Problems of data collection, processing and use of informal venture capital

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Abstract

During the exploration of informal venture capital the authors of the work frequently came across with various definitions of such terms as informal investors and business angels. This research showed that various investigators, organizations and associations have different interpretation of the above-mentioned terms and, accordingly, use them differently. The analysis carried out during this work allows one to confirm that, in process of data collection on the number of informal investors and business angels and its processing, a distortion of data describing the number of business angels takes place in some cases. The problem is that, even if the procedure is correct but the inquiry-making quality is poor, a significant distortion of data is possible. In the authors’ opinion, some mistakes in detection of the number of business angels can occur due to different understanding and usage of definition of business angels, and incorrect methods and organization of numeric data collection.

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1. Introduction

Over the last years, companies which needed venture fund financing of the initial stages faced some difficulties of finding investors from venture capital funds; therefore, the role of informal venture capital increased significantly (Sahlman, A., W., Richardson, E., 2013). At present, informal venture capital (hereinafter IVC) is one of the essential sources of financing new (young) cutting-edge and innovative companies (Mason, Harrison, 2013; Schertler, Tykvová, 2009; Mason, 2008; Gullander, Napier, 2003; Freear, Sohl, Wetzel, 2002). In their works, Mason and Harrison refer the activity of business angels to IVC activity (Lahti, 2008, Avdeitchikova, Landstrom, Mansson, 2008). Various European researches show that there is a tendency in Europe to increase the number of business angels and business angel networks (European Commission, 2010; EBAN, European Angel Investment Overview, 2012).
Besides, business angel organization processes undergo some improvements. They co-operate in syndicates and groups to raise the investment efficiency (Mason, Botelho, Harrison, 2013). Moreover, a peculiar feature of the activity of business angels is that they not only provide financial support to enterprises but also actively participate in company’s activities (Lahti, 2008, Avdeitchikova, Landsstrom, Mansson, 2008). IVS researchers show that this movement has a significant impact on economies around the world (Mason, Botelho, Harrison, 2013; OECD Publishing, 2011). That’s why researchers pay great attention to this form of financing start-up companies. In addition, it should be noted that in some countries there are various forms of state support of IVC (Avdeitchikova and Niklasson, 2009). Taking into account that the state tends to use the most effective forms of support while researchers study IVC condition - both of them are in need of objective quantitative and qualitative data. Thus, the significance of data presentation is increasing as well as its reliability. Therefore, the issues of data collection and reliability with respect to the number of business angels and informal investors will be examined in this article. In addition, this study identifies the causes of possible errors in assessing the number of business angels and informal investors.

2. Literature Review and Hypotheses

A number of researchers and organizations emphasize lack of quantitative IVC data and its poor quality (Avdeitchikova, 2012; Kraemer-Eis et.al, 2012; European Commission, 2010; Mason and R. T. Harrison, 2013; Prohorovs, 2014). The first issue is that different researchers and organizations use different definitions of the concepts of business angels and informal investors. Different definitions of these concepts subsequently lead to the distortion of data on business angels and informal investors.

One of the first definitions of informal investors was given by Seymour and Wetzel, who characterize them as “Investors who provide risk capital other than small business investment corporation, venture capital, other institutional investors, and public equity markets; those with high net worth and financially sophisticated; excludes family, friends and debt instruments” (Seymour and Wetzel, 1981). Global Entrepreneurship Monitor (GEM) specifies Informal Investors Rate as “Percentage of 18-64 population who has personally provided funds for a new business, started by someone else, in the past three years” (Global Entrepreneurship Monitor, Homepage, 2014). According to Centre for Strategy & Evaluation Services, informal investors consist of business angels, as well as of family members or friends (Evaluation of EU Member States’ Business Angel Markets and Policies Final report, 2012). OECD, along with business angels, refers family, friends and founders to informal investors (OECD Publishing, 2011).

Different definitions of business angels will be examined further. Mason and Harrison give the following definition of business angels: “A high net worth individual, acting alone or in a formal or informal syndicate, who invests his or her own money directly in an unquoted business in which there is no family connection and who, after making the investment, generally takes an active involvement in the business, for example, as an advisor or member of the board of directors.” (Mason and Harrison, 2008).

The European Trade Association for Business Angels (EBAN) gives the following definition of business angels: “A business angel is an individual investor (qualified as defined by some national regulations) that invests directly (or through their personal holding) their own money predominantly in seed or start-up companies with no family relationships. Business angels make their own (final) investment decisions and are financially independent, i.e. a possible total loss of their business angel investments will not significantly change the economic situation of their assets. BAs invest with a medium to long term set time-frame and are ready to provide, on top of their individual investment, follow-up strategic support to entrepreneurs from investment to exit. They respect a code of ethics including rules for confidentiality and fairness of treatment (vis-à-vis entrepreneurs and other BAs), and compliance to anti-laundering” (EBAN, Glossary, 2013).

The American professor Darian M. Ibrahim gives a broader interpretation of business angels: “Angel investors are typically defined as wealthy individuals, — accredited investors under the securities laws, who invest personal funds in high-tech start-ups. A more expansive definition also includes individuals who invest in — lifestyle firms of a non-technical nature founded by friends or family” (Ibrahim, 2010).

It should be noted that business angels can be divided into visible and invisible (EBAN, European Angel Investment Overview, 2012). It can be assumed that significant differences in the number of invisible business angels can be explained by the fact that the assessment of their number is being made by using only indirect methods, which can give significant differences in results for a variety of reasons.

Besides, an overestimate of the number of business angels can occur because researchers incorrectly use a definition informal investor or equate it with the definition business angel. As a result, quantitative data is being distorted and, in most cases, to the higher side.
Further, mistakes may arise due to problems in methods, organization, process of collection and processing of data on informal investors and business angels.

For example, GEM evaluation methods are based on inquiry of physical persons. According to GEM evaluation methods, persons who have personally provided funds for a new business started by someone else, in the past three years, are related to the category Informal Investors. It should be noted that GEM inquiries do not include a minimum amount of investments. Thus, a wide range of persons, including family, friends and colleagues becomes Informal investors. Calculations made by Centre for Strategy & Evaluation Services while evaluating the number of European business angels based on GEM data, even using a decreasing coefficient, yielded the highest results as against other evaluations made by themselves, and in comparison with evaluations of the number of business angels by other sources (Evaluation of EU Member States’ Business Angel Markets and Policies Final report, 2012).

Hypothesis: depending on the used definitions of informal investors and business angels, the used methods and methodologies and the quality of quantitative data collection, the calculated number of business angels (primarily invisible ones) may vary considerably.

3. Methodology

3.1. Research Goal

The goal of this research is to identify the causes of potential errors in evaluating the number of business angels.

3.2. Research tasks

- To compare different definitions Informal investors and business angels.
- To compare the definitions Informal investors and business angels in Estonia, Finland, Latvia, Lithuania and Sweden.
- To compare the correlation of number of informal investors and business angels in Estonia, Finland, Latvia, Lithuania and Sweden.
- To determine possible reasons, as a result of which significant deviations in calculations of the number of informal investors and business angels may occur.

3.3. Methods of research

The researches of scientific sources, analysis of Global Entrepreneurship Monitor (GEM) data, Eurostat data (The statistical database of the European Commission) and other organizations were taken as a methodological basis for this research. Monographic method, logical and constructive method, descriptive statistics method and benchmarking study were used in this research as well.

3.4. Research results and discussion

Different opinions of researchers on the groups of persons whom they consider to be informal investors can be seen while comparing various definitions of informal investors. Comparison of definitions of informal investors is given in Table 1.

As opposed to definitions of informal investors, which are used by GEM and Centre for Strategy & Evaluation Services, Seymour and Wetzel exclude families and debt instruments from informal investors and that fact brings their definition closer to definitions of business angels. Thus, researchers who will be guided by the definition informal investors offered by Seymour and Wetzel may get to understand that there is no difference between definitions informal investors and business angels.

The definition OECD extends criteria offered by GEM and Centre for Strategy & Evaluation Services and adds founders to them. Since every founder may have its own investor or several investors, and there may be founders among responders during inquiries, as a result, the number of informal investors may be several times as large when using OECD as against that obtained though the usage of formulations suggested by M and Centre for Strategy & Evaluation Services.
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Table 1. Comparison of definitions of informal investors

| Characteristics | Seymour and Wetzel | GEM | Centre for Strategy & Evaluation Services | OECD |
|-----------------|--------------------|-----|------------------------------------------|-------|
| Who are they    | Investors who provide risk capital | Percentage of 18-64 population who have personally provided funds for a new business, started by someone else, in the past three years | Business angels, as well as family members and friends | Business angels, as well as family, friends and founders |
| Relationships   | Apart from instruments | family, debt | Including relationships | family and founders |

Source: developed by the authors

Having compared the definition of business angels offered by Darian M. Ibrahim “A more expensive definition also includes individuals who invest in household products-related companies of a non-technical nature founded by friends or family” it may be concluded that this definition of business angels coincides with that of informal investors offered by GEM and Centre for Strategy & Evaluation Services. As a result, using the formulation of business angels offered by Darian M. Ibrahim (not by EBAN and the majority of authors including Mason and Harrison) in quantitative evaluation, the number of business angels may appear overestimated by a few times and more.

As the authors expect, besides issues related to the variety of definitions discussed above, errors may arise due to issues related to collecting methods, collection organizing, collection and processing of data on informal investors and business angels (the results of inquiries largely depend on how they are made, how respondents understand the essence of the questions asked, how respondents are selected and, possibly, on several other factors). Let’s consider this by using specific examples. In this work, the analysis of the problems in evaluation of the number of informal investors will be carried out in terms of three Baltic countries: Latvia, Lithuania, Estonia and two countries of northern Europe: Finland and Sweden. Let’s consider data on Informal Investors Rate provided by GEM (ref. Table 2).

Table 2. GEM-issued data on Informal Investors Rate (Percentage of 18-64 population who have personally provided funds for a new business, started by someone else, in the past three years)

| Country     | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 |
|-------------|------|------|------|------|------|------|------|
| Estonia     | -    | -    | -    | -    | -    | -    | 8.7  |
| Finland     | 2.7  | 3.3  | 2.8  | 2.2  | 3.4  | 4.4  | 3.1  |
| Latvia      | 5.3  | 1.6  | 5    | 6.7  | 10.6 | 7.1  | 7.3  |
| Lithuania   | -    | -    | -    | -    | -    | -    | 6.1  | 9.3  |
| Sweden      | 2.6  | 3.7  | -    | -    | 6.6  | 8.7  | 4.3  |

Source: Global Entrepreneurship Monitor

As can be seen from the Table 2, Informal Investors Rate in Latvia is higher than in Finland over a period from 2006 to 2012 (except for 2007), it’s also higher than in Sweden (except for 2007 and 2011). For illustration purposes, let’s move on from the relative data on informal investors to the number of informal investors in the examined countries. With reference to GEM data on Informal Investors Rate and Eurostat civil data on countries at the age of 18-64 (covering the period from 2006 to 2012) we will calculate the absolute values of the informal investors (ref. Table 3).

Let’s compare changes of number of Informal Investors in Finland and Latvia in dynamics. This analysis shows that the change of number of Informal Investors in Finland seems to be more logical in comparison with Latvia. From 2006 to 2007 the growth of number of Informal Investors in Finland can be seen, and it coincides with the dynamics of Fund raising for CEE private equity (EVCA CEE, 2013). Then, from 2008 to 2009 in a period of crisis a decrease of number of Informal Investors is observable, while in 2010 and 2011 during crisis recovery again the number of Informal Investors is growing. A decrease of the number of Informal Investors in Finland in 2012 still remains obscure.
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The dynamics of changes of Informal Investors in Sweden according to tendencies coincides with a change of number of Informal Investors of Finland. The dynamics of the number of Latvian Informal Investors differs from that in Finland and looks somewhat strange. For example, in 2007 (before the crisis begun) the number of Informal Investors decreased by 3.3 times (down to 52 thousand) as compared to 2006. Then, from 2008 to 2010, on peak of crisis, the number of Informal Investors begins to grow rapidly. In 2010 the number of Latvian Informal Investors increases in 6.4 times (on 121 thousand) as compared to 2007 (this situation occurs against the backdrop of global crisis). Subsequently in 2011 again we can see the decrease of the number of Informal Investors by 1.5 times (to 50 thousand) as compared to 2010.

During the period from 2006 to 2012, a sizeable fluctuation of the number of Informal Investors can be seen in Finland, Latvia and Sweden. A summary table 4, which reflects significant fluctuation of number of Informal Investors of Finland, Latvia and Sweden in a period from 2006 to 2012 is shown below.

| Country | Minimum number of Informal Investors | Maximum number of Informal Investors | Scatter in maximum and minimum values of Informal Investors | Tendency in change of Informal Investors against the backdrop of global crisis |
|---------|--------------------------------------|-------------------------------------|-------------------------------------------------------------|---------------------------------------------------------------|
| Finland | 73 539 (2009)                        | 147 397 (2011)                      | 2 times                                                     | Decrease by 33% in 2009 as compared to 2007                   |
| Latvia  | 22 594 (2007)                        | 144 299 (2010)                      | 6.4 times                                                   | Increase in 2009 by 319% as compared to 2007                  |
| Sweden  | 144 252 (2006)                       | 501 053 (2011)                      | 3.5 times                                                  | No data available                                            |

It can be seen from Table 4 that the number of informal investors in Latvia during the period from 2006 to 2012 increased by 6.4 times, while within several years it changed by 319%, which makes us think of the objectivity of data on the number of informal investors (and, if the conclusion on the number of business angels is made on that basis – on the number of business angels, too).

Then we will compare data provided in Tables 2 and 5 to test the assumption that Informal Investors Rate and Gross domestic product are interconnected.
Table 5. Gross domestic product at market prices (GDP per capita), Euro per inhabitant from 2006 to 2012

| Country  | 2006  | 2007  | 2008  | 2009  | 2010  | 2011  | 2012  |
|----------|-------|-------|-------|-------|-------|-------|-------|
| Estonia  | 10 000| 12 000| 12 100| 10 400| 10 700| 12 100| 13 000|
| Finland  | 31 500| 34 000| 34 900| 32 300| 33 300| 35 000| 35 500|
| Latvia   | 7 200 | 9 600 | 10 500| 8 600 | 8 600 | 9 800 | 10 900|
| Lithuania| 7 400 | 8 900 | 10 100| 8 400 | 8 900 | 10 200| 11 000|
| Sweden   | 35 000| 36 900| 36 100| 31 500| 37 300| 40 800| 42 800|

Source: Eurostat 2014

As can be seen from the data presented in Table 5, GDP per capita in Latvia is lagging behind substantially from GDP per capita of Finland and Sweden; nevertheless, Informal Investors Rate of Latvia exceeds that of Finland and Sweden (ref. Table 2). The result of comparison between the Latvian per capita and Informal Investors Rate with that of Finland and Sweden (per unit) are presented in Table 6.

Table 6. Comparison between GDP per capita and Informal Investors Rate of Latvia with that of Finland and Sweden from 2006 to 2012

| Indices | 2006  | 2007  | 2008  | 2009  | 2010  | 2011  | 2012  | Average value |
|---------|-------|-------|-------|-------|-------|-------|-------|---------------|
|         |       |       |       |       |       |       |       |               |
|         | GDP per capita of Latvia with respect to GDP per capita of Finland | 23% | 28% | 30% | 27% | 26% | 28% | 31% | 27% |
|         | Informal Investors Rate of Latvia with respect to Informal Investors Rate of Finland | 1.96 | 0.48 | 1.79 | 3.05 | 3.12 | 1.61 | 2.35 | 2.05 |
|         | GDP per capita of Latvia with respect to GDP per capita of Sweden | 21% | 26% | 29% | 27% | 23% | 24% | 25% | 25% |
|         | Informal Investors Rate of Latvia with respect to Informal Investors Rate of Finland | 2.04 | 0.43 | No data available | No data available | 1.61 | 0.82 | 1.7 | 1.32 |

Source: the authors’ calculations.

The calculations shown in Table 6 attest to a paradoxical situation - just like the analysis of the time history of Informal Investors Rate fluctuation (see Table 3). Despite the fact that the average GDP per capita of Latvia constituted only 27% from GDP per capita of Finland (3.7 times as little) within the period 2006 – 2012, the Informal Investors Rate of Latvia exceeds that of Finland by 2.05 times on an average. The situation looks similar if we compare Latvia to Sweden. GDP per capita of Latvia constituted 25% from GDP per capita of Sweden within 2006 – 2012 on an average, while Informal Investors Rate of Latvia exceeds Informal Investors Rate of Sweden by 1.32 times on an average.

We might assume that the unexpectedly high Informal Investors Rate of Latvia may be connected with some peculiar features of the countries examined. However, if we compare the Latvian data with that of Lithuania and Estonia and the data of Finland with that of Sweden, it appears that the above-mentioned paradoxical difference between Informal Investors Rate in Latvia and in Finland is connected with the data collection and processing methods applied by Global Entrepreneurship Monitor (GEM). This conclusion is confirmed by the fact that the number of Informal Investors in Latvia has changed by 6.4 times within 2007 – 2009 which looks strange.

Since the concept “Informal Investors” embraces relatives and friends apart from business angels, the following assumptions may be made, possibly explaining why the Informal Investors Rate of Latvia exceeds the Informal Investors Rate of Finland by 2.05 times.
There is a strong probability that owners of young companies apply for financial help more frequently to their relatives and friends, not to business angels. Moreover, it can be assumed that relatives invest small sums. As a result, though investment sums turn out to be small due to the predominance of the relatives and friends’ share, they demand the attraction of a large number of investors. Since GEM does not specify any minimal amount of investments required for a person’s being qualified as Informal Investors - respondents from different countries may differently understand the sums that they consider to be investments. Perhaps that’s exactly why the share of Informal Investors in countries with a low GDP per capita is higher than that in the countries with a high low GDP per capita.

We might assume that the reason for a lower Informal Investors Rate in countries with a higher GDP per capita may be that young enterprises in Finland and Sweden have great opportunities for being supported by governmental agencies in order to start their business; accordingly, young companies apply to Informal Investors less frequently. It is also possible that there exist financial and crediting institutions crediting young business tax-free as is accepted in Latvia. Alternatively, State Agency for Guarantees may operate on a larger scale, which makes obtaining of credits easier and abates the necessity of applying to Informal Investors. That’s why the behavior of owners of young companies may greatly differ in different countries and may affect both the number of Informal Investors and the business angels share therein. If the authors’ assumptions hold true, we must agree that the business angels/Informal Investors ratio may differ a few times in various countries.

A number of investigators state the evaluated numbers of business angels based on GEM data on the number of Informal Investors. For example, Centre for Strategy & Evaluation Services evaluates the number of business angels in EU27 based on the data on the Informal Investors number in eight countries (Evaluation of EU Member States’ Business Angel Markets and Policies Final report, 2012).

Therefore, the authors believe that the definition of the number of business angels based on data on the number of Informal Investors may lead to deviation by several times and more. To rate the accuracy of such calculations, let us compare the number of Informal Investors calculated under GEM methods, with the number of visible business angels operating in countries considered in this work (see Table 7).

Table 7. Estimating the number of Informal Investors with respect to one visible BA in 2012

| Country | Visible Bas number | Number of Informal Investors (GEM) | Informal Investors/visible BAs ratio (showing the number of Informal Investor falling on one BA) |
|---------|-------------------|----------------------------------|--------------------------------------------------------------------------------------------------|
| Latvia  | 22                | 95 901                           | 4 359                                                                                             |
| Estonia | 43                | 73 666                           | 1 713                                                                                             |
| Finland | 450               | 103 536                          | 230                                                                                                |
| Sweden  | 850               | 248 496                          | 292                                                                                                |
| Lithuania | 31              | 174 380                          | 5 625                                                                                             |

Source: developed by the authors, based on: Prohorovs, 2014; GEM 2012; EBAN and authors calculation

Let us consider a few examples based on the data shown in Table 7. The number of visible business angels in Latvia is 20 times as little as in Finland, while the number of Informal Investors in those two countries differs by 7% only. To show the differences between Informal Investors/Visible BAs ratios within those five countries, we place the results into Table 8 (comparing between the Informal Investors/Visible Bas ratios in the countries examined).

Table 8. Assessment of the number of Informal Investors to one visible BA ratio in 2012

| Country | Latvia | Estonia | Finland | Sweden | Lithuania |
|---------|--------|---------|---------|--------|-----------|
| Latvia  | 1.00   | 2.54    | 18.95   | 14.93  | 1.29      |
| Estonia | 1.00   | 7.45    | 5.87    | 3.28   | 24.46     |
| Finland | 1.00   | 1.27    | 19.26   | 1.00   | 1.00      |

Source: developed by the authors (based on the data of Table 7)

As it can be seen from Table 8, minimal differences in Informal Investors/Visible BAs ratios are observed between Lithuania and Latvia (1.29 times) and between Finland and Sweden (1.27 times), while the minimum difference in the
ratio observed between Finland and Lithuania is 24.5 times, Sweden and Lithuania - 19.26 times and between Latvia and Finland – 18.95 times.

Therefore, we can draw the conclusion that the range of Informal Investors/Visible BAs ratios in different countries is very wide.

4. Conclusion and recommendations

There exist various definitions of the concepts of Informal Investors and Business Angels. This should be taken into account when investigating the number of Informal Investors and Business Angels and, especially, when counting the number of Business Angels based on the number of Informal Investors.

GEM conducting investigations on the number of Informal Investors probably uses a unique methodology with respect to various countries. However, the findings of our research of the Informal Investors index in GEM show that the fluctuations of the number of Informal Investors in Latvia are very impressive (319% within two years), while the data proper greatly differs from that of the countries comparable to Latvia – as Estonia for example. That’s why GEM data on the number of Informal Investors in Latvia are doubtful. One can assume that, at the level of specific countries, GEM providers and partners are facing considerable defects in methods, organization, and process of Informal Investors data collection. Accordingly, by using GEM data in indirect methods of BA number evaluation with no additional check may lead to considerable misinterpretation of results – by several times and more as is shown in Tables 7 and 8. Therefore, when using the data on the number of Informal Investors and Business Angels, obtained from different sources, investigators should assess the methods for data collection and processing wherever possible, in order to avoid any essential errors in quantitative evaluations. Moreover, to provide for a higher data reliability and adequacy, the data should be compared to analogous data from other sources; the time-split data should also be correlated and then compared with the analogous data from other countries. This would allow one to understand which data can be used and which require an additional check or should be expelled from investigations.

In surveys conducted by GEM, on the basis of which the conclusion about the number of Informal Investors is made, the minimum amount of investment (required to get into the category of Informal Investors) is not specified. As a result, even respondents who invest minimum amounts are qualified as Informal Investors. In our view, it would be advisable to establish a minimum threshold for the amount of investment – to be qualified as a casual investor, - or at least include in the questionnaire the further question whether the sum of investment exceeds 10000 EUR for example.

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