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Stimulating Business Angels in the Czech Republic

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Executive Summary

The objective of this study is to assist the Ministry of Finance of the Czech Republic[1] to capture the current state of angel investment activities in the country. This study is carried out in the wider context of developing domestic capital markets, identifying gaps and potential, and offering relevant policy recommendations for increasing risk investment activity in the country to better contribute to private sector growth, innovation, and consequently economic growth. This study complements the earlier analysis of the World Bank (2017) Capital Markets Assessment report[2], which focused on the broader capital market development agenda and more traditional financing instruments, with an emphasis on later stage financing.

Equity financing is the most appropriate form of funding to support innovative high-growth firms. High-growth firms tend to contribute disproportionately to job creation and are often at the earliest stages of innovation and looking to commercialize research and development. Because these firms do not yet have a saleable product or customers (being 'pre-revenue'), bank or other forms of lending are unsuitable. Thus, external equity investment becomes essential for innovative high growth potential firms. In the Czech Republic, the share of young high growth enterprises measured based on turnover growth[3] is just 1.4 percent of the active enterprise population, compared to Estonia's 4.3 percent.[4] However the Czech Republic ranks above the European average in terms of the share of high-growth companies, as identified using the criteria of growth in employment.[5]

Equity investors, particularly business angel investors, bring not only financing to high growth firms, but also expert advice, post investment mentorship, and market connections ('smart money'). Business angels are typically 'hands on' investors who are either experienced business people or entrepreneurs (or both), and the firms they back also benefit from their advice, insights, knowledge, and contacts. This non-financial assistance is particularly important in the earliest development stages where the management team is incomplete and usually inexperienced.

[1] This study is supported by the European Commission's Structural Reform Support Service.

[2] "Capital Market Assessment /Market Development Options Czech Republic," *The World Bank* (September 2017).

[3] Refers to enterprises which are five years or younger in terms of operations and have turnover growth of at least 10% per annum in the past 3 years.

[4] "High growth enterprises (growth by 10% or more) and related employment by NACE Rev. 2," Eurostat.

[5] Growth in this case is defined as annualized growth in employee numbers of more than 10% per year over a three-year period and at least 10 employees when this growth began. "1 in 10 enterprises in the EU recognized as high-growth companies," European Commission, http://ec.europa.eu/eurostat/web/products-eurostat-news/product/-/asset_publisher/c2r9i0eawvMY/content/DDN-20171019-1/pop_up?_101_INST%E2%80%A6

There are, however, considerable disincentives and barriers to entry that are likely to restrict the number of individuals willing to become business angel investors. This form of investing requires the individual to learn new skills, is potentially extremely time-consuming, and is very risky in comparison to other traditional forms of investment (data from the US suggests that up to 70 percent of investments made by angels fail to return capital, never mind a profit[6]). It is appropriate therefore for governments to consider the introduction of policies and incentives to encourage more individuals to consider angel investing, with the state benefiting from the resulting additional economic growth.

No assessment of demand for, or supply of, equity investments (particularly from angel investors) was available for the Czech Republic. This report attempts to fill this gap by providing a systematic assessment of business angel activities, and the ecosystem surrounding innovation finance in general. This report assesses the following three components: (i) supply side of investments (banks; founder, friends and family (3Fs); proof-of-concept competitive grants; crowdfunding; venture capital; and business angels), (ii) demand side of investments (high-growth firms), and (iii) the local framework conditions shaping demand and supply. The analysis is based on literature reviews, published data sources, and qualitative interviews.

Weak risk finance activity in a given market could be explained by potential gaps in the supply and/or demand-side of investments as well as issues surrounding local framework conditions. On the supply-side, issues relate to the absence or low capacity of angels, venture capitalists, and crowdfunding platforms. The absence or low capacity of business angels in turn can potentially be due to disincentives to investing, such as the need for angels to learn new skills (correlated with investor experience), information asymmetry, and lack of tolerance for certain attributes associated with investment-making (e.g., lack of liquidity, time-consuming, and risky). On the demand-side, possible issues may include a perceived lack of deal flow of investable ventures that demonstrate capacity to grow and capture markets, weak entrepreneurial culture, and low levels of business innovation and knowledge creation. Issues related to local conditions are attributable to weak incentive structures among supporting intermediaries (e.g., incubators/accelerators, technology transfer offices (TTOs), universities, weak business regulatory conditions, and lack of exit markets). These assumptions of potential gaps shape this assessment of the current situation of the Czech Republic's risk financing ecosystem.

Core Findings

On the supply side, the Czech Republic has an emerging early stage investment community. It is small both in terms of the number of investors and the amount invested. The market appears dominated by a small pool of very high net worth individuals operating largely individually and investing directly into companies or via a private personal fund structure or family office. While there are one or two for-profit platforms, organizations that charge membership fees for access to investment opportunities, and some private investment clubs, there are no visible business angel networks (BANs) of the type typically found in developed European markets. There appears also to be a general lack of syndication of investments (more than one investor involved in funding the company to mitigate risk). Further, visible investment activities appear concentrated geographically in Prague and in the information, communication, and technology (ICT) sector. This combination of low levels of syndication and portfolio size and a general concentration in a single industry sector, together with low availability of follow on funding from venture capitalists suggests that angel investing in the Czech Republic is subject to a higher than necessary level of risk. Combined with a low number of individual investors, this high risk makes the Czech market fragile. A few individuals withdrawing from the market due to bad experience, changes in personal or economic circumstances, or simply retiring could have a disproportionate impact on available investment funds.

[6] The study was funded by Ewing Marion Kauffman Foundation and the NASDAQ OMX Education Foundation and was based on exit data primarily from the period 2010 – 2016.
https://angelresourceinstitute.org/research/report.php?report=101&name=2016%20Angel%20Returns%20Study

On the demand side, credible deal flows do exist, based on the existence of success stories. Nonetheless, these success stories are relatively few and concentrated in certain locations and sectors. Most startups are based in Prague and Brno, and primarily in the ICT sector. There are relatively few academic spin-offs (these tend to focus on non-ICT innovations). The lack of detailed structured data makes it difficult to quantify the existing level of credible demand. Information made available through this report indicates that overall, demand falls short of the critical mass needed to support a developed market. Existing issues affecting a credible pipeline of potential deal flows and shaping the current set-up of demand in the Czech Republic include a lack of information and education on the part of founders, poor linkages between academia and industry, and weak entrepreneurial culture and education.

While issues in the local environment may affect the flow of angel investments these are clearly not insurmountable, based on the Czech Republic's competitive ranking on relevant indicators and the evidence that investment deals are being conducted. The Czech Republic ranked 31st out of 137 countries on the World Economic Forum's Global Competitiveness Index (GCI) 2017-18 and is the highest placed Central and Eastern European (CEE) country in the European Union (EU) 28, ranking 13th (between Estonia and Spain). Key findings on the current local framework conditions include:

- Reported issues in the regulatory environment regarding perceived difficulties in starting a business, outdated company laws, and expensive bankruptcy costs.
- A lack of clarity in terms of exit conditions, especially the level of exit opportunity for new technology companies as opposed to more traditional manufacturing and engineering companies (dominated by mergers and acquisitions). There have been only a few examples of technology company exits, such as AVG (which went public at the New York Stock Exchange in 2012 and was later sold to Avast Software in 2016) and Cognitive Security (sold to CISCO in 2013), and thus relatively few examples of Czech company success stories. This is not surprising given that early stage investing in the Czech Republic is still relatively young and exits typically take 5 to 8 years to achieve in developed markets.
- Startups receive varying levels of business development and mentoring support (from none to intensive) despite the availability of support intermediaries (e.g., incubators, accelerators). Intermediaries supporting the creation of more academic spinoffs are hindered by institutional issues such as complicated processes in starting university spin-offs, ineffective TTOs, and weak incentive structure for commercialization of ideas, although there are government efforts to re-align universities' incentive structure through 'smart funding'.
- Uncertainty that existing government investment readiness programs, while available and aiming to improve the quality of potential investable deal flows, sufficiently address the issues investors care about most, particularly the investability of the startup's proposition and investor engagement. Government financing programs aim to stimulate the supply side by providing direct or indirect public capital to innovative firms, although it appears that the Czech government lacks experience in the provision of public capital given unsuccessful attempts to create financing support platforms.
- An absence of specific tax incentives or co-investment funds currently available to encourage or support business angel activities. The inability under Czech tax legislation to carry losses incurred on the sale of securities in a given year forward to offset against future gains, or against income, may discourage high risk investing such as that undertaken by business angels.

Recommended Actions

This report proposes a number of short-term, medium-term, and long-term policy recommendations for enhancing business angel awareness and investments in the Czech Republic (see table 1). The recommendations are problem-driven (based on the analyses of supply side, demand side, and local environment conditions for business angel investments) and phased (anchored on administrative and political cost considerations). They include the following:

Component 1 (short-term) - Data Collection and Mapping

Available data for the early stage market in the Czech Republic on both the demand and supply sides is weak. An essential first step is therefore to create a systematic understanding of demand and supply for angel investments. Specifically, data can be used to monitor the risk finance market to better inform policymaking. The data should be updated annually.

Recommendation 1.1: Commission time-series data on angel investment activity (similar to existing venture capital market data). This helps provide an accurate measure of market size, investment activity, and the types of investments being made, among other indicators. An initial "baseline" analysis is required to establish the present situation, both to inform policy development (what problem needs to be addressed) and to facilitate future program monitoring (what success has been achieved). This can be done using survey interviews (as the New Zealand Government did when forming their Seed Co-Investment Fund (CoFund)[7]) and/or compilation of secondary data sources. Baseline information should include international benchmarking of angel investments, and when updated regularly this will provide useful information on deal size, number of investments, levels of syndication, industry sectors, and geographic location of investors and investee companies.

Recommendation 1.2: Conduct a taxpayer base analysis. This analysis helps quantify the number of individuals who appear to have sufficient wealth / income to be potential angel investors. This will inform understandings of the potential investment capital that may be available in the Czech Republic. Collected data can be used to set reasonable expectations regarding the likely total pool of investors and create an estimate of their annual investment value. Ideally, data would consider characteristics that tend to define the likelihood of an individual being an angel investor, including disposable income, demographics (e.g., age, education, gender), and location. This analysis would not seek to identify individual tax payers, but rather produce aggregate data showing how many tax payers fall into specified bands of amounts of tax paid, with the objective of determining how many individuals pay the highest amounts and may therefore have income levels sufficient to support angel investing. Further, this analysis will inform the development of government policies to help stimulate investment. For example, disaggregated analysis based on geography helps identify regions where specific shortfalls to potential demand may require additional policy intervention. Based on analysis of potential investor's capacity, policies can be enacted to provide differing support structures depending on investor types. An example is from the UK Government: while offering the same tax incentives to both equity crowdfunding investors and business angels, higher protection is given to less sophisticated retail investors.[8]

Recommendation 1.3: Commission a demand side survey targeting startup founders/ entrepreneurs. This helps provide an assessment of credible demand side needs as well as uncover issues and guide policy interventions for different types of founders/investment applicants. These might include reluctant applicants (equity averse founders), discouraged applicants (founders who do not apply as they do not know how to, or have fears of being rejected), and unprepared applicants (founders who wish to obtain finding, but do not have the skills or collateral to effectively apply, or who do not understand the real needs of investors). Individual companies need not be identified, rather incubators and accelerators could be asked to report how many of their companies have actively sought equity funding, in which industry sectors, and at what values.

Component 2 (medium-term) - Promotion and Market-Structuring

The development of an effective angel investment market in the Czech Republic is inhibited by a lack of knowledge about the nature and operations of business angels. Individuals may not realize they can be an angel investor or know how to start; founders may not know where to find angels, whether their business is suitable for investment, or what steps they should take to attract investment. This recommendation helps to increase market capacity and the capability of business angels and develop the connection between investors and founders.

Recommendation 2.1: Create a Czech National Angel Association (NAA). A Czech NAA can help improve the efficiency and effectiveness of the existing market, improve coordination and linking of existing investors, and provide better information, signposting, and access to training and international practices. This organization would not itself make investments but fulfil a "market making" function on behalf of the Government to support economic development policy. The Czech Government could seed fund the establishment of an NAA with the remit

[7] Ministry of Economic Development. *Baseline Review of Angel Investment in New Zealand (Undertaken as Part of the Formation of the Seed Co-Investment Fund).* New Zealand: Research, Evaluation and Monitoring Team, Industry and Regional Development Branch, November 2007. https://www.mbie.govt.nz/publications-research/publications/evaluation-of-government-programmes/Archive/report.pdf

[8] Equity-based crowdfunding platforms are required to obtain a license or to have regulated activities managed by authorized parties. They are also required to have a screening process to sort sophisticated and non-sophisticated investors. A "non-sophisticated" investor is not allowed to invest more than 10 percent of their net investable assets through crowdfunding platforms.

to facilitate an increase in the capacity and capability of business angels in the country. While all angels and angel organizations would be encouraged to be members of the national association, its status as a development agency would allow it to be completely independent of any one angel's / network's interests. It would encourage individuals to be angel investors, but with no vested interest in which angel network that individual joins (or does not join). It would be able to deliver policy and programs on behalf of government that a private sector organization may not be motivated to engage in. Due to the very early stage of development of the Czech angel market and the need for government financial support, the more recent Halo Business Angel Network (HBAN) established by Enterprise Ireland in 2009 could serve as a good model for the Czech NAA.

The NAA could potentially become a member of Business Angels Europe (BAE). BAE can give practical support and guidance for the development of the Czech NAA as well as create linkages with other NAAs. BAE's members include the national associations of the most developed angel markets in Europe, including Germany, France, Spain, and the UK.

Recommendation 2.2: Introduce a self-certification system for business angels in the Czech Republic. Accrediting or certifying business angels may help remove any regulatory barriers hindering the easy distribution of early stage investment propositions to investors or limiting the number of investors participating in any individual investment.

Long-term option A - Establish a CoFund

CoFunds are increasingly being used by governments to stimulate behavioral changes in current and potential investors, encouraging them to take more risks. CoFunds lower the risk of investments by encouraging syndication, allowing more investments to be made and providing portfolio diversification. They are used where there is a lack of market capacity and lack of follow on funding (in less invested-in sectors or geographic locations) to help encourage more individuals to become angel investors, and for existing investors to invest more. A critical design element of these CoFunds is that the co investment (of public funds and private investor funds) occurs at the level of individual deals, not at the level of the fund. The objective is to encourage "business angel type behavior", involving a hands-on involvement by the private investor, as opposed to a passive involvement in a fund managed by a professional fund manager. Based on the recommendations of the Organization for Economic Cooperation and Development (OECD), such a co-fund is appropriate once there is at least a minimal level of existing angel activity[9] for the fund to engage with. Information flow is also a pre-requisite before considering this option. An example of a suitable fund structure for the Czech Republic would be one similar to that adopted by the Development Agency in Northern Ireland, where a professional fund manager is tasked with helping to coordinate the sourcing of investments, finding and encouraging new and existing angel investors to invest in each individual deal, and conducting a detailed review of the angel co-investors' due diligence and proposed deal structure. The fund manager must fund at least 50 percent of the value of each investment made from private investors.

Long-term option B - Tax Incentivization

The tax structure is being used by many countries to encourage individuals to take on the extra investment risks of being a business angel.[10] The tax treatment of capital gains or losses realized on disposal of an investment will influence the risk appetite and decision-making process of a prospective investor. For instance, tax relief for capital gains or the provision of loss relief on a more favorable basis than the baseline tax system could support the de-risking of investments in young, growing, and innovative businesses. Given a general lack of market capacity and under-investment in certain sectors in the Czech Republic, such measures could help to increase the number of business angels (and particularly encourage more angels to become "visible" in the market) and widen the pool of angel capital by encouraging investment in a broader range of sectors. However, this measure can only be fully effective within a functioning ecosystem built upon a free flow of information and a culture of risk-taking and investment. These pre-requisites take time to be established, matched by appropriate policy interventions (e.g., general promotion of angel investment and facilitating the education of potential

[9] OECD, "Financing High-Growth Firms: The Role Of Angel Investors," (OECD Publishing, 2011), http://dx.doi.org/10.1787/9789264118782-en.

[10] A European Commission (EC) report "Effectiveness of tax incentives for venture capital and business angels to foster the investment of SMEs and start-ups", Institute for Advanced Studies (2017), looked at best practices in tax incentive programs for investors in 36 countries from within Europe and the OECD.

new investors to enable them to make informed investment decisions). The design of a tax incentive for the Czech Republic will need to take account of the specific characteristics of the Czech tax structure (generally a flat rate of 15 percent applied on all taxable income). Existing exemptions from capital gains tax on all forms of investments in securities held for a minimum period of three years are likely to make specific incentivization for "high risk" investments more difficult. A review of tax legislation should also consider any existing provisions that may discourage high risk investing, such as the provisions allowing losses on the sale of securities (in the case of a business angel investment characterized by the high probability of the failure of the venture and total write-off of the investment) only to be offset against gains on securities sold in the same year (capital losses cannot be carried forward or offset against income).

While these recommendations are primarily focused on the supply-side, improving demand-side interventions and framework conditions are equally important. Effective demand-side interventions (e.g., investor ready programs) stimulate and ensure an adequate pipeline of credible deal flows. Ensuring conducive legal framework conditions (underpinned by deeper legal analyses) prior to the implementation of CoFunds and tax incentivization schemes is likewise a pre-condition for implementing these long term strategic options.

Timeframe	Recommendation
Short-term	**COMPONENT 1. DATA COLLECTION AND MAPPING** Data collection and mapping to create a systematic understanding of demand and supply for angel investments. **1.1.** Commission time-series data on angel investment activity to be updated annually (similar to existing venture capital market data). **1.2.** Conduct a taxpayer base analysis to quantify the number of individuals in Czech Republic who have the potential to be a business angel and repeat annually. **1.3.** Commission a demand side survey targeting startup founders/entrepreneurs on an annual basis.
Medium- term	**COMPONENT 2. PROMOTION AND MARKET STRUCTURING** Promotion and market-structuring to increase market capacity and capability of business angels, and connection between investors and founders **2.1.** Create a Czech National Angel Association (and become a member of BAE). **2.2.** Introduce a self-certification system for business angels in the Czech Republic.
Long -term	**OPTION A. COFUND** Establish co-investment funds to encourage more individuals to become angel investors, and for existing investors to invest more because they lower the risk of investments by allowing more investments to be made and providing portfolio diversification. **OPTION B. TAX INCENTIVIZATION** Introduce tax incentives to increase the number of business angels and encourage them to invest in a broader range of sectors