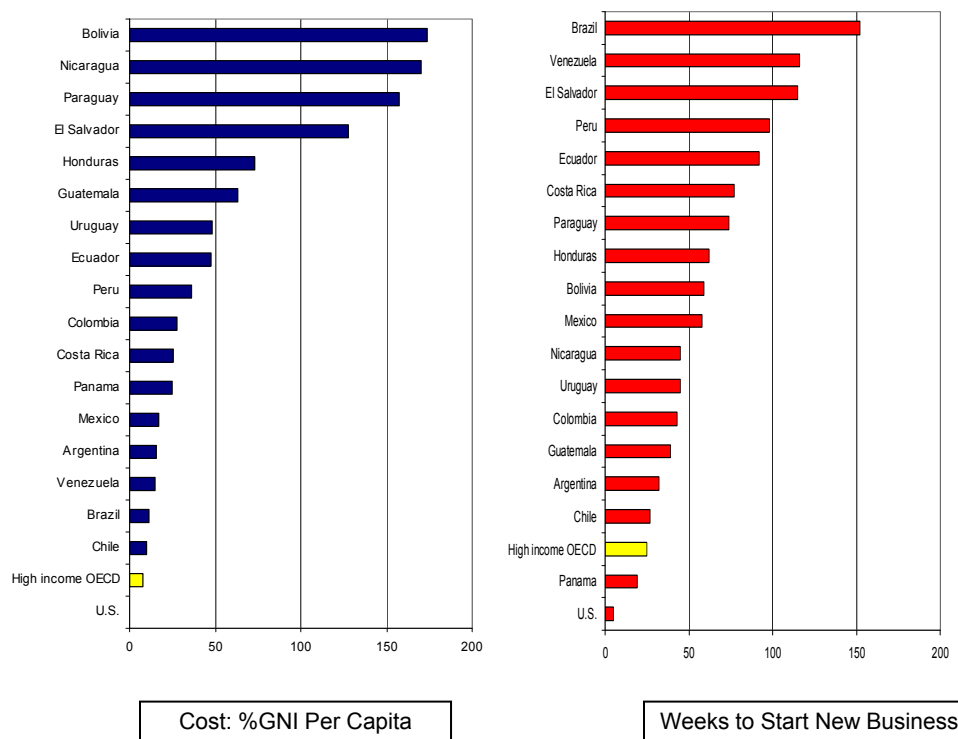
In large part, the economies of Latin America seemed to have reached calmer waters by beginning of 2005. Most had inflation under control and, but for Argentina, had reached reasonable level of government debt. Economic growth had resumed keeping pace with the global economy and foreign investment flows were steady if still too small. Mexico, the region's second largest economy had achieved a milestone in the region that would have seemed unthinkable a decade earlier: investment grade government debt. With few exceptions, the largely open economies of the region were growing or at least stable. Nevertheless, economic growth and broad living standards were below expectations.

In retrospect, it seems that the decades of the 1980s and 1990s taught the hard lessons of macroeconomic stability in a global economy. But now that some stability has been achieved, the nations of Latin America look for ways to sustain and promote growth from within. The essence of internal or "organic" growth is the birth of entrepreneurship and new, competitive firms. Macroeconomic concerns have long dominated policy in the region, but that is changing. More recently, governments have centered many of their policies on reforms that promote entrepreneurship and the creation of new competitive firms. That is great news for entrepreneurs in the regions, because reforms are badly needed. In much of Latin America, the bureaucratic and economic challenges facing entrepreneurs are daunting. To thrive and meaningfully contribute to growth, entrepreneurs will need a much more efficient and friendly governmental and regulatory environment than they currently face. Of course, new firms also need financing and experienced business professionals to guide them in their efforts. That is where angels come in. The formal capital markets in emerging economies are young and well beyond the reach of new firms. Moreover, highly skewed wealth distributions mean that private sources of startup funding are relatively scarce or, for most, well outside their social networks. Angels can assist with both financing and the institutional challenges that may otherwise crush new firms. As the following figures show, the institutional challenges for new firms in most of Latin America are substantial.

Institutional Measures

In any country, governmental approvals such as business licenses, tax permits, and official registrations are a fundamental part of new firm creation. As **Figure 1** shows, in much of Latin America the official recognition process for new firm creation can be expensive and time-consuming. Whether measured as a percentage of Gross National Income (GNI) per capita or the number of weeks it takes to start an officially recognized new firm, entrepreneurs throughout Latin America face substantially higher barriers to new firm formation than their counterparts in the United States or in high-income OECD nations.

Figure 1. Starting a Business in Latin America

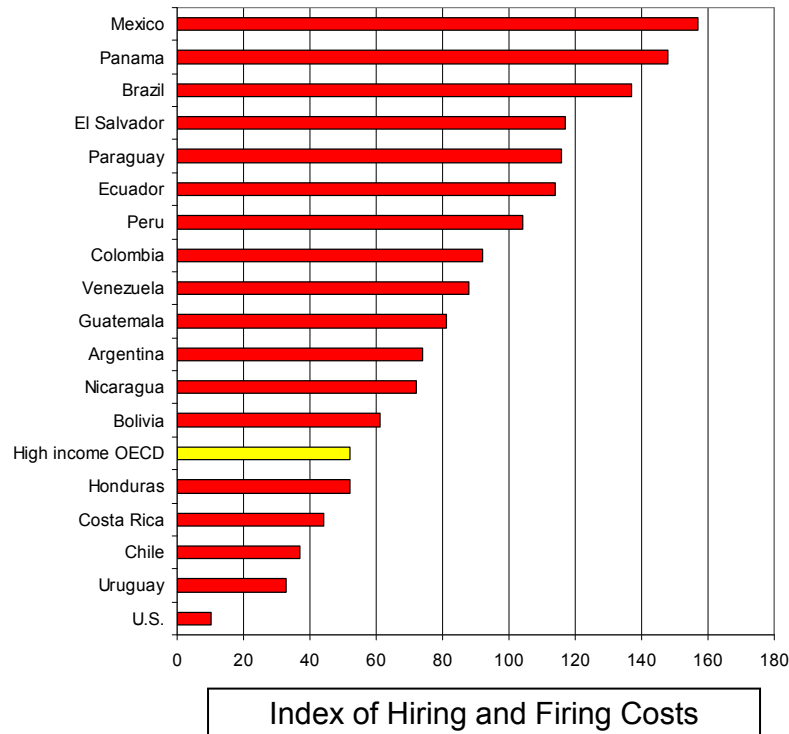


Source: World Bank.

The challenges of managing new firms can also be substantial. **Figure 2** presents an index of the costs of hiring and firing workers in officially recognized firms. Costs of hiring and firing include mandatory weeks of severance pay, health insurance, pension costs, and required payments to various levels of government. Taken together, those costs raise the costs of growth and the risks associated with an economic downturn for new firms. As a consequence, larger and more established firms face less competition from startups.

Figure 2. Hiring and Firing Costs

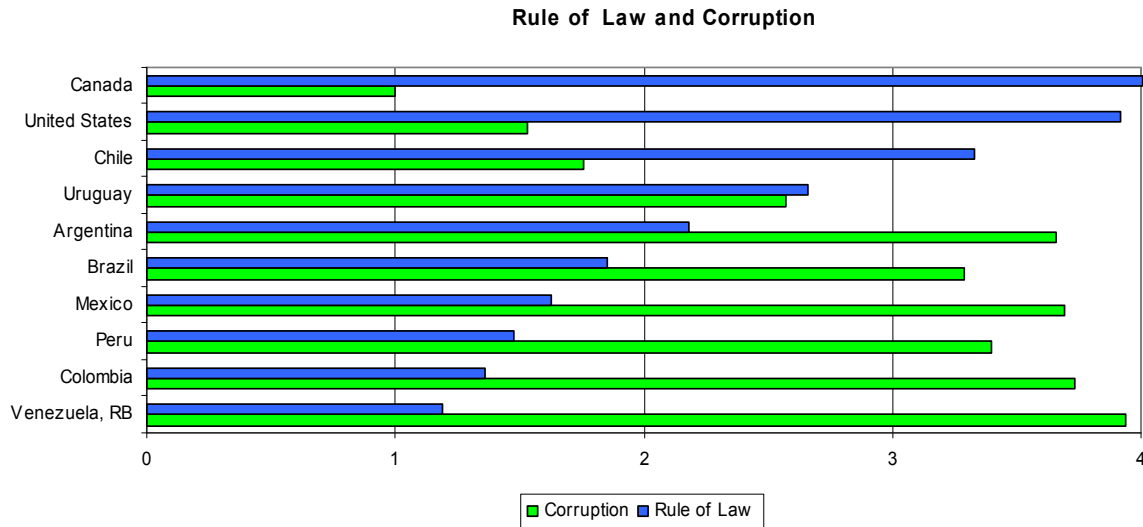
Source: World Bank.



Interactions with government agencies and the legal system occur throughout the life of firms. Even when legal disputes don't arise, the rule of law and the efficacy of the court system determine the security that accompanies business contracts. Similarly, government agencies influence a wide range of business activities and can significantly impact firm performance. Most Latin American countries, like the majority of emerging economies throughout the world, still have far to go in promoting adherence to the rule of law and government agencies that operate efficiently. **Figure 3** presents indices reflecting adherence to the rule of law and perceptions of corruption.

Figure 3. Contract Security

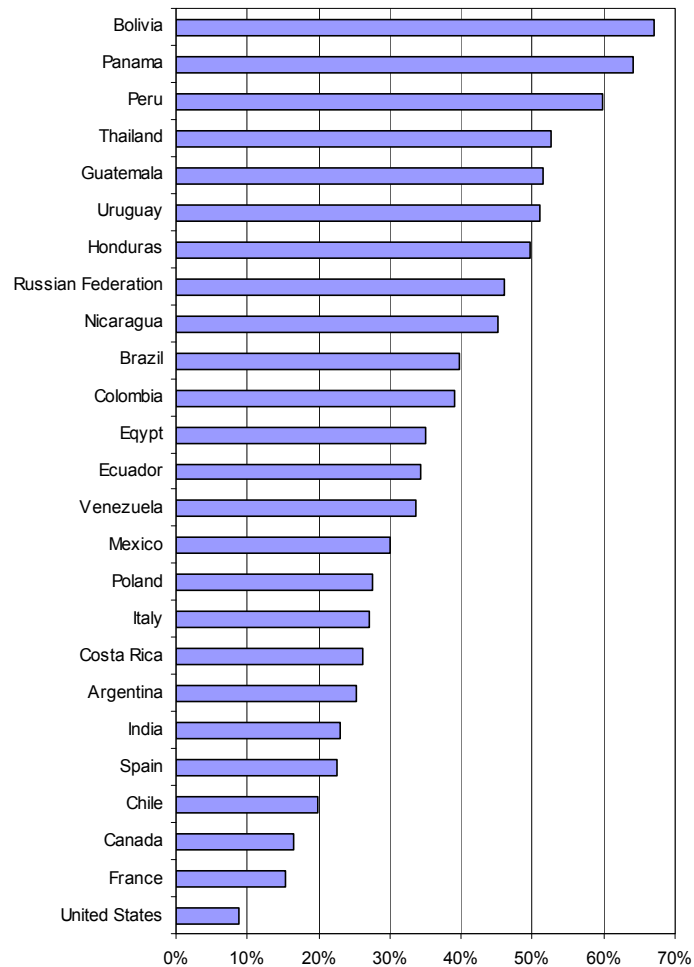
Source: World Bank.



Given the substantial costs of operating officially, it isn't surprising that, when combined with weak governance, many firms simply opt out of the formal economy. Instead, they operate outside the formal institutional infrastructure and bear all the challenges that go along with the need for informal finance, contract enforcement outside the official legal system, and a lack of regulatory oversight. Faced with those challenges, is it safe to say that firms that, on their own or with the help of angels, operate in the formal economy have an advantage over underground firms? Alas, firms that operate in the informal economy have their own advantages that sometimes tilt the playing field in their favor.

Firms that operate in the informal economies often don't pay income or property taxes, import tariffs, or meet costly safety and health standards. As a result, those firms achieve a sizable cost margin over their competitors that operate in the formal economy. Consequently, the institutional environment bites twice for many new entrepreneurs: it's costly and challenging to navigate, and it spawns competitors who operate outside the laws and have built-in cost advantages. To succeed in such an environment, entrepreneurs must leverage the advantages of formality to such an extent that they outweigh the cost advantages of operating underground. Angels seem well suited to assisting new firms with these challenges. **Figure 4** shows the size of the informal economy in select Latin American countries and the world.

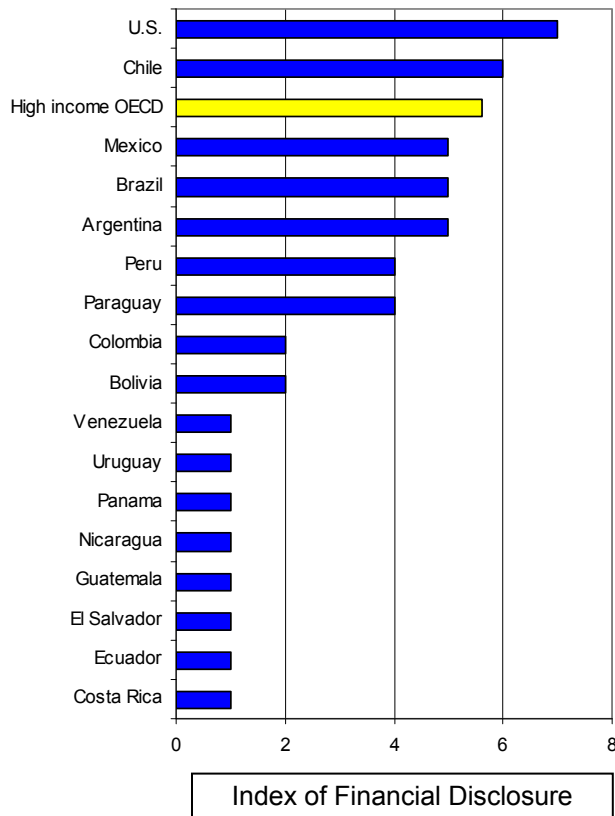
Figure 4. Size of the Informal Economy as a Percentage of GDP in 2000



Legal and governmental institutions are critical for the promotion of early-stage entrepreneurship, and though most associate securities markets with late-stage firms, the depth of a nation's financial system influences firms at all stages of development. Indeed, robust financial markets are both the seed and the flower of economic development and a healthy level of entrepreneurship. Though the securities markets in Latin America's largest economies are growing, they remain relative young and illiquid. One reason that these markets remain inaccessible to most firms is the lack of protection for most investors, particularly minority investors. As **Figure 5** shows, protection for investors in most Latin American countries substantially lags behind that of high-income OECD nations.

Figure 5. Protection of Investors

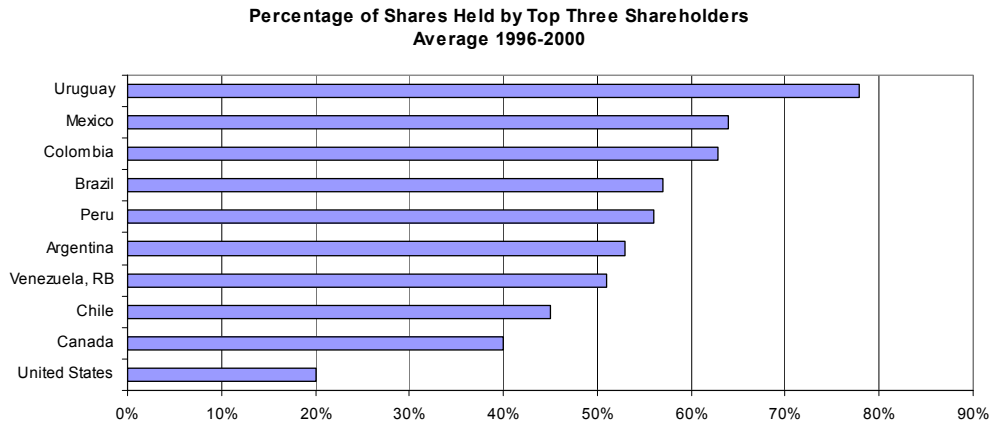
Source: World Bank.



Because of relatively weak protections for minority shareholders wealthy investors will seek security for their investments through majority ownership positions. Along with the historical foundations for business conglomerates, or *Grupos*, the lack of support for minority investors leads to concentrated ownership on Latin American exchanges. As **Figure 6** shows, in most countries in the regions, the top three shareholders own more than half of all shares in the average listed firm.

Figure 6. Ownership Concentration

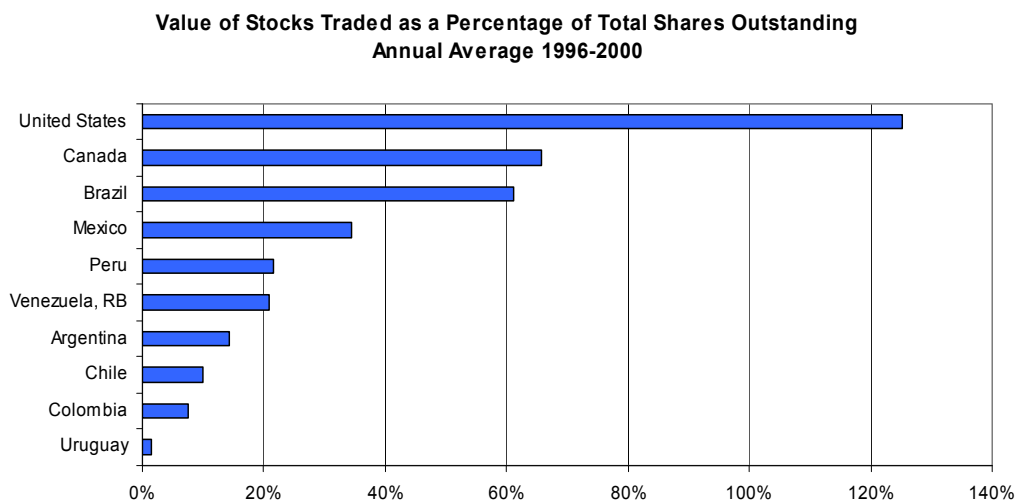
Source: DataStream.



A natural consequence of high ownership concentration is a relatively low level of trading activity. When ownership is concentrated, fewer traders are active in the market and the average share may be sold once a year or less. Liquidity for most issues remains low and as a result the risk of purchasing any given share is higher than in more liquid markets. **Figure 7** reveals that turnover in Latin American equity markets is reasonably high in some markets, but that illiquidity is an important concern on most of the regions exchanges.

Figure 7. Equity Market Turnover II

Source: DataStream.

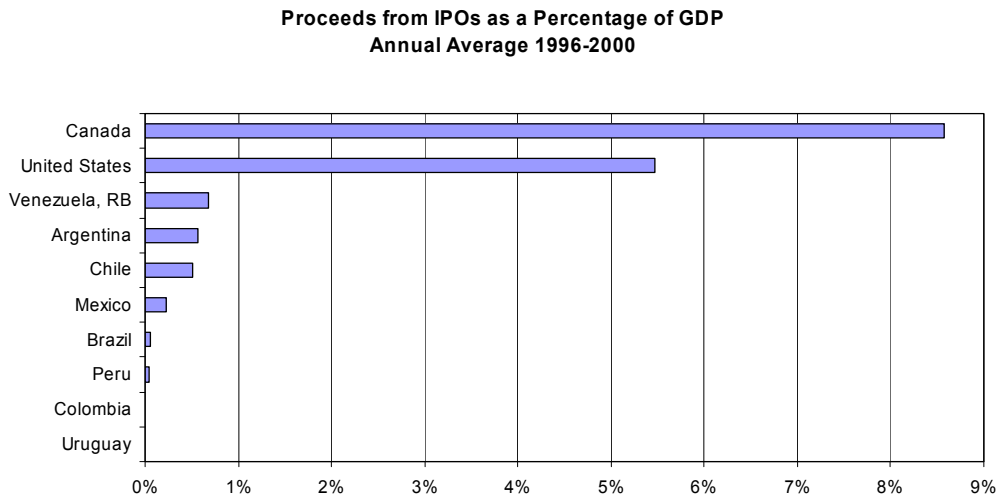


The combination of relatively illiquid markets for most securities and substantial institutional challenges for entrepreneurs results in a small market for initial public offerings (IPOs), which is evident in **Figure 8**. The market for IPOs is improving in many parts of the

region, but remains too small to attract aggressive entry by VCs and thereby limits the exit opportunities for angels.

Figure 8. Relative Size of IPOs

Source: DataStream.



The challenges of entrepreneurship in Latin America are substantial, but so too are the opportunities. Despite the apparent institutional weaknesses, entrepreneurial activity is blossoming throughout the region. Alongside the growing interest in entrepreneurship, the formation of angel groups is making an impact on a new generation of firms and managers. The ultimate impact and success of angels in Latin America remains to be seen, but it does seem that their style of investing may be just what the region needs to promote internal growth. In addition to their adaptable style of investing, the personal involvement angels bring to new firms may be even more important in societies in which success is closely tied to one's ability to navigate a complex institutional and social system. In high-income economies, where the institutional environment is robust and inclusive, personal ties seem to be less crucial to business success than in lower-income economies. Angels, it seems, have much to offer and much to gain from Latin America. What they need to get started is a basic understanding of best practices and the ability to learn from sister networks how best to adapt to the local environment.

Discussion Questions

Certainly, many questions and challenges remain regarding the role and future of angel investing. Can Angel investing substantially impact the economies of emerging markets, or is it just a way to enrich a few entrepreneurs and financiers? Does the prevalence of angels reflect institutional weaknesses or strengths? What are the implications of angel investing for foreign firms looking to invest in emerging markets? Finally, why has there been so little angel investing in emerging markets, and what does that tell us about finance, entrepreneurship, and the process of economic development?