THE ROLE OF THE EXIT IN THE INITIAL SCREENING OF INVESTMENT OPPORTUNITIES: THE CASE OF BUSINESS ANGEL SYNDICATE GATEKEEPERS

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ABSTRACT. The exit process has been largely ignored in business angel research.. The practitioner community identifies the difficulty in achieving exits as the most pressing problem for investors. This has been attributed to the failure of investors to adopt an exit-centric approach to investing. The validity of this claim is examined via a study of the investment approach of 21 'gatekeepers' (managers) of angel groups in Scotland and Northern Ireland. Most gatekeepers say that they do consider the exit when they invest. However, this is contradicted by a verbal protocol analysis which indicates that the exit is not a significant consideration in their initial screening process. The small number of exits achieved by the groups is consistent with the general lack of an exit-centric approach to investing. Only three groups exhibit evidence of a strong exit-centric approach to investing. The lack of exits may have a negative impact on the level of future angel investment activity.

Key words: business angels, angel groups, exits, investment screening, verbal protocol analysis, co-investment funds

1. INTRODUCTION

The core of the entrepreneurial process is the creation of financial value. Yet, compared to the emphasis that has been given to the start-up, scholars have devoted remarkably little attention to the exit process, and specifically to the harvest event where the financial value that has been created is extracted. Many studies have equated exits with failure and so have only considered businesses that cease trading involuntarily. Where the harvest event has been considered this has typically been in the context of an IPO

(often linked to venture capital investments), with such studies adopting a narrowly financial perspective. In recent years this omission has started to be addressed (DeTienne, 2010; DeTienne and Cardon, 2012; Wennberg et al, 2010; Wennberg and DeTienne, 2014). This literature has adopted an entrepreneur-centric view of the exit, defining it as "the process by which the founders of privately held companies leave the firms that they helped to create" (DeTienne and Cardon, 2012: 353). Three situations are identified in which exits occur: (i) when the firm ceases trading for financial reasons (e.g. bankruptcy), (ii) when a firm is acquired and subsumed into another organization, and (iii) when a founder leaves an on-going business (e.g. through family succession, sale of the business or forced departure) (DeTienne and Wennberg, 2013). Meanwhile, the individuals involved in any of these situations may continue as entrepreneurs by starting or buying another business.

An important limitation of these studies is their conceptualisation of the exit decision and exit process as revolving around the entrepreneur. But an entrepreneur-centric view of the exit is inappropriate in cases where businesses have raised finance from business angels and venture capital funds. These investors are making equity-based investments for capital gain and therefore require a harvest event to realize this financial return: venture capital funds need to return the cash to their limited partners while angels need liquidity to be able to make further investments. Hence, for these businesses it is not 'if' but 'when' an exit will occur. The key distinguishing feature of these exits is that both the investor and the entrepreneur will be involved; indeed the investor may take the lead in developing an exit strategy, managing the exit process and determining its timing. The

actual exit process normally involves all of the shareholders in the business – both internal (e.g. entrepreneur(s), senior management team and in some cases employees) and external investors - selling their entire shareholdings , typically via the sale of the business to another company (a trade sale). This can be either a one-off process or staged over a period of time. The entrepreneur might leave the company immediately or may be required by the new owner to work in the acquired business for a period of time.

Although investor-led exits are only a small subset of all entrepreneurial exits they are significant for several reasons. First, the fact that they have previously raised investment and have now attracted a buyer signals that these are high growth potential businesses which have already achieved some level of growth. Second, exits enable angel groups and venture capital funds to attract further investors by demonstrating their ability to make a financial return. Third, they provide investors with both the financial liquidity and the motivation to make further investments. Conversely, a lack of exits constrains the re-investment process through its adverse impacts on investor liquidity and motivation. Fourth, exits are likely to set off a process of entrepreneurial recycling in which members of the entrepreneurial team will reinvest their newly acquired wealth, along with their accumulated experience and time in other entrepreneurial activities, including starting another company, becoming an investor in young businesses, mentoring and involvement in entrepreneurial support organisations (Mason and Harrison, 2006). And finally, with the growth in public sector co-investment funds which invest alongside private investors, the need for exits is now also an issue for government. In short, the ability of investors to achieve exits is a major determinant of the vibrancy of

entrepreneurial ecosystems (Mason and Brown, 2014). For all these reasons, investor-led exits should be included in the emerging entrepreneurial exits research agenda (DeTienne and Wennberg, 2013).

Our focus in this paper is on business angels - high net worth individuals who invest their own money, either alone or with others, directly in unquoted businesses in which there is no family connection. It is now widely accepted that business angels play a critical role in financing the early stages of growing businesses (Mason and Harrison, 2000; Sohl, 2012). They have become an even more significant source of funding for entrepreneurial businesses in recent years as a result of the contraction in venture capital investing and decline in bank lending (Mason and Harrison, 2011; 2015).

There is growing concern amongst angel investors that exits have become harder to achieve since the technology crash of the early 2000s (Waddell, 2013). This has two dimensions. First, there are simply fewer exits. As one experienced angel has observed, "the overall impression when talking to Angels around the world is that they have become frustrated with the lack of successful exits or liquidity events, resulting in them not receiving the return on their investments they hoped for" (Gray, 2011). Second, those exits which do occur are taking longer to achieve. John Waddell, manager of Archangels, which claims to be the oldest functioning angel group in the world, observed in evidence to a Scottish Parliamentary Committee that "in 2005 the average time between investing and existing for early stage companies was about three years; it is now 10 years or more … There has been an exit drought" (Waddell, 2013: col. 3697). The

same problem has been highlighted by the National Angel Capital Association of Canada in its most recent investment report (NACO, 2014: 44). “A main challenge for a number of angel groups is the length of time to exit. Long investment time horizons restrict the Angels’ ability to reinvest in new companies. The lack of fund circulation means groups must recruit new members in order to remain active. Much of the Angel group managers’ time is spent seeking new membership in an attempt to address investor fatigue”.

The low rate of exits is attributed by Gray (2011) to the failure of the angel community to build the exit into their investment appraisal. He ascribes this attitude to two beliefs that he argues are widely held by angels. First is the belief that “good investments will always find exits”. This view has been articulated by the prominent entrepreneur, venture capitalist and angel investor Luke Johnson (2012) who has stated that “if the business works you will be spoilt with choice of exit”. Angels who hold this view would not see any need to consider exit possibilities at the investment stage nor would they seek to pursue an exit strategy after the investment had been made. The second belief is that it is inappropriate to discuss exits with entrepreneurs prior to investing or to actively pursue exits post-investment as somehow this puts the entrepreneur and the investor on an unequal basis. Johnson (2012) has argued that it is off-putting to the entrepreneur who is passionate about their business to be asked about the exit in their first conversation with a prospective investor. However, this approach to investing has been claimed to reduce the prospects of achieving a successful exit. First, it increases the risk that investments will be made in companies for which there are no prospective acquirers. Second, those exits

which do occur will be opportunistic and therefore fewer than if a strategic approach to the exit was adopted.

In this paper we use verbal protocol analysis to examine the validity of the claim that the managers of angel groups – often termed gatekeepers - are not sufficiently exit-centric in their approach to investing on a sample of gatekeepers of angel groups in Scotland and Northern Ireland. We find that only a small minority of groups give significant consideration to the exit at the initial screening stage. This is consistent with the small number of exits that the groups have achieved.

2. LITERATURE REVIEW

The business angel literature reflects in microcosm the criticism of the wider entrepreneurship literature that exits have been ignored. The emphasis is on the process of making investments, with much of the research focusing on the investment decision-making of business angels (e.g. van Osnabrugge, 2000; Mason and Harrison, 1996; Mason and Rogers, 1997; Feeney et al, 1999; Mason and Stark, 2004; Riding et al, 1993; Clark, 2008) and on the types of investments that they have made (Mason and Harrison, 2010; 2011). Angels typically subject opportunities to a two-stage decision-making process comprising a selection stage – or initial screen - in which investors decide whether they are interested in the opportunity and wish to give it more detailed consideration, and the post-selection stage which involves a more thorough assessment of the opportunity (Maxwell et al, 2011). The emphasis at the initial screening is on tangible, objective criteria (Brush et al, 2012), notably investor fit, market and

entrepreneur (Mason and Rogers, 1997). A high proportion of the deal flow – anywhere from 70% to 90% - is rejected at this stage (Riding et al, 1993; Carpentier and Suret, 2013). The decision-making is made on a non-compensatory basis (Maxwell et al, 2011), with rejection being based on the accumulation of perceived deficiencies (Mason and Rogers, 1997).[1] The remaining opportunities are then subject to some form of due diligence. At this stage in the decision-making less quantifiable items and intangibles become important (Brush et al, 2012), notably people factors, specifically the personal qualities of the management team (e.g. trustworthiness, capability for hard work, coachability) and a judgement on their capability to successfully exploit the opportunity (Feeney et al, 1999). Rejection at this stage is generally based on one or two fundamental issues (Mason and Harrison, 1996). In those cases where the angel wants to make the investment investigation would normally be undertaken to verify all material facts (Mason and Harrison, 1996). If nothing negative emerges from that stage the angel will then seek to negotiate the terms and conditions of an investment. Central to this process is the valuation of the business.

The picture that emerges from these studies is that business angels give very little thought to the exit in either their investment appraisal or post-investment involvement, do not have clear exit plans at the time of investing and are relaxed about the timing of the exit (Wetzel, 1981; Gaston, 1989; Harrison and Mason, 1992; Landström, 1993; Mason and Harrison, 1994; Lumme et al, 1998; Maxwell et al, 2011). Indeed, in one

[1] Interestingly, in the UK version of Dragon's Den 58% of 'deals' that were agreed on-screen subsequently fell through. The main reasons were, first, the subsequent research identified problems that had not been recognized at the initial pitch, second, that the business had received funding from another source, and third, that the motivation of the entrepreneur to appear on the programme was to seek publicity for their business (Real Deals, 2013; Financial Times, 2013).

study, ‘potential exit routes’ was ranked 24th (out of 27) investment criteria by angels (Van Osnabrugge and Robinson, 2000). There is also no evidence in studies of the post-involvement of angels in their investee business that preparing the business for an exit is one of their value-added contributions. Indeed, this activity was not mentioned in any of the studies reviewed by Politis (2008). However, Collewaert (2012) notes that the investor’s intention to exit may be a source of conflict with the entrepreneur.

There has also been very little discussion of the outcomes of the investments or what influences such outcomes. There are no studies of the exit process and only a handful of studies which have examined the investment returns of business angels (Lumme et al, 1998; Mason and Harrison, 2002; Wiltbank and Boeker, 2007; Wiltbank et al, 2009; Wiltbank, 2009; Roach, 2010; Vo, 2013). Wiltbank’s studies suggest that higher returns are associated with greater time spent doing due diligence and greater interaction with investee companies (Wiltbank and Boeker, 2007; Wiltbank, 2009). However, there is no evidence whether a pro-active approach to exit by the angel has an influence on returns.

Venture capital funds, in contrast, are much more concerned than angels about exiting their investments (van Osnabrugge, 2000). They typically raise their money in the form of a 10 year fund and so need to invest in, and exit from, their investee businesses within this period, normally in around five years, in order to be able to return profits to the investors in the fund and demonstrate a successful investment track-record to raise a further fund. This requires the exit to be planned and managed. Moreover, they have a portfolio approach to investing and so are seeking to maximize returns to the fund which

typically is achieved by one or two very successful exits. As a rule of thumb, all of the returns come from 10%-20% of investments (Peters, 2009; Zider, 1998). This, in turn, encourages a "swing for the fences" approach to investing in which the emphasis is on achieving large exits, typically through an IPO. These have been shown to generate superior returns and as well as providing reputational benefits (Söderblom and Wiklund, 2006). However, they account for only a minority of venture capital exits (less than 20%). The venture capital literature therefore gives more prominence to the exit, largely based on the statistical analyses of databases, albeit with a disproportionate emphasis on the IPO process (e.g. Espenlaub et al, 1999; Gompers, 206; Dolvin and Pyles, 2006; Bessler and Seim, 2012; Lerner et al, 2012). Angels are much less likely than venture capital funds to exit via an IPO (Johnson and Sohl, 2012; Carpentier and Suret, 2014). Exit considerations feature in relatively few studies of the investment decision-making of venture capital funds (e.g. Kollman and Kuckertz, 2009) and their value-added contributions (Large and Muegge, 2008).

It may have been appropriate in the past for angels to take a relaxed view of exits. Angel activity was more of a hobby activity, angels were making fewer investments and investing less money and personal reasons for investing were more important, notably the excitement of being involved in a new venture or investing in 'hot buttons' (Wetzel, 1981), from which psychic income was derived. In addition, the existence of a stronger funding escalator meant that there was greater likelihood that an angel-backed business would go on to attract follow-on funding from a venture capital fund (Freear and Wetzel, 1990) which, in turn, would manage the exit. However, the emergence of managed angel

groups (Mason, 2006; Sohl, 2007; 2012; Gregson et al, 2013; Mason et al, 2013) and various fee-based intermediaries offering 'packaged' investment opportunities has increased the emphasis on the need for an exit. Angel groups operate more professionally, with a more formal process of assessing opportunities. There is a more arms-length relationship with investee businesses and hence less likelihood of developing an emotional attachment to investments (Ibrahim, 2008). For both reasons there is less opportunity to derive psychic income. Moreover, angel groups are investing more frequently, making bigger investments, are less reliant on venture capital funds for follow-on investment and hence are more likely to fund a business to an exit. They also need exits both to provide their members with the liquidity to make new investments and to attract new investors. Fee-based intermediaries need to demonstrate that the investment opportunities they offer their members are capable of generating good financial returns.

However, the literature on exit strategies is sparse. The main contributions are from practitioners (Peters, 2009; McKaskill, 2009) who argue for the need for an exit-centric approach to investing in which the exit is considered at every stage in the investment process. McKaskill (2009) argues that because the exit is the central event in the entire investment process it needs to play a major part in the investment decision. A key consideration at the initial screening stage should therefore be who is likely to buy the company and how much money will be required to get the business to the point when it can be sold. Angel investors also need to raise the necessity for an eventual exit with the entrepreneurial team and discuss this with them in the context of their ambitions and

aspirations and the realism of their expectations. At the due diligence stage the priority for an exit-oriented investor is to identify any financial or legal issues that would complicate an exit. An exit-oriented approach to investing would also give careful consideration to valuation. If the angel investor places too high a value on their investment it will not attract an investor at the next round. Exit considerations would also dominate the legal stage. Exit strategies should influence the initial term sheet. Achieving alignment of interests between the entrepreneur and investor is critical. Both will therefore want to structure a deal that offers the most flexibility when it comes to an exit, whenever that will be. A key consideration here would be the class of share that angels accept. Preferred shares give investors more rights. An exit-oriented investor would have regular discussions on the exit strategy after the investment is made (e.g. at every board meeting) and would put in place various actions to facilitate a sale, such as a due diligence file for prospective purchasers.

Crafting an exit strategy should be done long before the need arises (Kensinger et al, 2000). Investors therefore also need to decide on whether to prepare their business for a financial or strategic exit. A successful financial exit requires that the business has achieved significant size and growth and is capable of further increasing revenue and profits. This takes time and money, which reduces the return, the business has to overcome the challenges of growth and the risks of failure increase. A strategic exit, in contrast, involves assigning value on the basis of future profits achieved by a buyer who is able to exploit the assets, competences or capabilities of the business being acquired to generate significant revenue opportunities or solve a threat. Hence, it may not matter

whether the business has achieved profitability. A strategic exit requires the identification of at least one, and ideally several, businesses that might want to buy the investee business, understanding why such businesses would want to make the acquisition and positioning the business in such a way that it comes to the attention of potential acquirers. Setting up commercial relationships with such companies is often a means of creating a clear path to a strategic sale (McKaskill, 2009).

Peters (2009) has advocated an ‘early exits’ strategy, arguing that the interests of angels and venture capital funds have become increasingly divergent. He therefore recommends that angel investors should focus on early stage businesses with limited capital requirements that have the prospects of being sold in an M&A deal for less than $30m in three or four years. Although the returns will be smaller, there is less risk and dilution, hence the overall portfolio returns will be greater. Recent evidence (Geron, 2014) shows that not only are most exits small (less than $5m) but also the highest multiples were for companies that raised less than $3m and between $5 and $10m, confirming that angel investors can generate solid returns by investing smaller amounts at lower valuations.

It is likely that the investor will bring the strategic sale opportunity to the attention of the entrepreneur. However, even if the entrepreneur sees the possibility of a strategic sale they are unlikely to have the knowledge or skills to execute it. The investor and entrepreneur therefore need to work together to build the investment case, identify the strategic value, select potential strategic buyers, work out a possible exit value and then determine what needs to be done to prepare the business for sale (McKaskill, 2009).

An exit oriented approach to investing also has implications for portfolio management. It is inevitable that angels will have within their portfolios companies that are likely to fail, companies that will continue to trade but will not generate a profitable exit (the 'living dead') as well as those that offer good prospects of achieving a successful exit. There is an emerging realisation that successful angel investing is about minimizing the losses as much as maximizing the gains. Two particular strategies are critical. The first is to have 'good' failures, by which it is meant that angels must adopt tactics that minimise the losses when an investee company is closed down. Outcomes that are worse than simply losing all their money are (i) failures in which the investor also has to cover the costs of winding down the venture and paying accountants to provide the financial accounting needed for the investor to take his/her tax deduction; (ii) ongoing litigation expenses even after the investee company has no value; and (iii) reputational damage arising from broken relationships with co-investors and adverse media coverage (Ohio TechAngels, 2009).

The second requirement is to 'fail fast'. A big dilemma for angels concerns those companies in their portfolio that are underperforming but not failing – the so-called 'living dead'. These are companies that have not realised their initial promise of value creation but neither are they likely to fail. They are making a little money which is just enough to keep the entrepreneur's dream alive but there is no possibility that it will generate returns to their investors. Moreover, the entrepreneurs do not want to give up because of what they have invested financially and emotionally. A key requirement is

therefore for angels to be able to recognise the symptoms of a 'living dead' investment at an early stage and take appropriate action – sell it, merge with a competitor, turn it over to the management or simply close it down (May and Simmons, 2001). Managing 'living dead' investments has attracted surprisingly little attention in the venture capital literature (Ruhnka and Feldman, 1992) and none in the business angel literature.

3. DATA AND METHODOLOGY

The study is based on 21 semi-structured interviews with the manager - often termed the 'gatekeeper' (Paul and Whittam, 2010) - of 18 angel groups based in Scotland and also Halo of Northern Ireland. In three groups the gatekeeper role was shared by two individuals. In two cases the individuals were interviewed separately. In the third case both gatekeepers were present at the interview. The groups that were interviewed included all 16 that were publicly listed as members of LINC Scotland at the time, the business angel trade association.[2] Two other groups that are not members were also interviewed. All interviews were transcribed.

The focus on angel groups reflects the transformation of the angel market since the 1990s from one in which angels operated anonymously, investing for the most part on their own or with small groups of friends and business associates in ventures that they came across through personal social and business networks to the present situation in which angels have recognized the advantages of organising themselves into groups to invest collectively (Mason, 2006; Sohl, 2007; 2012; Ibrahim, 2008; Gregson et al, 2013;

[2] All the significant angel groups operating in Scotland are publicly-listed members of LINC Scotland.

Mason et al, 2013). The greater investment capacity of angel groups means that they now have a significant investment presence in the early stage finance market and have been able, to some extent, to close the sub-£2m funding gap created by the decline in early stage venture capital funds. With the shift in the approach of governments to the 'equity gap' from establishing public sector financed venture capital funds to the creation of co-investment vehicles (Murray, 2007; Mason, 2009), angel groups have also become important partners with government.

Angel groups have a variety of operating models. However, the most common is a two-stage process involving an initial screen which is undertaken by the group's manager (who may be a member of the group or a hired professional), with those opportunities which get through the initial screening then considered by the members of the group. Those opportunities that attract sufficient interest are then investigated in more detail, either by the gatekeeper or by a sub-group of members with relevant sector knowledge. It is important to emphasise that the angel group does not invest as an entity: each member makes their own investment decision. Largely unrecognized by scholars, the gatekeeper is therefore now a significant actor in entrepreneurial finance, with the power to reject investment opportunities and may also present opportunities to group members; however, the angels themselves make their own decisions whether to make an investment.

In Scotland the initial groups – Archangels and Braveheart – were established in the early 1990s, preceding the formation of Band of Angels which is the oldest group in the USA.

In 2002 membership of LINC Scotland – the trade body for business angels - comprised 300 solo angels and just these two syndicates which had about 70 angel members between them. Ten years later (2012) a total of 24 groups had been created, although some subsequently either closed or amalgamated. At this point in time LINC Scotland had 19 groups in membership, which it estimates comprised about 700 investors in total. Individual membership of LINC Scotland is now below 100. Of the 18 Scottish-based angel groups interviewed for this study, nearly one-third (six, or 30%) were three years old or less, underlining the recent growth in the formation of syndicates. Membership ranges from less than 10 to over 100.

An initial approach was made via an email to the gatekeeper to request an interview. In several cases it was not possible to identify the gatekeeper, but in these cases the recipient of the email forwarded it to the relevant individual. The interviews included two different techniques to collect data. Initially, gatekeepers answered several questions about the exit strategy of the groups. Coding of these open questions followed a six-step thematic analysis (Howitt & Cramer, 2007) for "identifying, analyzing and reporting patterns within data" (Braun and Clarke (2006, p. 79). Subsequently, each respondent completed a verbal protocol. This is a technique which involves respondents "thinking out loud" as they perform a particular task, in this case undertaking the initial screening of a potential funding opportunity. The technique has been used successfully to examine the decision-making process of both venture capitalists and business angels (Hall and Hofer, 1993; Zacharakis and Meyer, 1995; Mason and Rogers, 1996; 1997; Mason and Stark, 2004; Smith et al, 2010) and has also been applied in a variety of other contexts (see Ericsson

and Simon, 1993). However, it is the first time that the technique has been applied to angel group gatekeepers. The verbalisations of respondents are recorded, transcribed and then the content is analysed by means of a coding scheme devised for the specific research questions. The results of this analysis are generally presented as frequency counts supplemented by direct quotations.

This methodology provides a more reliable and much richer understanding of the decision-making process of investors and the criteria used to evaluate investment opportunities than is possible from approaches that use questionnaires, surveys and interviews (Shepherd and Zacharakis, 1999). People have difficulty in accurately recounting their cognitive process in retrospect, hence self-reported, retrospective data are subject to conscious or unconscious errors associated with *post hoc* rationalisation and recall bias. There are also cognitive perceptual limitations, with evidence that venture capitalists have limited insights into their decision-processes (Zacharakis and Meyer, 1998; Shepherd, 1999). The consequence is that they often overstate the number of criteria actually used, understate the most important criteria and overstate the least important criteria (Shepherd and Zacharakis, 1999). Hence, as Zacharakis and Meyer (1998: 72) note, "past studies provide a laundry list of factors that may be biased in that they list a multitude of factors that have a relatively small influence on the decision." As a real-time experiment which does not require investors to introspect about their thought processes, verbal protocol analysis sidesteps these recall, *post hoc* rationalisation and cognitive biases (Shepherd and Zacharakis, 1999).

Nevertheless, verbal protocol analysis has some limitations. First, a frequency count of 'thought units' is an imperfect indicator of the importance of a factor in the final decision (Zacharakis and Meyer, 1995). No weightings are placed on the responses to measure emphasis and the topics mentioned most frequently are not necessarily those that have the ultimate influence on the decision. Nor does it allow for different convincer patterns. In other words, people may repeat something several times if they are unsure but say it only once if they are absolutely sure. Second, subjectivity is involved in coding, analysing and interpreting the transcripts (Riquelme and Rickards, 1992). Third, some respondents may be uncomfortable or self-conscious about thinking and speaking out loud which may distort their thinking (e.g. resulting in excessive repetition of what they are reading). Fourth, it is impossible to entirely remove the effect of the artificiality of the situation. Fifth, from a practical point of view it ignores the role of the source of funding opportunity which is an important initial influence on the investor's attitude to the opportunity (Hall and Hofer, 1993; Mason and Rogers, 1997). However, Ericsson and Simon (1993) argue that verbal protocol analysis is a valuable method of analysing decision-making as long as the following criteria are met: the information reported must be the focus of attention; the task is not highly routinised by habit; there must be only a short time between performance and verbalisation; verbalisation does not require excessive encoding; reports are oral; subjects are free from distraction; instructions are clear; and completeness in reporting is encouraged. These conditions are all met in this study.

The focus here, as in previous studies using verbal protocol analysis, is on the initial screening stage – the stage when an investor has become aware of an investment opportunity and considers it with a view to obtaining sufficient initial impressions to decide whether it is worthy of detailed consideration or should be rejected out of hand. This stage is done fairly quickly, typically in less than 10 minutes (Sweeting, 1991; Hall and Hofer, 1993; Mason and Rogers, 1996; 1997). The initial screening stage is where some 80% to 90% of investment opportunities are rejected (Riding et al, 1993). One study of Canadian business angels reported that they accepted just 6% of the investment opportunities for detailed consideration (Haines at al., 2003). As noted earlier, the factors which prompt a rejection at the initial screening stage are different to the reasons for rejection at later stages in the investment decision-making process (Mason and Harrison, 1996; Riding et al, 1993; Brush et al, 2012; Mitteness et al, 2012; Carpentier and Suret, 2013). The novelty of this study is that it uses VPA to examine the initial screening of angel group gatekeepers whereas the focus of previous studies was on solo angels. The gatekeeper's objective in their initial screening is to decide whether the proposal has sufficient merit to be of interest to members of the group, balancing the twin requirements of providing group members with sufficient deal flow and not wasting their time with deals that they regard as being un-investable.

Each respondent was shown a current real investment opportunity which was sourced from a business angel network in England. The selection of an English case was intended to minimize the risk that the Scottish gatekeepers would be familiar with the business. It was given a fictitious name to protect its anonymity. The angels were asked to read the

opportunity in the same way that they would normally read an investment proposal but verbalise their thoughts as they did so. The instruction that they were given was to say out loud the thoughts that came into their mind. Respondents were not required to provide any explanations or verbal descriptions (Ericsson and Simon, 1993). One of the authors was present as each respondent performed this task and reminded respondents to think out loud if they lapsed into silence for more than 10 seconds. A short de-briefing session was then carried out with each investor after they had completed the evaluation which asked them to reflect on their approach to exits. The locations included the gatekeeper's office, a coffee shop and the researcher's office.

The verbalisations were recorded and subsequently a complete transcript was made for each respondent's consideration of the investment opportunity. Following the approach of Mason and Rogers (1996; 1997) these verbatim transcripts were then broken down into short phrases, or 'thought segments' – that is, phrases and sentences that are independent thought units – to permit analysis. These thought units were then coded into one of ten categories relating to different types of investment criteria (Table 1). Both authors were involved in triangulating the codings to ensure robustness (Leitch et al, 2010). The frequency counts for each category of investor were then aggregated and compared. Additionally, representative quotes of the identified themes were used to help illustrate the results (Ryan and Bernard, 2000).

TABLE 1 ABOUT HERE

4. EXITS AND FAILURES

The groups had made surprisingly few exits (Table 2) which is consistent with practitioner views that achieving exits is perhaps the biggest challenge facing angel investors. Collectively, the groups made 37 exits which represents just 4% of their investments. The majority of groups - 12 of the 17 that provided data - have not made any exits. Not surprisingly, exits are concentrated amongst the oldest groups (10 years and older), with the three longest established groups accounting for 92% of total exits. Nevertheless, the small proportion of exits amongst the groups aged five to nine years old is clearly apparent, with the vast majority of these groups having not made a single exit. The contrast with earlier studies of exits by UK business angels which reported median holding periods to exit of four years (Mason and Harrison, 2002) and six years (Wiltbank, 2010) is striking. Equally surprising, is the low number of failed investments (Table 2). These account for 17% of total investments. The three oldest groups account for 82% of all losses. Previous studies have reported that the median failed investment emerges after two or three years (Mason and Harrison 2002; Wiltbank, 2010).

This admittedly crude data is consistent with both practitioner observations on the increasing time required to achieve an exit and the claims that angels do not have strategies either for exiting their investments or for managing their 'living dead' investments. In the next section our interviews with the gatekeepers examines the validity of these claims.

TABLE 2 ABOUT HERE

5. INTERVIEW EVIDENCE

Direct questioning of the gatekeepers suggests that the vast majority are fairly attuned to the need to consider the exit at an early stage in the investment process. Just one stated that *"I don't look at exits because they're so far away. There's so much we have to do between now and when they exit. All I look at is the now and how we can add value and build value"* (GK18). When asked what aspects of the exit they consider the other gatekeepers reported that key issues were possible buyers (cited by 62% of gatekeepers), the likelihood of an exit (48%) and the likely return (38%). Less frequently mentioned issues were timing (29%), route to exit (29%), type of exit (19%) and willingness of the entrepreneur to exit (14%). However, they did not expect the entrepreneur to provide a lot of detail about exit possibilities in the pitch/business plan, with one saying that *"I don't expect it to be fully developed"* (GK8). Just over half of the gatekeepers (52%) simply wanted to see evidence that the entrepreneur had 'thought about' the need for an exit; only a minority wanted detail on exit route (24%), likely buyers (19%), returns (19%), timing (14%) and willingness to exit (5%). Most gatekeepers agreed that *"the management have to want an exit"* (GK6). In other words, at the investment appraisal stage these gatekeepers are simply looking for evidence of an alignment of interests with the entrepreneur of the need for an exit: *"I would expect there to be something about an exit whether it be in the pitch or in the business plan. If it wasn't there … I would be delving in to see if we are aligned…. I think it is very important that we are aligned"* (GK7). Another observed that *"we would only invest if we believed in a viable plan and a viable exit plan … [so].. there needs to be some form of exit plan … even if it's a good*

investment because you need to know how you're getting your money out" (GK1). This gatekeeper went on to say that an exit plan *"would demonstrate that [the management team] realize they're in a capital game rather than a lifestyle business."* Conversely not mentioning exits *"could be a deal breaker before you even start"* (GK6).

Some gatekeepers went further, arguing that an awareness of exit possibilities by the management team was a positive signal of its quality. One observed that having an exit plan *"is a point that says it could be a good team"* (GK5). Another commented that if the management team *"have considered the exit and thought about timescale ... [and] they've thought who the buyers may be, then yes we are encouraged"* (GK7). Another noted you would back a management team who had an exit strategy *"because you think they can deliver not only a product and commercial terms and ultimately an exit"* (GK17). This was because exit possibilities are *"a reflection of market knowledge. It's really important for the team to have that because that will drive all the decisions. They should be very much aware of the exit landscape when they're looking for an initial investment"* (GK1). In similar vein another gatekeeper argued as follows: *"Do they understand business? Do they understand what the investors need? If they do then they should know who's acquiring and whose making investments. So I think that shows they understand a bit more about the business"* (GK19). Naivety about exit options would be interpreted negatively by investors – an unrealistic exit plan *"loses credibility"* (GK2). Other gatekeepers gave more emphasis to the sector than the entrepreneur, arguing that opportunities for exit overlapped with market factors. *"In most sales that we have achieved, they have been trade sales ... So this goes back to are you operating in the*

right market place, are there big boys out there that would want small fish to swallow? … The more there is a clear market and a niche for … the company to get into, the better the chances for an exit at some point" (GK6).

Surprisingly, these views did not translate into a recognition by gatekeepers of the need to be pro-active in seeking an exit. Certainly, there was only one gatekeeper who took the extreme position that *"good investments will find their own exits"*. whereas seven disagreed (33%), with one stating firmly that *"I don't agree that good investments will find their own exits. I think they need to be helped"* (GK10). However, the majority (62%) were ambivalent, with one stating that although good investments will find their own exits *"this doesn't mean you don't do anything to try to achieve an exit …"* (GK17). Indeed, most gatekeepers believed that the likelihood of an exit was linked to their value added contributions. One gatekeeper argued that *"you won't sell unless you build, so you build it and at some point you've added enough value that a sale happens"* (GK2). Another made a similar point: *"If you invest to build you'll get an exit"* (GK4) – going on to say that *"taking the company from now to something better is also building and if you're doing that then you can sell it."* However, this approach contradicts McKaskill's (2009) view on investing for a strategic exit. He argues that any investment in the business should be directed towards creating the conditions for an exit and not for more product development, market penetration or any other part of the business concept, none of which may be relevant to the buyer's decision to purchase the business. A rather more sophisticated approach with echoes of Peters (2009) was *"to fund the company to a value inflection point at which we should be able to realize the investment"* (GK4).

Finally, although about half of the gatekeepers indicated that their group has a strategy for dealing with the 'living dead' in their portfolio, this did not come through as being particularly proactive. Most were aware of the need to have 'good failures' as discussed earlier. The danger *"that you can wind up spending more time with the poor companies than you spend with the winners"* (GK6) was also recognised. Another commented that *"if a company does not work that's the sort of scenario where we might send that back to the management team … we have done that on a number of occasions"* (GK 4). However, it is acknowledged that this will realize just a fraction of the original investment.

6. THE INITIAL SCREENING PROCESS: THE SIGNIFICANCE OF EXITS

We cannot be sure that gatekeepers actually practice what they say they do when appraising investment opportunities or even that they are aware of what they do. The second stage in the study therefore sought to put gatekeepers in a position where they simulate as accurately as possible their approach to appraising investments. The approach we adopted is verbal protocol analysis, a technique in which participants are asked to 'think out loud' as they perform a task, in this case the initial screening of an investment opportunity. The advantages and disadvantages of this methodology were discussed earlier. Gatekeepers were asked to discuss a real investment opportunity that was provided by an English business angel network. Given the importance of 'investor fit' (Mason and Rogers, 1997) one of the challenges with this methodology is finding a sufficiently general case that is likely to appeal to a wide range of investors. The case was a medical instruments company at the pre-revenue stage with proprietary IP that had

£100,000 of equity committed and was looking to raise a further £500,000. We changed the name of the business to preserve its confidentiality. In order to avoid it being rejected simply on the basis of its location we asked investors to make the assumption that its location was 'nearby'. Given our focus on the exit it should be noted that the investment proposal contained a short sub-section on exit strategies (4 lines in a 7 page document).

As described earlier, the transcripts were divided into discrete thought units. Each of these though units was then classified where possible on the basis of the specific investment criterion. Eight codes related to specific investment criteria and two other codes were used when the thought unit referred to an action or to something other than an investment criterion. Each of the eight investment criteria was further sub-divided.

The first level coding revealed the breadth of the screening process, with no factor accounting for more than 16% of thoughts. As previous studies have noted, investors focus on a much smaller number of criteria when considering those opportunities that pass the initial screening stage (Mason and Harrison, 1996; Feeney et al, 1999). In previous studies of angel decision-making using VPA, financial considerations, market and the entrepreneur/management team have consistently been the top three criteria (Mason and Rogers, 1997; Mason and Stark, 2004; Smith et al, 2010). In this study financial considerations is also the most significant criterion and markets is also in the top three. However, gatekeepers give greater emphasis to the attributes of the business (ranked 2nd) and slightly less emphasis to the entrepreneur/management team (Table 3). The exit, which did not have a separate coding in previous studies because it was not

discussed, attracted comments from 15 gatekeepers. These comments accounted for just 4% of the total, the lowest of all of the identified criteria (Table 3) and a much lower level of comment than might have expected from the responses to the direct questions. However, there was significant variation between gatekeepers (Figure 1). Two gatekeepers were very focused on exits, with this theme accounting for 18% and 20% respectively of their comments. In a third case 11% of the gatekeeper's comments related to exits. Indeed, these three gatekeepers accounted for 48% of all the exit-related comments. The approach of one of these exit-oriented groups is described as follows: *"We actually put as much effort into the exit at the investment stage as we do checking the business plan…. There is now a three to five page document and that document …. identifies the key milestones, not in product development or going to market but in exit value….. At those milestones we identify who might be interested in it and why they would be interested in it"* (GK10).

TABLE 3 ABOUT HERE

FIGURE 1 ABOUT HERE

TABLE 4 ABOUT HERE

Drilling down to look at the specific aspects of the exit that gatekeepers mentioned (Table 4) reveals that the highest share of comments related to an exit plan (how to achieve an exit), accounting for just over one-third of all comments on exits, and mentioned by just over half of all gatekeepers. This is followed by the timing of exit, with 21% of exit comments and mentioned by six gatekeepers (29%). Both the exit value and potential

buyers accounted for fewer comments and were mentioned by 19% and 24% respectively of gatekeepers. So here again the evidence suggests that gatekeepers were primarily interpreting exit information in two ways, firstly, as a source of assurance that their need for an exit was matched by the entrepreneur's recognition that there needed to be an exit event if they were to secure investment, and second as one way in which to assess the quality of the management team. For these gatekeepers, as noted above, details were less of a concern. Only a minority of gatekeepers actually sought details of how the exit might be achieved.

The VPA analysis identified variations in the emphasis that gatekeepers give to the exit when they are assessing investment opportunities, suggesting that some gatekeepers are more exit-centric than others. This raises two final questions: first, how might this be explained; second, is this reflected in exit outcomes? The average proportion of exit-related comments in the VPA for all gatekeepers was 5%. This was defined as the threshold level for being exit-centric in investment screening. On this basis seven gatekeepers were identified as being exit-centric (Figure 1). The three gatekeepers with the highest exit-centric scores , and the seventh, were all fairly mature groups (six (2), seven and eight years old) but none had achieved any exits. We might therefore speculate that their lack of exits which, in turn, can be expected to have resulted in growing investor fatigue and difficulties in raising further finance from both existing and new members to make new investments, might have prompted a more exit-centric approach to investing. Meanwhile, the gatekeepers ranked 4th to 6th in terms of their exit-centricness

were the oldest groups, tentatively suggesting that length of time investing, and the experience that has been derived, may also lead to greater emphasis on the exit.

7. CONCLUSION

Governments around the world have identified business angels as being a key player in a vibrant entrepreneurial ecosystem (OECD, 2011). It is therefore essential that the business angel market operates as effectively as possible. This means not only a concern about the level of investment activity but also with exit activity. Whereas angel investment activity has been stable, or even increased, since the onset of the financial crisis (Sohl, 2012; Mason and Harrison, 2015) practitioners report that there is now a major problem in achieving exits. This is confirmed by the experience of the angel groups in this study even after allowing for the youthfulness of several of them. The lack of exits, in turn, has a negative impact on future angel investment activity. However, this issue has been ignored by researchers who have continued to focus on investment decision-making and, to a lesser extent, investor- entrepreneur relationships. Meanwhile, policy-makers regard the number of investments arising from their initiatives as their measure of success.

In the context of a growing interest in the exit in entrepreneurship literature this paper has investigated the exit-orientation of angel groups in Scotland and Northern Ireland, examining the approach of their gatekeepers to the investment process, and linking this, albeit tentatively, to actual exit activity. Angel investing is becoming increasingly

concentrated amongst angel groups as individual angels recognise the benefits of investing with others in structures with a professional approach to investing. We find that most angel gatekeepers do not adopt an exit-centric approach to their investment decision-making. Although most say that they consider the exit when they invest this is largely to ensure alignment of interest with the entrepreneur for the need for a future exit. Gatekeepers are not seeking a detailed exit strategy, nor do they expect one to be in place prior to investing. Moreover, except for a handful of gatekeepers exit issues did not loom large in their screening of investment opportunities. Indeed, few gatekeepers took an extreme position. Only one gatekeeper held to the proposition that "good investments will find their own exits." Most thought that building value would result in an exit. However, there was no recognition that financial and strategic exits require different strategies (McKaskill, 2009). Moreover, the hands-on activities of some gatekeepers could be seen as being potentially prejudicial to achieving a strategic exit. Exit-centricness amongst gatekeepers was associated with the age of the group and in its most extreme form with some well-established groups that have not achieved any exits. It would therefore appear that the views of those commentators in the angel community advocating the need for an exit-centered approach to investing has achieved limited penetration amongst Scottish and Northern Irish angel groups. It also needs to be acknowledged that the economic environment since the post-2000 technology crash and especially since the onset of the global financial crisis in 2008 has not been conducive for exits. All of this is consistent with the small number of exits that the groups have achieved in aggregate.

There are also important implications for policy-makers. The growth of co-investment funds around the globe as a means of addressing supply-side gaps in the availability of start-up and early growth capital (Mason, 2009; OECD, 2011), an approach which Scotland pioneered with the launch of the Scottish Co-Investment Fund (SCIF) in 2003, means that achieving exits is now also a significant issue for governments, especially as such funds are intended to be evergreen. One of the features of the SCIF was that it would be a passive investor, automatically following its investment partners into investments that were eligible under the scheme. Although the Fund has representation rights on the boards of investee companies it normally does not take these up. The SCIF currently has a portfolio of over 600 companies. A key question for the SCIF and its political masters - and also for government agencies running coinvestment funds in other jurisdictions - is whether it should use its powers to become more proactive in seeking exits. But this begs three further questions. What can they do in practice? Would it be successful? And would they be willing to make the hard decisions to close down 'living dead' companies in their portfolio in view of the potential negative political and media that such actions would be likely to attract?

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Table 1. Thought segments classification

Investment Criteria	*Description*
1. THE PEOPLE	Issues regarding: the entrepreneur, management team, the inventor. Their background, experience, qualities, etc.
2. PRODUCT	The nature of the product: technical aspects, intellectual property protection, competitive advantages, design, etc.
3. MARKET	This includes points on market: organization, growth, competition, geography, size, etc.
4. BUSINESS PLAN	Specific comments on the plan: length, presentation, content missing data, etc.
5. EXIT	Who? When? How much? Type of exit. Existence of an exit plan
6. FINANCIAL CONSIDERATIONS	Amount of investment, amount raised, future funding needs, valuation, equity share, cash-flows, valuation, etc.
7. INVESTOR ATTRIBUTES	Issues regarding investment fit, investment experience
8. ATRIBUTES OF THE BUSINESS	This includes a broad scope of issues: e.g. strategy, business model, risks, operations, time frame, etc.
9. OTHER	Comments on any aspects of the business which cannot be coded in any other category
10. ACTION	Specific comment on what to do next.

Table 2. Investment outcomes by age of angel group

outcome	Age of group			
	Less than five years old	Between five and nine years old	Ten or more years old	Total
	Percentages of investments made			
Exits	2.1*	1.1**	17.9	4.3
Still in the portfolio	91.2	83.5	34.9	78.8
Losses	6.7	15.4	47.2	16.8

Notes:
* this was a property business which is an atypical investment for an angel group to make.
** accounted for by just one group

Table 3. Verbal protocol analysis: thought units classified by investment criteria

	Criterion		%
9.	OTHER	0	0%
5.	EXIT	56	4%
10.	ACTION	100	7%
7.	INVESTOR ATTRIBUTES	140	9%
1.	THE PEOPLE	155	11%
4.	BUSINESS PLAN	161	11%
2.	PRODUCT	200	14%
3.	MARKET	208	14%
8.	ATTTRIBUTES OF THE BUSINESS	221	15%
6.	FINANCIAL CONSIDERATIONS	234	16%

Figure 1. Mentions of exit by gatekeeper (source: interview survey)

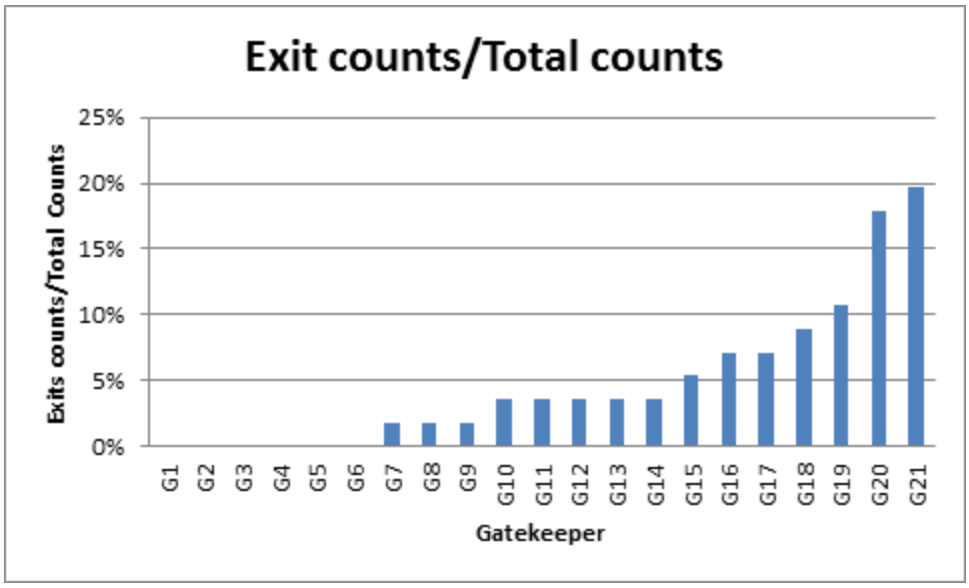

Table 4. Types of comments related to exits

Aspect of exit		comments		gatekeepers	
		n	%	n	%
5A	Exit Value	7	13	4	19
5B	Buyer	6	11	5	24
5C	When	12	21	6	29
5D	Exit Plan	19	34	11	52
5E	Exit Other	12	21	6	29
	Total	56	100%	-	-