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SMALL BUSINESS Financing Profiles

SME Financing Data Initiative September 2006

Informally Financed SMEs

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Highlights in 2004

... of informally financed SMEs

- Incidence of informal investment was higher among firms in the manufacturing, wholesale/retail and knowledge-based sectors.
- Firms in which business angels invested were more likely to have owners under 40 (25 percent) than firms financed by family or friends (22 percent) or other firms (13 percent).
- On average, firms that received angel financing reported higher revenues (40 percent) and total assets (25 percent) than other firms.

... of the financing of informally financed firms

- 26 percent of angel-financed firms sought external capital compared with 19 percent of firms without informal financing.
- Angel-financed firms were more likely to have their applications for debt approved (85 percent) than firms financed by friends and family (70 percent).
- Firms financed by friends and family were more likely to draw on all available sources of financing at the business start-up stage, whereas firms financed by business angels were less likely to cast as broad a net.
- Angel-backed firms tended to be more substantial and better capitalized than those financed by friends and family.

This profile looks at small and medium-sized enterprises (SMEs) that received financing for risk capital through the informal marketplace in Canada. The informal marketplace is composed of two types of investors: family or friends, and business angels (individuals who invest their personal funds at arm's length in businesses owned and operated by individuals unrelated to them). This article examines the differences between these two types of investors and the impact of their investments on SMEs.

This work is based on research drawn from the comprehensive database of the SME Financing Data Initiative. The project is among the first efforts to study the demand side of the informal investment market in Canada.

Findings for this profile were taken from financial statement information from more than 800 respondents of the Survey on Financing of Small and Medium Enterprises*, 2004 in the following categories:*

- *equity financing from friends and family;*
- *equity financing from business angels;*
- *current loans from friends and family;*
- *current loans from angels;*
- *loans from friends and family received during start-up; and*
- *loans received from angels during start-up.*

Incidence and Importance of Risk Capital in Canada

Risk capital comes from both the formal market, which is essentially venture capital companies managing third-party capital, private equity and initial public offerings (IPOs) on public markets, and the informal market, which comprises business angel investments and investments from friends and family. Risk capital is increasingly recognized as an important source of financing, particularly for SMEs with high growth potential that are seeking substantial amounts of capital for expansion in return for a share of the business. However, risk capital is a financing strategy suitable to only a small proportion of SMEs. In 2004, just 1.2 percent of all SME owners sought risk capital.

Among the various sources of risk capital, informal investments are the single largest source of external equity capital for Canadian SMEs. Among all SMEs

Definitions

For the purposes of this analysis, small and medium-sized enterprises (SMEs) are defined as firms with fewer than 500 employees and less than $50 million in annual revenues. Excluded are non-profit or government organizations, schools, hospitals, subsidiaries, co-operatives, and finance and leasing companies (SME Financing Data Initiative).

Informal investors are individuals who invest personal funds in businesses owned by someone else. There are two types:

- "Love money" is personal funds invested by **friends and family**.
- **Business angels** are typically well-educated, high net-worth individuals who invest their personal funds at arm's length in businesses owned and operated by individuals unrelated to them. The angels are frequently entrepreneurs or former entrepreneurs. They have much to offer to new firms, both in financing and in knowledge and experience in operating a business.

Caveat on the data
The majority of informally financed firms in the sample examined in this profile received informal investments before they were questioned for the S*urvey on Financing of Small and Medium Enterprises*, 2004. Their responses may relate to financing that was received before 2004.

reporting on financing activity that took place in 2004, 23 percent of requests for equity financing were made to friends and family, and 22 percent to private angel investors. Only 7 percent of requests for equity financing were made to the formal side of the risk capital market, venture capital firms.

Supply of Informal Investments and Venture Capital in Canada

In 2001, the aggregate flow of investment funding from business angels in Canada was at least $3.5 billion, averaging approximately $117 000, invested in about 30 000 businesses. Friends and family members who invested in small firms collectively comprised a substantially larger pool of investment capital, with an aggregate flow of investment capital of more than $5 billion during 2001 (Riding, 2005). Together these accounted for nearly twice the venture capital invested by venture capitalists.

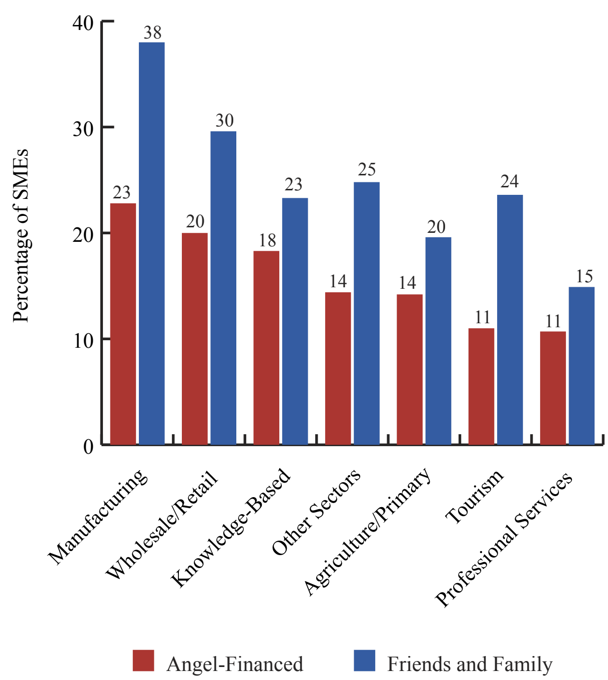
Incidence of Informal Investment

In 2004, business angels played a financing role in more than 200 000 SMEs, or about 15 percent of the 1.36 million SMEs in Canada. By comparison, friends and family have been involved financially in more than 328 000 Canadian enterprises, almost 25 percent.

By Industry Sector…

Figure 1 shows the incidence of financing by informal investors across each sector of industry in 2004. The results indicate that business angels are involved in firms across all sectors but are most likely to be associated with enterprises in the manufacturing, wholesale/retail and knowledge-based sectors, and least likely to participate in the tourism and professional services sectors. Investments from friends and family cross all sectors; however, their investments are more prevalent in the manufacturing and wholesale/retail sectors. Professional services and the agricultural and primary sectors are least likely to attract investment by friends and family.

Figure 1
Percentage of Informally Financed SMEs by Sector

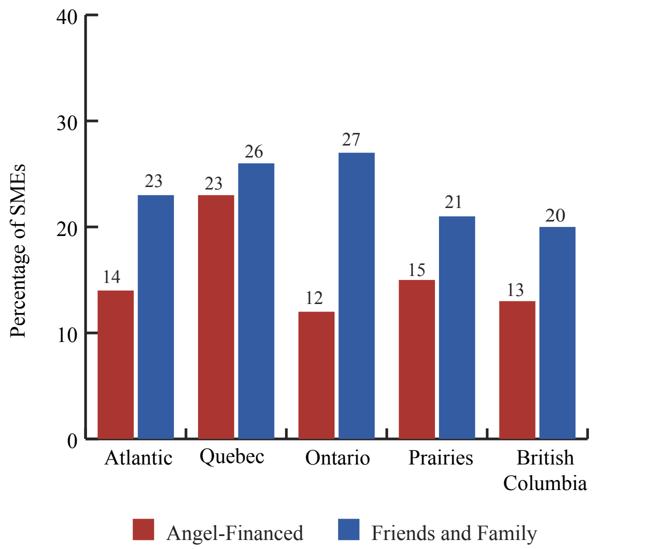


Source: SME Financing Data Initiative, Statistics Canada, *Survey on Financing of Small and Medium Enterprises*, 2004.

By Region…

Figure 2 shows the relative frequency of investments by friends and family and by business angels across each region. The findings illustrate that investments by business angels and by friends and family are found in all regions; however, business angels are especially active in Quebec. This finding may warrant further investigation.

Figure 2
Percentage of Informally Financed SMEs by Region



Note: Information regarding the Territories has been suppressed to meet the confidentiality requirements of the *Statistics Act* and/or for data quality reasons.
Source: SME Financing Data Initiative, Statistics Canada, *Survey on Financing of Small and Medium Enterprises*, 2004.

Attributes of Informally Financed SMEs

SMEs that have received investments from business angels differ in several ways from other firms (see Figure 3). First, angels are more likely than average to invest in SMEs owned by younger people. Twenty-five percent of angel-financed firms have owners who are under 40 years of age; this compares with 22 percent of firms financed by friends and family, and only 13 percent of other firms.

Business angels are also more likely to invest in businesses that are majority-owned by women. In Canada, during 2004, 17 percent of angel-financed firms were majority-owned by women. This compares with 14 percent of the firms in the other two categories — majority male and male/female partnerships. Other research has found that female business owners are less likely than male business owners to apply for venture capital (Orser, Riding and Manley, in preparation). The research has also found they are concentrated in service sectors, which this analysis shows is less attractive to risk capital investors.

Finally, firms owned by individuals whose first language is French were more likely to receive investments from business angels. This is in keeping with the previously noted finding that a relatively high proportion of angel-financed firms are in Quebec (see Figure 2).

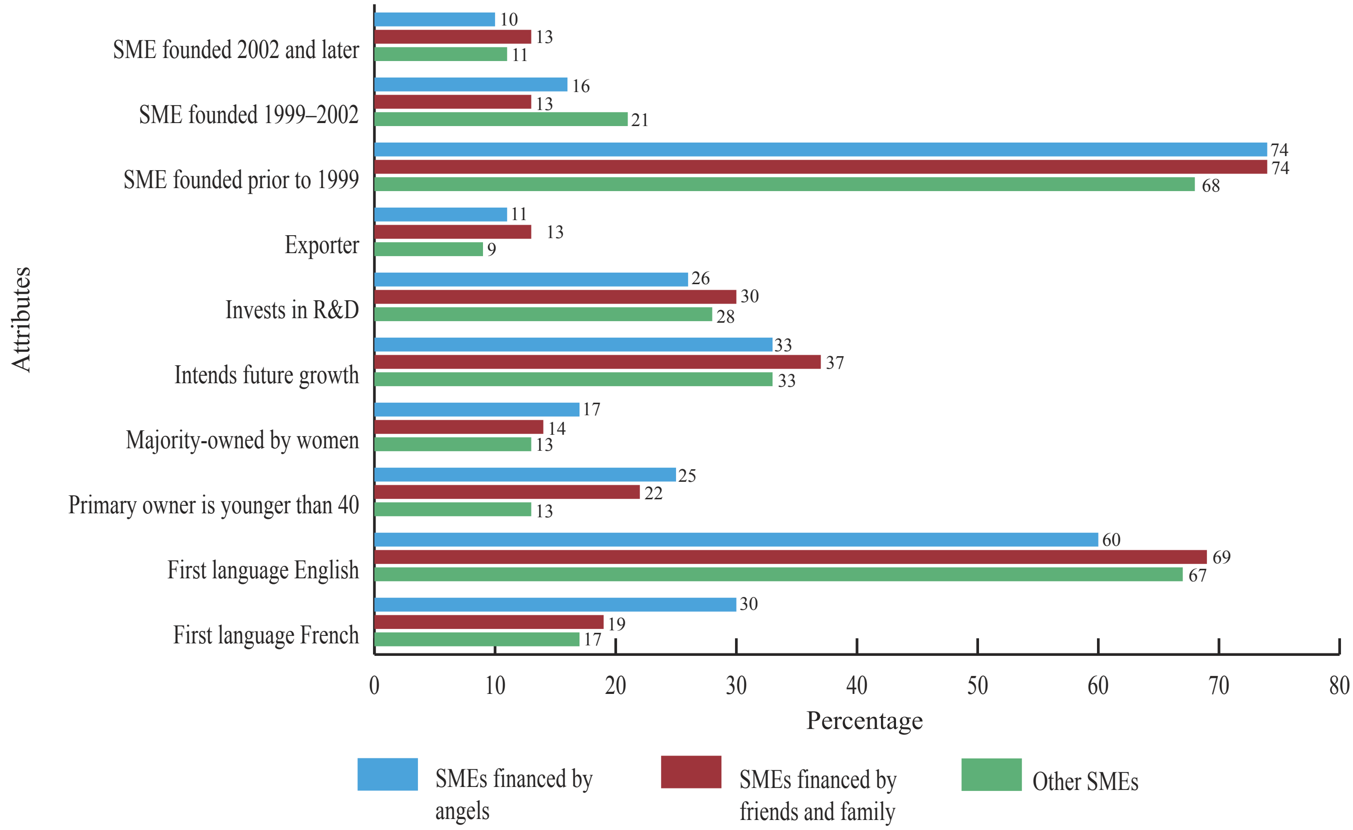
Other business demographic characteristics of SMEs financed by angels and by friends and family differ very little from each other and from other firms (see Figure 3). The propensity of angel-financed firms to engage in exporting, at 11 percent, is similar to that of firms financed by friends and family (13 percent) and to other firms (10 percent). SMEs in these three categories are equally likely to invest in R&D (approximately 28 percent of firms).

Financial Performance

Both angel-financed SMEs and those financed by friends and family are larger than other SMEs. On average, firms that received angel financing reported revenues that are 40 percent greater and total assets that are 25 percent greater than other firms. Firms financed by friends and family report both revenues and total assets averaging 23 percent more than other firms. This suggests that informal investment has indeed spurred growth for these SMEs. Table 1 outlines average values of various measures of financial performance for each of the three categories of SMEs.

Table 1 also shows that angel-financed SMEs report higher levels of financial leverage (use of debt). For firms financed by angels, the ratio of total debt to total equity is higher (1.54) than firms financed by friends and family (1.16) or other firms (1.11). Perhaps this is

Figure 3
Business Demographics by Informal Investment History



Source: SME Financing Data Initiative, Statistics Canada, *Survey on Financing of Small and Medium Enterprises*, 2004.

because of the accreditation role that business angels can play. The presence of an external partner may provide comfort to lenders and allow angel-financed enterprises to carry a higher level of debt financing than other SMEs.

Financing Activity

Access to sufficient levels of capital is a critical component for the successful growth and development of any business. Business angels and friends and family are themselves sources of financial capital; however, as illustrated in Table 2, firms financed by angels are more likely to apply for most forms of external financing (26 percent). In particular, angel-financed firms are more likely to seek commercial loans, and have their applications approved (85 percent), than firms financed by friends and family (70 percent). This is apparently consistent with the finding noted above that the presence of business angels provides a certain amount of credibility to the firm with suppliers of capital (Madill, Haines and Riding, 2005). This finding may also be consistent with the non-financial value that angel investors often bring to firms.

It is also striking to note the relatively low approval rates associated with bank loan applications and trade credit requests for firms that have received informal investment from friends and family. The 70 percent loan approval rate is substantially lower than the average SME. Conversely, firms financed by friends and family are much more likely to have sought additional equity financing (3.7 percent application rate compared with 0.6 percent of angel-financed firms and 0.6 percent frequency for other firms).

Table 1
Financial Statement Figures for 2004

	Angel-Financed SMEs	SMEs Financed by Friends and Family	Other SMEs
Sales	$754 498	$666 545	$532 150
Total Revenue	$811 151	$718 399	$581 807
Current Assets	$244 743	$218 371	$193 253
Total Assets	$619 925	$609 094	$493 866
Current Liabilities	$187 806	$157 662	$108 509
Total Liabilities	$375 919	$326 781	$259 454
Retained Earnings	$116 861	$137 661	$135 750
Owner's Equity	$136 225	$150 069	$102 921
Total Equity*	$244 006	$282 313	$234 412

* Figures give the average values of various measures of financial performance for SMEs. They may not add up exactly due to rounding and the absence of some income statement or balance sheet data.

Source: SME Financing Data Initiative, Statistics Canada, *Survey on Financing of Small and Medium Enterprises*, 2004.

The collective picture of lower loan approval rates and higher equity solicitation rates raises the question of the extent to which financing by friends and family is a response to situations of financial distress.

Table 2
Financing Request and Approval Rates for 2004

Type of Financing		Angel-Financed SMEs	SMEs Financed by Friends and Family	SMEs Without Informal Financing
		(Percent)		
Sought any Type of Financing		26	21	19
Debt Financing	**Request Rate**	22	20	15
	Approval Rate	85	70	92
Trade Credit	**Request Rate**	13	10	9
	Approval Rate	96	92	92
Equity Financing	**Request Rate**	0.6	3.7	0.6

Note: The estimates associated with the approval rates for equity financing are less statistically reliable, and hence not provided, due to the lower frequency of responses.

Source: SME Financing Data Initiative, Statistics Canada, *Survey on Financing of Small and Medium Enterprises,* 2004.

Suppliers of Debt Financing

Most debt financing requests were made to chartered banks or credit unions and caisses populaires (approximately 90 percent for all groups of SMEs). In seeking external debt financing, the three groups held different objectives. Firms financed by business angels were more likely to be trying to finance fixed assets (62 percent) than working capital (44 percent). Firms financed by friends and family sought financing for fixed assets 38 percent of the time and working capital financing in 66 percent of applications. While further research will be required, this latter result suggests that investments from business angels are more likely to be for expansion purposes, and investments from friends and family are more likely to address cash shortfalls.

Firms financed by business angels also received debt financing on relatively better terms than other businesses (see box below), again suggesting that the presence of angels provides substantial benefits for access to other forms of financing, in this case to commercial loans.

Capital Structure

SME owners draw upon a variety of financing methods. Figures 4 and 5 compare the top 10 sources of financing used by firms financed by business angels with those financed by friends and family. Figure 4 shows the distribution of all financing sources reported by firms in 2004, regardless of the year the financing was authorized or obtained. Figure 5 shows sources of capital that firms reported as having been employed at start-up.

Credit Conditions for Angel-Financed Firms

- The most requested forms of debt were term loans (38 percent), mortgages (34 percent) and increases in lines of credit (19 percent).
- Angel-financed firms, on average, requested term loans for $151 000 and were authorized for $152 000 (compared with $145 000 requested and $141 000 authorized for the other two categories of SMEs).
- For mortgages, $400 000 was requested and $408 000 was authorized for angel-financed firms (compared with $165 000 requested and $188 000 authorized for the other two categories of SMEs).
- 29 percent of owners of angel-financed firms requesting financing were required to pledge personal assets as security (compared with more than 36 percent for the other two categories of SMEs).
- 32 percent of owners of angel-financed firms requesting financing were required to pledge business assets (compared with at least 44 percent for the other two categories of SMEs).
- Angel-financed firms were less likely to be asked to support their loan applications with business plans (18 percent for angels, 20 percent for firms financed by friends and family, 26 percent for other SMEs).
- Angel-financed firms were less likely to be asked to support their loan applications with personal financial statements (34 percent compared with 42 to 45 percent for the other two categories of SMEs) or appraisals (9 percent compared with 13 to 31 percent for the other two categories of SMEs).

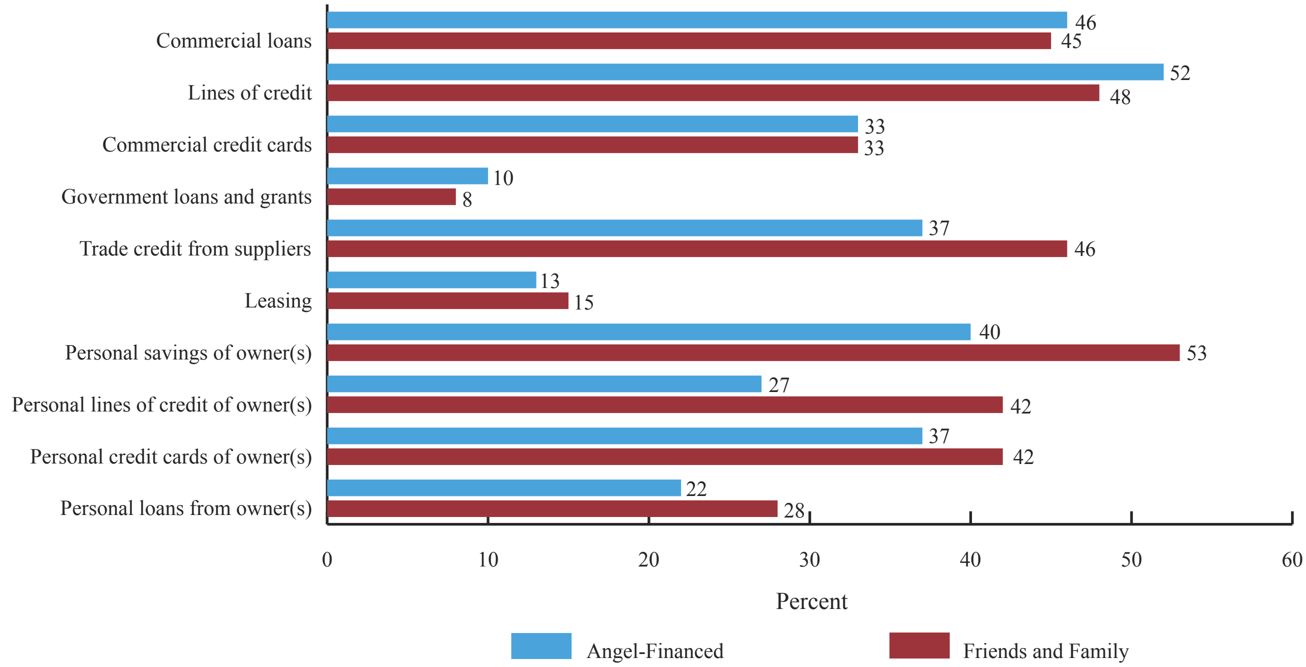
Source: SME Financing Data Initiative, Statistics Canada, *Survey on Financing of Small and Medium Enterprises,* 2004.

The comparison shows that established firms that had historically been angel-financed were more likely to employ formal sources of capital such as commercial loans. Firms financed by friends and family were more likely to rate informal sources, such as personal credit cards, loans from owners and trade credit, as important. This distinction confirms a sense that firms financed by friends or family may, financially, be stretched more thinly than firms financed by business angels.

Figure 5 illustrates the usage of various forms of capital at the start-up stage, prior to the first sale of goods or services. At this stage, all businesses are primarily financed through owners' personal savings and credit instruments, a common financing behaviour for these businesses. Informal investment was also important at the start-up stages of businesses, with 10 percent of firms reporting having received angel financing at start-up and 17 percent of firms reporting start-up financing from friends and family.

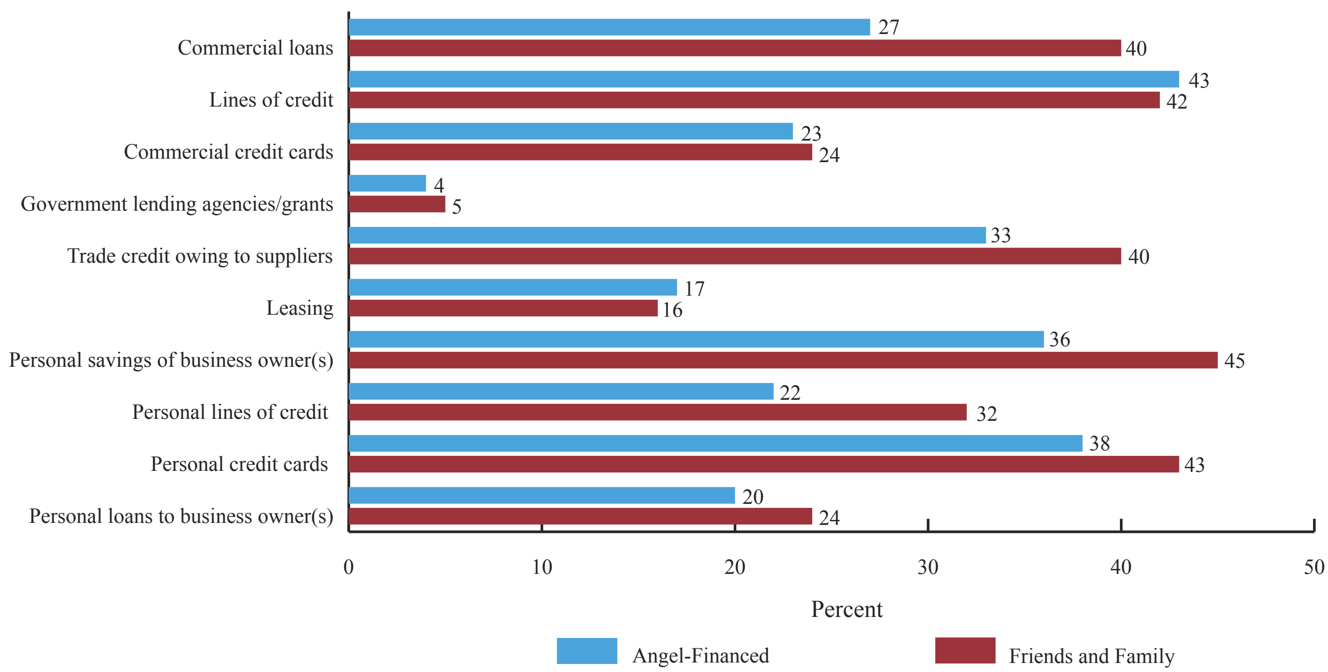
Figure 5 also indicates that firms financed by friends and family are far more likely to draw on all available sources, whereas firms financed by business angels are less likely to cast so broad a net. Perhaps this is because, on average, angels invest more capital — typically at the start-up stage — than friends and family, so angel-financed firms may not need additional financing from other sources. For those SMEs that did require additional capital, the presence of business angels appears to ease the way to commercial lending (see Table 2).

Figure 4
Top 10 Historical Sources of Financing



Source: SME Financing Data Initiative, Statistics Canada, *Survey on Financing of Small and Medium Enterprises*, 2004.

Figure 5
Top 10 Sources of Financing Used at Start-up



Source: SME Financing Data Initiative, Statistics Canada, *Survey on Financing of Small and Medium Enterprises*, 2004.

SUMMARY AND DISCUSSION

This profile examined SMEs that are financed by two forms of informal investment: business angels, and friends or family of the owner(s). SMEs financed by these informal investors are, in general, somewhat larger than most other SMEs, and they operate in all sectors of the economy and in all regions.

But two different pictures emerge of the firms depending on their source of informal investment.

Firms financed by angels are considerably larger (suggesting higher levels of historical growth) than other firms, and are more likely to seek — and receive — other more formal forms of financing, including commercial loans. They also report, on average, higher levels of total revenues. Firms financed by business angels are apparently more likely to be approved for external capital in the form of commercial loans and trade credit than other firms, implying that angels perform an accreditation role as well as being a supplier of capital in their own right — not to mention their role as mentors and advisors.

According to other research, business angels are associated with successful entrepreneurial firms that achieve relatively high rates of return (Riding, 2005).

Firms financed by friends and family are less likely to have loan applications approved and are more likely to resort to personal loans than to commercial loans to finance their firms. Commercial lenders also seek more personal and business collateral in support of the loans, as well as more documentation in support of loan applications, from firms financed by friends or family versus those financed by business angels. From other research, friends and family are known to lose their investments comparatively often and make high rates of return relatively rarely (Riding, 2005).

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SME Financing Data Initiative

Small Business Financing Profiles is an ongoing series of articles on specific segments of the marketplace and a component of Industry Canada's reporting efforts on SME financing.

Consistent with recommendations in 1999 from the Task Force on the Future of the Canadian Financial Services Sector, the SME Financing Data Initiative is a comprehensive data collection program on SME financing in Canada. In partnership with Statistics Canada and Finance Canada, Industry Canada reports on the supply of, and demand for, small and medium-sized business financing to provide a complete picture of SME financing.

As part of the initiative, Statistics Canada administers a series of national surveys on small and medium-sized enterprises (*Survey on Financing of Small and Medium Enterprises*) and financial providers (*Survey of Suppliers of Business Financing*). Industry Canada supplements these surveys with additional research into niche areas of SME financing.

For further information on the SME Financing Data Initiative and access to statistical findings and reports, visit **www.sme-fdi.gc.ca**. For information regarding the methodology of the *Survey on Financing of Small and Medium Enterprises*, contact Klaus Kostenbauer at 613-951-0691 with the Small Business and Special Survey Division at Statistics Canada or visit Statistics Canada's website at **www.statcan.ca**.

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