

# INFORMAL VENTURE CAPITAL IN HUNGARY

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Informal venture capital plays a key role in the financing of emergent enterprises, especially innovative start-up firms in at least three respects. First, informal venture capital fills the equity gap between founders, family and friends and institutional venture capital funds (which because of their high transaction costs do not make relatively small investments). Second, the informal venture capital market is substantially larger than the formal (institutional) venture capital market in terms of both the amounts invested in firms at their start-up and early growth stage and the number of enterprises invested in. Third, business angels are hands-on investors, contributing their skills, expertise, knowledge and contacts in the businesses they invest in.

I will present the results of an empirical survey on the investment activity of Hungarian business angels. I will also consider a range of facts public policy options to promote informal venture capital activity in Hungary.

*Key words: informal venture capital, business angels, public policy*

## **1. Introduction**

The venture capital market can be divided in two parts: an institutionalised market segment dominated by investment associations and funds and an informal segment dominated by 'invisible and anonymous' private individuals. Business angels representing the supply side of the non-institutionalised venture capital market are private individuals who perform activities related to financing and developing enterprises similar to venture capital (Osman 1998), who, owing to their special features, are able to fill in the finance gap present on the capital market and contribute to the success of innovative enterprises. Their role is significant since they represent the largest source of venture capital<sup>1</sup> for small innovative enterprises (Gaston 1989, Mason-Harrison 1995, Mason-Harrison 2000, Van Osnabrugge-Robinson 2000, Bygrave et al. 2002).

The research of the venture capital market (as the sector itself) is in its childhood years in our country, and this is especially true in the case of informal venture capital investments (Ludányi 2001, Karsai 2002). In Hungary the first survey that also recorded the significance of informal investments was completed in 2001. Global Entrepreneurship Monitor, an international research program analyses the complex system of interrelations between entrepreneurial activity and economic growth and it also separately deals with the analysis of informal capital investments as a factor fundamentally affecting entrepreneurship processes. National results show that between 1999 and 2001 2.2 percent of the adult population made an

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<sup>1</sup> Various estimates were born regarding the size of informal venture capital markets in the individual countries. According to Van Osnabrugge and Robinson (2000) in the United Kingdom and the United States business angels invest 3-8 times more than venture capital funds. Based on Gaston's (1989) survey this proportion is 4-10-fold. In 2001 the authors of Global Entrepreneurship Monitor stated that in the countries participating in the research informal investment represented on average 1.13% of the GDP although they applied a broader definition than the former researchers. Taking into consideration the number of financed enterprises the difference is even greater (since it is multiplied by the lower average investment rate of business angels): according to some estimates business angels finance 30-40 times more companies than institutional venture capital does (Van Osnabrugge-Robinson 2000).

average of 1 million forints of informal investments. According to the definition interpreted in a highly comprehensive way, Hungary has 144 000 informal investors who supported national enterprises with 144 billion forints over the three-year period. The relatively high number derives from the permissive definition that also classifies the family members and relatives of the person starting a company as investors, and also includes unsecured debts in the concept. The proportion of business angels is below the world's average of 2.91 percent, however, it does not significantly differ from the European average (Ács et al. 2003).

Kinga Garab (2001), the director of the first national Business Angel Club<sup>2</sup> publishes considerably different data. According to her judgement the number of active business angels in Hungary is estimated to be 30 and she also mentions 200 further potential business angels; she defines the average sum of their investments to fall within the range of 7.5 and 75 million forints.

Szerb and Varga (2002) published information referring to business angels' active involvement in financing national technology-based start-up firms: four out of the ten national high-tech firms receiving institutional venture capital investment reported having received angel capital before. This also demonstrates that on the national venture capital market the financing activities of institutional investors and business angels build upon one another. Furthermore, Hungary has developed another way of special cooperation: among the individual members of the Hungarian Venture Capital and Private Equity Association several business angels can be found, which suggests the presence of information flow between the informal and formal venture capital market and, to a certain extent, the interpenetration and supplemental nature of the two markets.

However, at present there are no comprehensive data available in Hungary regarding the size and features of the 'angel market' in the narrower sense - that we aim to analyse - and the investors' motivations, preferences and activities. Today mainly the researchers of the field, prepared entrepreneurs and experts are the only ones who know this investment type, which greatly contributes to the fact that Hungary's informal venture capital investments play a less significant role in the life of enterprises capable of growing than in Anglo-Saxon countries (especially in the United States and Great Britain).

Underdevelopment goes back to several factors. The 14 years since the change of the political system were not enough to realize such significant accumulation of capital in Hungary as in Western Europe or North America in the past 50 years. It clearly follows from the modest financial situation of households and private individuals that the supply of informal venture capital is also at a lower level. The young market economy also accounts for the fact that the country could not accumulate such amount of entrepreneurial experience and business skills as the 'West', which greatly hinders 'becoming an angel'. Due to the weaker national enterprise culture there are less precisely designed innovative projects, which may also create problems in the demand for venture capital. Furthermore, national enterprise development culture is traditionally based upon credits. In many cases entrepreneurs do not have the knowledge necessary for realizing a more sophisticated financing strategy. The dissemination of business angel investments is further obstructed by the relatively closed nature of enterprises from a financing aspect: many entrepreneurs regard the narrow space limited by internal sources as a given facility because they fear losing the control over the enterprise.

The effective operation of the informal venture capital market is hindered by the chaos of the stock exchange and the system of mediatory institutions as well as the lack of trust and deficiencies present in the areas of law and business ethics. Insofar national SME development

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<sup>2</sup> The Business Angel Club was established in June 2000 jointly by the Hungarian Innovation Association and INNOSTART and was the first initiative of this type. The Club aims to offer 'innovative enterprises and investors a forum to meet'. (Information about the Business Angel Club is available at [www.innostart.hu](http://www.innostart.hu).)

policy has not recognized the opportunities lying in informal venture capital investment and presently there are no apparent governmental initiatives to 'espouse' this novel form of financing. The competent ministry aims to contribute to easing small enterprises' lack of capital by regularly designing loan-based schemes (e.g. Széchenyi card, Europe Loan, etc.) although in the early life cycle of enterprises types of financing like venture capital would prove the most optimal.

## 2. Methods

Our research<sup>3</sup> was completed in the spring of 2003 among Hungarian business angels with the aim to gain information about the basic characteristics of the market and also to ground another more comprehensive research. In the course of compiling the sample we could rely on no completed database. The reason for this is that on the rather early-stage market no mediatory or professional organizations exist that would undertake compiling and processing relevant information. The investors are 'anonymous' private individuals unwilling to provide information on their activities and also remain invisible to the statistics.

We could not predict what numbers the sample should represent and based on what criteria it should be representative, which created further problems. Due to the small size of the sample and the above-mentioned uncertainties, the results, similar to most first-generation foreign surveys, cannot be subjected to complex statistical analysis (Hindle-Wenban 1999, Tashiro 1999, Harrison-Mason 1996, Weber et al. 2000, Just 2000).

In the research the compilation of the sample meant the most difficulties. The relevant literature developed three methods for the identification of angel investors (Sorheim-Landstöm 2001, Hindle-Wenban 1999). According to the first method, on the basis of some element that is also characteristic of business angels (e.g. they are billionaires, they have enterprises, etc.) a greater sample is generated, which is likely to include a certain number of individual venture capitalists. With the help of the second method researchers find investors through financed enterprises. The third method uses the help of already identified investors to enlarge the sample through which the involvement of new angels in the research takes place.

Our research followed the footsteps of small sample processes the main point of which lies in selecting subjects to be interviewed *already* from the circle of business angels.<sup>4</sup> In our case this method was snowball sampling<sup>5</sup>: based on information received from some experts dealing with this field we tried to involve the most possible investors in the sample. Our final sample included 28 persons and feedback showed that in reality only 18 persons out of this group dealt with venture capital investment as private individuals. 14 persons returned the completed questionnaires (this represents a returning rate of 78%). Due to the small size of the sample<sup>6</sup> the results cannot be subjected to more complex statistical analysis and because of the lack of representativity any conclusion should be handled with care.

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<sup>3</sup> The Department of Finances, Faculty of Economics and Business Administration, University of Szeged supported the survey that was completed jointly by the author of the present paper and Zsolt Makra.

<sup>4</sup> Contrary to this, large sample analyses do not apply pre-screening but work with a sample of the population that is representative in some respects. Lately the interest of researchers seems to focus on such large sample analyses. An example of such analysis is the already mentioned GEM research.

<sup>5</sup> Snowball sampling is usually applied in the case of rare and difficultly recordable numbers. In the course of sampling some selected individuals are used as points of departure, then their social network is searched for further sample elements and the new individuals also provide information helping to involve further subjects in the sample. It must be seen that this method does not result in a random sample, however, sampling often could hardly be organized in any other way (Hunyadi et al. 1996, 315. o.).

<sup>6</sup> Compared to the samples of empirical surveys in different fields the size of our sample may seem insignificant, however, it needs to be noted that in the literature there are more internationally recognized

When designing the questionnaires we had to consider several aspects. Wherever it was possible we tried to avoid the expression 'business angel' as it may scare many investors. In order to encourage answers we also paid close attention to designing the form so that filling out should not take more than 15 minutes. However, the shortness of filling time also limited the number of questions that could be included. Following the emerging needs, an English version of the Hungarian questionnaire was also created, its structure and content being totally the same as that of the original copy.

In the first round questionnaires and cover letters were sent out electronically and were repeatedly sent via fax upon request. We also contacted members of the sample via telephone increasing trust and willingness to respond this way. Phone discussions also offered a chance to clarify potential misunderstandings. In the cover letter we clearly defined whom we consider business angels. In our survey we regarded as business angels those private individuals who directly provide capital to enterprises that do not include family relations or ownership.

### 3. Results and discussion

The angels examined in the survey are males of 44 years of age on average and 86% of them have higher education qualifications. Economic degrees (eight), occurred most commonly followed by technical diplomas (three). Twelve members included in the sample reside in Budapest or in Pest County, the rest live in Szeged. 93 percent of the sample members are company owners and have an average entrepreneurial experience of 14 years. It is interesting that four of the identified investors are not Hungarian citizens and two further persons have double nationality. Five of them formerly lived in some Anglo-Saxon region where informal venture capital investments are more commonly known and popular than in Hungary. All but one of the sample members live in Hungary. On the basis of their residence, experience, qualification and profession Hungarian angels create a slightly more homogeneous group than foreign angels in international comparison. This, however, is probably due to the small sample. The comparison shows that Hungarian angels are the most active, most qualified and the greatest proportion of them also have entrepreneurial experience (1. table). The comparison of incomes cannot be accurate owing to the different times of surveys, the different methods and the changes in the value of currencies. Nevertheless, it is apparent that despite the multiple differences in welfare there is no significant difference among the incomes of Norwegian, British, American and Hungarian angels (it is in the range of 10 and 20 million forints, calculated with an exchange rate of 210 HUF/USD). We may have found the 'élite' of Hungarian angels; furthermore, great business experience and high income may partly result from the activity that seems high even compared to international standards.

#### 1. table International comparison of some of business angels' features

	<i>United States of America</i>	<i>Great Britain</i>	<i>Germany</i>	<i>Norway</i>	<i>Hungary</i>
Age (year)	47 (median)	53 (average)	48 (average)	47 (average)	44 (average)
Sex (% refers to males)	95	99	100	97	100

surveys that were based on a similar scale of samples such as a German survey that interviewed 48 angels (Brettel 2003), while the sample of the Japanese survey restricted to interviewing 20 angels (Tashiro 1999).

Annual income	18,900,000 HUF (median)	17,020,000 HUF (average)	between 63,906,000 – 127,812,000 HUF (income of household, median)	16,023,000 HUF (average)	over 10,000,000 HUF (median) *
Wealth	157,500,000 HUF (median)	115,440,000 HUF (average)	1,472,000 HUF (average)	86,100,000 HUF (average)	n. a.
Qualification (% refers to degrees)	72	n. a.	n. a.	n. a.	86
Entrepreneurial experience (% of respondents)	83	57	75	46	93
Investment activity (number of investments in the past 3 years)	2	2	4,8	3,7	4,9
Average size of investment	12,369,000 HUF	3,700,000 HUF	42,000,000 HUF	16,023,000 HUF	15,000,000 HUF**
Sample (person)	435	86	48	425	14

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Note: \* based on 8 answers \*\*based on 10 answers. For the calculation of values we used the following exchange rates: 210 HUF/USD, 250 HUF/EUR, 370 HUF/GBP, 128HUF/DEM.

Source: the author's own research, Gaston (1989), Harrison-Mason (1996), Brettel (2001), Weber and partners (2000), the author's own compilation based on Reitan-Sørheim (2000).

#### 4. Conclusion

Without public or individual initiatives and interventions only a very slow evolvement of the national venture capital market can be expected, that is why I would like to make some proposals that are based on international experience and successful methods or that, taken into consideration Hungarian characteristics, may be effective.

The first and most important step is to carry out an *empirical survey* about active and potential angels and the national state of this segment of the venture capital industry. Decisions regarding further steps can only be made when data are available.

Since in Hungary the concept and activity of business angels are absolutely unknown launching an *awareness raising campaign*, introducing studies and publications as well as success stories, etc. is indispensable in order to make experts and potential investors aware of this area.

Establishing a *business angel network* and an organization offering mediatory services may be an effective tool and key institution of developing the informal venture capital market (EC 2003). Germany is a good example of this where the concept of business angel was entirely unknown at the establishment of BAND in 1998 but raising the interest of the players of the market and economy proved to be successful over three years. At present Europe's third highest number of mediatory agencies operate in Germany, a great number of books and publications are issued in this field and business angel networks include 190 registered angels and 1500 enterprises besides the significant incomes deriving from sponsorships, so the country has successfully raised some kind of interest in the business sphere as well. In Hungary the most ideal solution would probably be the establishment of a non-profit organization that would use sources of the government and sponsorships. Its task would be to operate a national-level electronical database and it would function as the centre of a certain kind of

business angel association. It would represent Hungary in EBAN<sup>7</sup>, regularly publish information on investment and coordinate the operation of the 6 regional offices that would join an already operating enterprise development network. Besides mediation the local offices would also deal with education, training, providing information, consulting services, preparing business plans and investment readiness programs as well as organizing regular investment forums.

The system of specially designed tax discounts offered to private investors has already been implemented in Great Britain. According to its principles if private individuals directly invest money in an enterprise not quoted on the stock exchange then with defined conditions they can decrease their personal income tax by a certain percentage of the invested money (Osman 2000). According to an impact study published in 2003 the reduced taxation of capital revenue greatly encouraged investments made in the early life-cycle of growing enterprises: 52-62 percent of the invested money would not have been invested if it had not been for the system of discounts called Enterprise Investment Scheme (Boyns et al. 2003).

Informal investments are accompanied by special risks. Besides influencing effective return intervention, that encourages investments by reducing risks, is also possible on the supply side: by introducing *equity guarantee schemes* the government can take over part of the risks from investors. In Belgium a regional equity guarantee fund was established in 1999 that protects investors who finance growing SMEs by overtaking 50 percent of the potential capital loss below a certain limit (Van Sebroeck 2000). In Austria AWS<sup>8</sup>, a governmental development agency can offer guarantee for the investment of business angels.

As a result of the measures described in the present paper in a few years national business angels would also be able to more significantly contribute to the development of innovation-orientated small enterprises and this way the entire economy. In our opinion the completion of the present research may already be regarded as a promising sign.

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<sup>7</sup> European Business Angels Network

<sup>8</sup> Austria Wirtschaftsservice Gesellschaft mbH.

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