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Business angel groups as collective action: an examination of the due diligence process

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Abstract

With the emergence of business angel groups, angel investing is increasingly an activity that is based on collective action. However, our understanding of the investment process of business angels is largely based on studies of angels who invest independently. This paper investigates the collective action practices of one UK business angel group – Henley Business Angels. We examine how the due diligence process is undertaken. This stage involves the verification of the information in the pitch and business plan and underpins the decision whether or not to make an investment. This stage in the investment process has attracted limited attention by researchers. We find that there is a lack of rigour in the due diligence that angels undertake. Further, the process involves limited collective action. Group members largely act on their own behalf in carrying out due diligence, generally investigating areas of interest or concern independently of other members. However, members typically do share and discuss information gleaned from their own due diligence process with other members in the group. Some members will also accept the due diligence of other members if it is outside of their own area of expertise or if they do not have the time to carry out the due diligence themselves.

Keywords Business angels · Business angel groups · Investment decision-making · Due diligence · Collective action

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Introduction

There is growing recognition that entrepreneurship is a collective rather than an individual endeavour (Lindgren & Packendorff, 2003; Dimov, 2007; Drakopoulos Dodd & Anderson, 2007; Johannisson, 2011; Ben-Hafaïedh et al., 2024), with a range of both informal and formal actors – including mentors, support organisations, universities, corporations and investors – interacting with, and assisting, entrepreneurs with starting and scaling their ventures (Hruskova, 2024). However, studies of entrepreneurship that adopt a collective action perspective have the entrepreneur and the entrepreneurial organization as their focus. In contrast, limited attention has been given to the collective actions of other actors in the entrepreneurial ecosystem. In particular, research on finance actors (bankers, business angels, venture capitalists) continues to take an individual-centric approach and largely ignore the collective nature of their funding decisions. Our purpose is to provide a contribution that departs from this individualistic perspective that dominates business angel research.

Business angels are high net worth individuals - typically cashed out entrepreneurs, corporate executives or business professionals - who invest their own money along with their time and expertise, either alone or with others, directly in unquoted businesses in which there is no family connection in the hope of financial gain (Mason & Botelho, 2018). They play a critical role at the start of the entrepreneurial pipeline, providing ambitious start-ups with the funding to make the transition from the concept and validation stages to revenue growth. Angels are estimated to make 20 to 40 times as many investments as venture capital funds (VCFs) at the pre-start-up, start-up and series A stages (EBAN, 2023). Many angel-backed start-ups go on to raise further rounds of finance from VCFs to scale up (Madill et al., 2005; Capizzi et al., 2022), with the British Business Bank (2020) commenting that "without an angel investor many [start-ups] will not make it to the next step."

Business angels have been a significant focus for research for more than four decades following Wetzel's (1981, 1983) pioneering research. The dominant focus of this research – which is highlighted in reviews of the business angel literature (White & Dumay, 2017; Tenca et al., 2018; Edelman et al., 2017) – has been, and continues to be, on the investment decision-making process. However, there has been only limited recognition in the literature that the emergence of angel groups means that angel investing is increasingly characterized by collective action and is no longer an exclusively individual activity (Mason et al., 2019; Croce et al., 2017; Butticè et al., 2021; Bonnet et al., 2022; Botelho & Mason, 2024). Collective action can be defined as an activity in which individuals co-operate by undertaking shared practices to pursue common goals because they believe that pooling resources and co-ordinating strategies with like-minded actors is a more effective way of creating outcomes that are in the interests of the group (Johnson & Prakash, 2007; Champenois et al., 2020; Castellanza, 2022). These practices are fundamentally relational (Champenois et al., 2020). Collective action is often achieved through the creation of a formal or informal organization (Hargreave & Van de Ven, 2006).

The European Business Angel Network (EBAN, 2023) has identified 358 active angel groups across 38 European countries which they estimate to have a collective membership of over 43,000 angels.[1] Their emergence has significantly transformed the angel market and enhanced its importance. First, it has increased the supply of investment funds through attracting new investors who would not have invested on their own and enabling existing angels to invest more (Bonini et al., 2018). Second, the access of entrepreneurs to finance has been enhanced on account of their visibility. Third, angel groups are able to make larger investments and more follow-on investments (Gregson et al., 2017). Fourth, it has professionalized the angel investment process and enhanced the support that they provide to their investee businesses. This, in turn, has made them credible co-investors alongside both institutional investors and government co-investment funds (Owen & Mason, 2017; Harrison, 2018).

Yet despite this fundamental transformation of the angel market, angel groups have not attracted significant attention by scholars (Tenca et al., 2018). It is recognized that angels who join angel groups are distinctive from those that invest independently (Bonini et al., 2018; Wirtz et al., 2020. The investment process of angel groups is also distinctive (Carpentier & Suret, 2015; Croce et al., 2017). However, there has been limited research on the functioning of angel groups from a collective action perspective. We address this research gap by means of a case study of how the members of one UK angel group undertake the due diligence process. In doing so, this paper simultaneously addresses a second gap in the angel literature which largely focuses on the initial stages of the investment decision-making, notably the pitching and initial screening stages (e.g. Clark, 2008; Clarke et al., 2019; Warnick et al., 2021), whereas the due diligence process and other later stages of the investment process have received limited attention.

Specifically, this paper addresses two research questions that have not been previously investigated. First, what does the due diligence process involve? Second, what collective actions do the members of business angel groups undertake to perform the due diligence process? The paper makes three contributions. First, it broadens the focus of the 'entrepreneurship as collective action' theme, which Ben-Hafaïedh et al. (2024: 4) have described as "the next frontier in entrepreneurship research", to the actions and decisions of other actors in the entrepreneurial ecosystem who influence the performance of new ventures. Second, it focuses on the due diligence stage of the investment process, whereas the vast majority of studies have either not differentiated between stages or focused on a single stage, particularly the initial screening stage. Third, by conceptualising business angel investing as collective action it advances understanding of the investment practices of angel groups.

The paper is structured as follows. The next section discusses the investment decision-making process of business angel groups from a collective action perspective, positioning the due diligence process within this process and highlighting the distinctiveness of due diligence from other stages in the process. The data are described in Sect. 3. The findings are presented in Sect. 4 and discussed in Sect. 5. The concluding section reflects on the study's contributions.

[1] The invisibility of solo angels means that it is not possible to estimate what proportion of the angel population this represents (Mason & Harrison, 2000, 2008). EBAN (2023) estimate that angels who are members of angel groups account for 10% of the angel population.

Angel groups as collective action

The decision-making of business angels is a sequential process that involves multiple stages (Maxwell et al., 2011; Maxwell, 2016) with a basic distinction between (i) the initial screening stage; (ii) the detailed evaluation or due diligence stage; and (iii) the negotiation of the terms and conditions of the investment, including valuation. Our understanding of the investment decision-making process is overwhelmingly based on studies of individual angels. The consensus in the literature that the key considerations are, first, the attributes of the entrepreneur, notably their capabilities, comprising their expertise, experience, integrity, honesty and trustworthiness, and the realism of their expectations, and second, the strength of the opportunity, notably the attributes of the product or service and its market potential, including competition, and barriers to new entrants, all of which are key influences on growth potential and financial return. Deal killers are linked to the entrepreneur/management team, flawed or incomplete marketing strategies and unrealistic financial projections (Riding et al., 1995; Mason & Harrison, 1996a, b; Croce et al., 2017; Mason et al., 2017).

However, although most of these investment criteria apply to all stages, their weightings change as the process unwinds, with opportunities being rejected for different reasons at different stages (Dal Cin et al., 1993; Landström, 1998; Mitteness et al., 2012; Jeffrey et al., 2016). Issues that investors consider at the initial screening stage are the source of the deal, with its credibility linked to referrer, along with any other investors in the business, and 'investment fit', along with the product/service concept, the potential of the target market and the entrepreneur/management team. Investors typically approach this process with a negative mindset (Mason & Rogers, 1997; Maxwell, 2016). The capabilities of the management team and the financial return become more important as the process proceeds (Dal Cin et al., 1993; Duxbury et al., 1997; Riding et al., 1995; Feeney et al., 1999; Riding et al., 2007). Because angels need to develop a long-term relationship with the entrepreneur they place increasing emphasis on the key signals that entrepreneurs provide of trust building and trust damaging behaviour as the process unfolds, which can only be assessed after extended interaction between the entrepreneur and the investor (Maxwell & Lévesque, 2014). The key reason why deals that reach the negotiation stage fail to proceed to an investment is generally because of disagreement over valuation (Mason & Harrison, 1996a), along with the terms and conditions of the investment and the investor's contribution.

Business angel groups operate on the basis of collective action, hence their investment decision-making process is distinctive from that of independent angels (Carpentier & Suret, 2015). According to Meinzen-Dick et al. (2004: 200) the features of collective action are "the involvement of a group of people, … a shared interest within the group, and …. some kind of common action that works in pursuit of that shared interest." Angel groups have emerged because angel investors have decided that investing collectively enhances investment outcomes compared with investing on their own (Shane, 2009; Paul & Whittam, 2010). Membership of an angel group enables individuals to develop a diversified portfolio of investments by spreading their capital across more investments. The visibility of angel groups and the networks of their members generate a larger and better quality of deal flow. Administrative support enables more efficient management of the various stages in the investment process. Pooling the knowledge and expertise of group members offers a wider set of insights and interpretations, provides more effective screening and selection of investments, assists individual members to test and validate the accuracy of their own judgements and enhances the collective ability of the group to provide more effective post-investment support. Transaction costs are reduced and efficiency is increased as groups build up knowledge that enables the development of effective due diligence procedures and standardised investment documents. And pooling the financial resources of their members provides angel groups with the 'deeper pockets' required to make both larger initial investments and follow-on investments. This enables members to invest in deals that they could not invest in on their own. Investing as a group also reduces (although does not eliminate) the power asymmetries with venture capital funds who, as follow-on investors in a business, can largely dictate investment terms, notably the valuation and deal structures that they offer to angels (Hellmann & Thiele, 2015; Leavitt, 2004). These benefits - notably increased overall investment, portfolio diversification, better quality deal flow, access to superior information and the expertise of other angels, and lower due diligence and transaction costs - have been confirmed in several studies (Kerr et al., 2014; Bonini et al., 2018; Antretter et al., 2020).

Our focus is on the collective action that members of angel groups undertake to make their investments. The investment process in angel groups is co-ordinated by a manager – termed the 'gatekeeper' (Paul & Whittam, 2010) – who may be one of the group's founding angels or a hired professional manager. The gatekeeper plays a critical role in the process, particularly the screening stage (Carpentier & Suret, 2015; Croce et al., 2017; Botelho & Mason, 2024). It is important to emphasise that angel groups are not pooled investment vehicles. Although members invest collectively, they each make their own investment decisions and make their own investments, with one of the consequences being that it is not the same members of the group who invest in each deal (Sohl, 2007). However, this creates a potential principal-principal problem, with conflicts arising between different principals (i.e. investors) on account of disparities in the amounts that they invest in specific deals (Young et al., 2008; Renders & Gaeremynck, 2012) which discourage members from working collectively. Bonnet et al. (2022) notes that the level of involvement of individual angels in the group depends on their decision-making style, human capital and investment motivation.

The most important consideration at the initial screening stage is 'investment fit'. The gatekeeper will pre-screen the proposals that the groups receive for their 'fit' with the investment focus of the group (e.g. sector, size of investment, stage, location) and then for their potential, eliminating the 'no hopers', with businesses also rejected at this stage for flawed or incomplete information and unrealistic financial projections. Those proposals that remain then undergo a further screening process, typically by a screening committee, to select those which have sufficient merit to be considered by the group. Those entrepreneurs whose proposals get through the screening stage are invited to pitch to members who then indicate their interest. The focus at this stage is on the market and product dimensions of the proposal. The quality of the pitch (Mason & Harrison, 2003; Clark, 2008) and entrepreneur passion have also been identified as influential (e.g. Cardon et al., 2009; Warnick et al., 2018). This stage has a high rejection rate, predominantly on account of concerns about the product, business model, market (size, potential, competition), lack of competitive advantage, market strategy and unrealistic ambitions. Rejection typically results from the cumulation of a number of deficiencies rather than for a single reason, what Mason and Rogers (1997) describe as a "three strikes and you're out" approach, whereas at later stages it is more likely to be because of a single 'deal killer'. There is significant attrition in the screening process, with more than 80% of the opportunities being rejected (Riding et al., 1993; Croce et al., 2017; NACO, 2023).

The group will undertake detailed investigation– or due diligence - on those opportunities that attract sufficient interest from members. The decision at this stage is whether or not to negotiate an investment. This process can take several weeks. The key variation around this model is the extent to which the members are actively involved in the investment decision-making process (Gregson et al., 2013). In larger groups a subset of members will be established to undertake due diligence in order to decide whether or not to recommend it to the wider group to invest. The due diligence process is more objective than the screening stage. It typically involves face-to-face meetings with both the entrepreneur and management team, visits to the business location, assessment of company documentation and a search for external information, all with the objective of verifying the information in the business plan to reach an informed opinion on the realism of the financial projections and potential financial reward (Riding et al., 1993; Carpentier & Suret, 2015; Mitteness et al., 2012). Members of the due diligence team will also use their networks to assess the key elements in the business plan. At this stage the merits of the investment are judged on the basis of both principal-related and financial factors (Dal Cin et al., 1993). Reasons for rejection are dominated by concerns about the potential of the product, technology, business model, and market and sales cycle, along with team weakness. The final stage involves negotiation about the term sheet. Rejection at this stage is typically linked to disagreement over valuation or ownership structure or dislike of the principals.

Methodology

The research is based on a case study of Henley Business Angels (HBA).[2] HBA was established in 2016 and operates under the auspices of the Henley Business School at the University of Reading. Reading (population c. 350,000), located in the Thames Valley region, 64 km west of London, has become the undisputed second region in the UK tech industry after London (Godley et al., 2021). HBA focuses its investments on entrepreneurs who have connections with Henley Business School or the University of Reading, or are based in the Thames Valley Area and which are seeking £50,000 to £500,000 to accelerate the growth of their business. To June 2024 it had received 471 applications for investment: 131 of these companies (28%) have been selected to pitch with 44 of these (34%) successfully raising £23m of investment

[2] henleybusinessangels.com.

from HBA members. It currently has 52 members.[3] Its members are required to meet the financial services regulation criteria of being either high net worth individuals or sophisticated investors and hence can receive investment opportunities. Semi-structured interviews of around one hour's duration were carried out with 16 members who volunteered to participate in the study, comprising 37% of its membership at the time of the study.

Sample characteristics

Fifteen of those interviewed were male and one was female. HBA had four female members (9%) at the time of the study, below the UK average of 14% (UKBAA, 2022). It is actively seeking to increase its gender diversity. Their professional backgrounds were varied, but with strong representation from the industrial, technology and life sciences sectors. Twelve interviewees (75% of those interviewed) had founded their own businesses.

Interviewees included both novice and experienced investors based on the length of time they had been investing and the number of investments that they had made. Seven interviewees had joined HBA on its formation in 2016; the remaining nine interviewees had been members for between three months and four years. Eight interviewees were also members of one or more other angel networks. Fourteen interviewees had made their first investment with HBA within two years of joining; the two other interviewees had not yet made any investments despite having been members for three and six years respectively.

The majority of interviewees who had made investments had invested on average in three or four companies through HBA, sometimes in two successive rounds. However, four members had invested in more than 10 companies, including investments made through other angel groups, one member had made 40 investments and another member had made around 70 investments. Investments ranged from £2,500 to £200,000, although most investments were in the £10,000 to £25,000 range.

Interview themes

The interviews focused on the due diligence process. It covered two main themes. First, angels were asked what aspects of the business they examined, the specific issues that they investigated, the weighting given to each of them and whether they used a compensatory or non-compensatory approach to their evaluation (Maxwell et al., 2011). Second, angels were asked about how the due diligence process was undertaken, specifically whether they carry it out themselves, with other members of the group or by external consultants. And in situations where angels invest as a syndicate, who takes the lead on due diligence, who pays for any external work, and to what extent are the findings shared with other members. Interviewees were also asked about the influence of other investors in the due diligence process in situations where they were present. We also took the opportunity to ask interviewees whether the process of due diligence had changed in the pandemic and how meetings held

[3] At the time that the study was undertaken (mid-2022) HBA had 45 members.

virtually over Zoom or Teams may have shaped how due diligence is undertaken. Interviews were recorded and transcribed.

Results

The HBA funding process

The HBA funding process encompasses nine steps (Fig. 1), starting with the application process (stage 2). Those applications that meet the group's investment criteria are invited to attend an investment readiness workshop (stage 3), followed by an interview (stage 4). Following the interviews a panel selects five or six businesses to pitch at a company presentation event (stage 5). These companies receive training and guidance to prepare for this event. After the company presentation event (stage 6) entrepreneurs and investors have the opportunity to meet to discuss the investment in more detail (stage 7). Members who are interested in investing will carry out their own due diligence and negotiation. HBA encourages interested members to work together and identify a lead investor to ensure cohesive and effective communication between the entrepreneur and interested members. This also allows members to share the load of due diligence and provide a forum for private discussion. Investments will be made directly by the interested member or group of members (stage 8). Our focus in this study is on the screening of proposals that HBA members undertake following the presentations (stage 6) and the due diligence carried out prior to potential investment (stage 7).

HBA members make their own decisions about whether to invest and how they go about investing, including due diligence procedures. Henley Business Angels Limited, Henley Business School, Henley Centre for Entrepreneurship and the University of Reading do not provide investment advice or promote any investment opportunity and are not authorised by the Financial Conduct Authority (FCA) in this regard. HBA is therefore not able to provide advice to members on what might be construed as best practice in the area of due diligence.

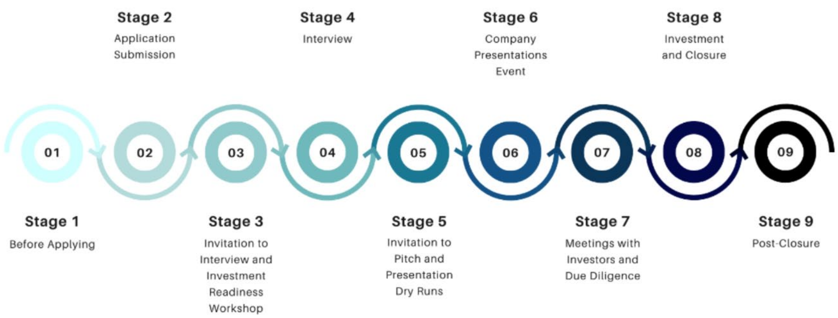

Fig. 1 The HBA funding process

Motivations for investing

The motivation of business angels for investing impacts their approach to investment (Croce et al., 2020). For example, if non-financial motivations are pre-eminent this influences the focus of the due diligence process and how it is conducted. Their attitude to risk is also likely to shape how they undertake due diligence, with investors with a high tolerance for risk expected to undertake the due diligence differently from those who adopt a cautious approach to investing.

A key motivation for all of the members interviewed for becoming a business angel was the financial return potential of angel investing. This was expressed by one interviewee as follows:

> *"I think if you're not doing it to try and make a return you're effectively ending up being a charity and you're probably not making the best decisions" (#16.)*

However, as previous studies have noted (e.g. Sullivan and Miller, 1996; Morrissette, 2007; Botelho et al., 2022; Falcão et al., 2023), most angels are not motivated entirely by financial considerations. When asked to weigh the importance of financial motives compared with other motives seven members placed a weighting of less than 50% on financial return compared with nine members who weighted this greater than or equal to 50%. Significant non-financial motivations for investing included for interest, fun or as a hobby (cited by10 members) and 'giving back' by providing advice and support to new entrepreneurs (cited by10 members). This is reflected in the following quote:

> *"I wanted to have some fun and I thought it was a kind of really interesting thing to do to see all these interesting opportunities and understand them and get involved. I thought I'd enjoy it and I also felt that I could add value as well from my experience and some expertise that I've accumulated over the years to help these companies grow" (#3).*

Another non-financial motive was for active involvement with an investee company, either as a non-executive director, adviser or in an interim executive role which one interviewee explained was *"to keep me busy"* (#15).

Most of the angels were in the process of building their investment portfolios to reduce risk (Gregson et al., 2017). Four members already had portfolios of 10 or more investments through HBA and other networks. Ten angels (63%) adopted the "1 in 10" approach– a standard venture capital metric - with the expectation that at least one out of every ten investments is required to be a 'winner' for the investment portfolio to generate positive returns (Zider, 1998). Only four angels specifically stated that they were wanting (though not necessarily expecting) all of their investments to succeed. Whatever their approach, angels were investing on the basis that they could afford to lose all of the money invested, taking advantages of tax schemes (SEIS and EIS) where relevant:

> *"When you invest you've got to write it off. Yes, you can lose the money and it wouldn't impact me to any great extent" (#5).*

> *"If I lose the money I'm not bothered, it's not a train smash to lose, I mean if it was a million pounds I would be bothered but yes if I lose £30,000 it's not the big issue for me" (#13).*

Ten of the 16 members (63%) interviewed focus their investments in sectors where they have experience and which they therefore know and understand, with this knowledge usually derived from having worked in the sector or started a business in the sector. This is reflected in the following comment:

> *"I only get involved in things that I understand; if you look at all the companies that I've invested in, with perhaps one exception, all of the others are basically in sectors in which I have a fairly significant degree of understanding from my corporate experience" (#2).*

Having a strong sector focus enables angels to better assess the technical and market strengths and weaknesses of potential investment opportunities. It also enables angels to provide added value support to the investee companies:

> *"I focus where I have deep knowledge [and] connections. You invest in what you know because you want to add something that goes beyond just the money. You want to be at least a sounding board if not somebody that's actively involved in doing things whatever that might be" (#5).*

Those angels who invested across a variety of sectors typically either did not have a particular sectoral background or wanted to diversify their risk. Moreover, a typical quarterly pitch meeting of five or six companies may not provide sufficient opportunities that attract sector-focused investors. Indeed, two angels who have been members for 3 and 6 years, respectively, have not yet made any investments for this reason.

Screening criteria

The screening process involves two stages. The first stage is undertaken by a screening panel of three to five people (the quorate is three) comprising members and one or more representatives of the HBA board of directors. HBA applies 12 criteria to select entrepreneurs to present at the quarterly members meetings (Table 1). These criteria are applied at the application stage and clarified through subsequent interviews with the entrepreneurs of those companies that successfully pass through the application stage. HBA does not undertake any verification of the criteria at this stage.

The second stage of the screening process is undertaken by individual members on those companies that successfully passed through the initial screening process carried out by HBA and were invited to make pitches to members. There was no standard approach to assessing opportunities. Members adopt a range of different criteria to screen potential investment opportunities in order to decide whether to investigate them further with a view to investing. Two members did adopt the investment criteria of HBA as their own principal screening criteria (Table 1). Five members specifically did not rely on the screening by HBA, either because they were unaware of the pro-

Table 1 HBA investment criteria

• UK registered company: registered office in the UK
• Raising £50k - £500k: in return for equity
• SEIS/EIS eligible: UK based angels will want to have companies approved by HMRC
• Most sectors considered: science and technology innovation-based businesses preferred. Certain sectors like arms & weapons, fossil fuel exploration and tobacco will not be considered.
• Strong management team: track record in company-specific industry or new venture development
• Highly attractive market: large and growing accessible market
• Funds used for growth: must show how funds will be used to increase the company's value
• High growth potential: opportunity to scale business model rapidly, both within the UK and internationally
• Sustainable competitive advantage: idea is better, cheaper or faster than competition
• Attractive financial return: meet expectation of >10X within 5-7 years
• Evidence of customer traction: venture is revenue generating or close to generating revenues
• Clear exit in medium term: typically via trade sale or IPO

cess or regarded screening as their own individual personal task. Others regarded the HBA screening as a useful pre-filtering and vetting process even if not necessarily always being fully aware of the criteria used:

> "*Perhaps foolishly I work on the basis that if they've gone through the mill of Henley Business Angels having been screened and interviewed and being prepared for the presentation and so on that there's a decent level of veracity in terms of the proponents being who they say they are" (#2).*

Nevertheless, although different processes were adopted by the interviewees to screen investment opportunities, their investment criteria were similar: the attractiveness of the sector to the investor; whether the company was solving a "big problem"; evidence of a real market need; the credibility, quality and passion of the founder and presenting team; the validity of the business model; the sustainability of the value proposition; growth and scalability; reasonableness of the financial projections; competitor risk; and whether the company is likely to disrupt the market. Throughout this process the people dimension was uppermost in members' investment criteria:

> *"I need to be convinced by the person in the first place, the entrepreneur needs to come across as competent, knowledgeable, obsessed and entrepreneurial and answering questions in a logical way and not dodging any question"* (#12).

Evidence of traction - revenues already generated from customers - was not necessarily a 'deal killer'.

Due diligence

Individual members typically carry out due diligence on one, or at most two companies out of the five or six companies that present, emphasising the attrition in the investment process. One member had considered only three companies out of a total of around 60 that had presented at pitch events that he had attended. The time required to carry out due diligence is a major constraint for many angels as most are not full-time investors and have many other responsibilities:

> *"Sometimes I'm very tight with time and I don't pursue as much due diligence as I would like after every meeting" (#11).*

Members described the purpose of the due diligence process as gathering more information about the business in order to reduce information asymmetries and uncertainty by checking what they think they are buying into, and finding out what the founders have not told them in the pitch. Specifically, it involves meeting the team, checking the business plan and assessing the quality of the information provided, judging whether the founder can deliver on the plan, gaining a better understanding of the business model, assessing whether there is a real market opportunity, and identifying areas where the member can add value as an investor.

The time spent by members in carrying out due diligence ranged from three to 20 hours for each proposition, including meetings with the presenting company team, over the course of two to four weeks, but on some occasions the process may take up to three months. Most members spent between five and ten hours on their due diligence. As noted earlier, angels may be constrained in the time that they have available for due diligence. This encourages a collective approach to due diligence, with one member commenting as follows:

> *"I don't have time to do due diligence, so I want to go in with a group of people. My thinking is three or four minds are better than one and someone in there will have the time to do the due diligence and someone in there will have a bit more insight into it than I will and if everyone likes it and they're all intelligent people I'll go in on the back of them"* (#13).

Members will start the process of due diligence with the company's online data room, a secure, usually virtual and cloud-based location where a company stores financial, legal and other documents that potential investors can access during the due diligence process. The data room includes such documents as a company's shareholder agreements, patent information, management accounts, financial projections and documents of title:

> *"Most experienced business angels will request access to the data room once their initial expression of interest is confirmed"* (#5).

The availability of this information is critical:

> *"if [the company] does not have a data room then goodbye"* (#12).

Members continue with their due diligence by engaging with the founder/CEO of the company. Although members would expect the founder to be knowledgeable about all aspects of the business, they recognise that they are not necessarily the *"fount of all knowledge"* and so may also involve the CTO and CFO in discussions of technical and financial issues. Indeed, members highlighted the risks of investing in a 'one man' show:

> *"I don't like to have just the founder because it means that there's either nothing else there or that he or she has got a dominant personality, so I need to see that there are other people involved..... I find that generally that the maverick entrepreneur doesn't know much about the money and the financial side of things, so you need to speak with somebody that knows about that, or he or she might not know about IP so you need to have somebody to engage with on that front" #12.*

Several members commented that they place considerable emphasis on how well founders answer their questions in terms of completeness, quality and promptness of response. Members will use the answers to questions to form a view of the transparency and honesty of the founders and whether they can trust them. A perceived lack of trust will almost certainly lead to a decision not to proceed further with an investment:

> *"I think it's important to find something that you want to be prodding at - that you're not happy with - and it's the reaction of the entrepreneur to it that is an important test. I remember when I asked the question about the revenue and the response was 'well, I can make the revenue whatever you want' sort of thing and it was like 'well fine that's your credibility shot'" (#4).*

In all cases members carried out the due diligence themselves. No external advisers or consultants were engaged professionally to conduct investigations on their behalf. This contrasts with venture capital firms (VCFs). Because VCFs are investing 'other people's money' and hence have a duty of care and are making much larger investments than angels they undertake an extensive due diligence process that involves outside professionals such as technology experts, commercial specialists, accountants, lawyers, recruitment firms and HR specialists who may carry out management psychometric testing. Even those VCFs that carry out due diligence largely on an internal basis are nevertheless likely to involve outside parties to assess IP issues, for legal advice and possibly also for specialist advice on technical matters where the firms' partners do not have in-depth knowledge of the specific technology (Arundale, 2019).

The pandemic and, in particular, the lockdown period, does not appear to have made a significant impact on the manner in which members have carried out their due diligence, despite the obvious constraints of not being able to conduct office or site visits or have face-to-face meetings. Questions and discussions continued satisfactorily using Zoom or Teams. Indeed, the time saved from not needing to travel to attend meetings has created more capacity to conduct deals. However, members indicated that their preference is for at least a first meeting to be face-to-face, so that relationships can be established and team behaviour observed.

Due diligence investment criteria

There was considerable variation both in the specific areas of an investment proposition that angels investigated in their due diligence and the extent of the due diligence procedures carried out. However, all angels reviewed aspects of the management team, the product or service, the market and the financial projections.

Team The principal method of investigating the management team was to search the internet for profiles and other postings by the team members and for third party comments, with LinkedIn, Google and Companies House being the primary sources. This information was taken on trust and not independently verified:

> *"I mean you take it on trust when people publish their degrees on the basis that you could pick up the phone to the school, to the university and ask the question so you hope they wouldn't put it on their LinkedIn if it wasn't true" (#6).*

However, four members said that they would contact people who know the team for comments. Others placed reliance on founders having successfully gone through the HBA screening process, although, as noted previously, HBA does not itself carry out any due diligence. Only one member said that references should be taken up. Other team-related issues considered by some members were whether and to what extent the founders have invested their own personal monies in the business, checking that salaries of the two highest paid people are not excessive and that sales employees are rewarded through commission.

Product Members form their own view on the desirability and workability of the product or service based on their own knowledge of the sector and the information that the entrepreneur, as the expert on the product, provides. If it is outside their area of expertise members might call experts in their network for a view or benchmark with similar companies (#12):

> *"The entrepreneur is always going to know more about their area than you will right, that's just by definition, so I think I'm always going to try and trust the team to tell me, I mean they wouldn't be doing it if they thought it's going to flop" (#14).*

Eight members said they would normally visit the office or work premises of the business to meet the founders and the team and see any product development that is in progress. However, six members regarded office visits as unnecessary unless the company is rich in physical assets. Nevertheless, as one interviewee notes, such visits have the potential to reveal issues that were not apparent through other due diligence procedures:

> *"I visited them at their office, I was actually horrified because I was kind of expecting to see a workbench with soldering irons and electronics and flashing lights and bits of wire and all I saw was just a couple of clean desks with some computers on it and a mock-up, I couldn't see any evidence of development work so I said what do you spend your time doing and he talked about all the grants that he was applying for and I suspected that his core competence was applying for the grants rather than developing the technology" (#3).*

Market Angels also largely formed their own views on the market potential for a company's products or services. Ideally, as one eminent UK business angel has advised, they should look for *"an opportunity with a sustainable business model, a realistic go-to-market plan, a deep marketing strategy and a future product and technology pipeline"* (Cowley, 2018: 70). Only two members said that they would review available reports on an industry's market potential such as those from Gartner or Statista, either because they do not have the time available to do this or because such reports are not sufficiently up to date or specific to a company's product or service:

> *"One of the things you can be absolutely confident of is that half of the data that you need isn't going to be available and half of the data that you can get is going to be inaccurate" (#2).*

Only one member (#15) specifically mentioned that they look to invest in companies that have technology, a product or a business model that has the potential to be disruptive and could therefore displace market incumbents. Three members indicated that they would discuss the market with experts in their network to assist them in forming a view as to whether a company's products or services have real market potential. The majority of angels placed considerable weight on their assessment the founder's own knowledge of the sector and market potential on the basis of how well they responded to their questions. Specifically, a founder who responded to a question about the existence of competitors by saying that there were no competitors would be rejected:

> *"I'll never invest in a company that tells me they have no competition .... [If] they'll say 'look we have no competition', [I'll say] oh dear well I'm not going to invest in you then. 'Oh really why?' 'Well if there's no competition there's no market because it's very unlikely you're the only company that's ever identified this option'" (#14).*

Financials Angels review filings of historic audited accounts at Companies House and trawl the on-line data room for the latest management accounts, financial projections and tax returns (if any). Two members indicated that they would wish to see bank statements or other confirmation of proof of funds, noting that this was a negative step:

"If you have a doubt and you need to go to a bank account then I would be out from the very beginning. If you don't trust the management accounts or audited .... accounts then it's better you stay away" (#10).

Members form their own views on the reasonableness and potential achievability of projections which in some cases were regarded as '*pure fantasy*'. Nevertheless, failure to meet financial targets is not necessarily a reason for rejection. One member was happy to invest in a second round of finance for a company that had failed to achieve the projections that were presented at the first round:

"They don't seem to get traction, I don't see anything wrong with the product and I admire the persistence of the team but there is something missing and I can't put my finger on it" (#13).

Legal Intellectual property was the dominant issue in legal due diligence with nine members (56%) indicating that they specifically review the status of companies' patents. Beyond that, members would inspect the data room for copies of shareholder and investment agreements and ask the founding team about the existence of any grievances or disputes, forming their own views on this information. Just one member indicated that he would approach a lawyer– who was a friend - for advice.

Valuation The majority of investors considered company valuation to be non-negotiable. Because of their relatively small equity stakes and amounts invested they took the view that they either had to accept the valuation proposed by the founders or decline to invest. However, six members said that they prepare their own valuation on the company, comparing it with the founder's valuation, or carry out a sense check, perhaps by making a comparison with similar listed companies or using data from Beauhurst reports. If there was significant variance they would ask the entrepreneur:

"I've come up with this valuation, why is there a difference with yours?" (#1).

Three members said they listen to other members' views on the reasonableness of valuations. Some members put a limit on a company's pre-money valuation; one member (#12) would not invest if it is in excess of £5 million. Some members would wish to see terms such as options/vesting, liquidation preferences, pre-emption rights and founders' pledges included in the offer letter and seek to negotiate if this this was not so.

Decision-making

The majority of members took a compensatory approach to the issues that arose from the due diligence process, letting the positives compensate for the negatives:

"I think you have to start off as an optimist because otherwise you'll never invest in anything .... so you have to start off looking for the best in the company .... then you have to be able to switch very quickly to being a pessimist so when

you're doing the due diligence you start to switch to say what's everything that could go wrong .... then you have to be able to drag yourself back from that to take a sensible middle ground. I think everything has compromise and you just have to decide whether the balance works for you, *and I think it has to be a personal choice" (#16).*

The approach of one member (#5) was to prepare a list of the pros and cons; if the pros exceed the cons then he "always sleeps on it" before making the decision whether to invest. Another member (#7) looks at two or three deals at the same time and decides which is best for him. If the due diligence reveals major issues of concern, particularly concerns that give rise to a lack of trust in the founder, and specifically their honesty, then members would not proceed with an investment:

"*The fact that I couldn't fully 100% trust the person I was dealing with although the idea continued to be interesting meant that I didn't proceed"* (#11).

However, if the issues were such that an investment could proceed then a member might seek to renegotiate the terms of the deal but this would normally only be feasible if they were investing in a syndicate with other members and therefore potentially had the depth of financial commitment to be able to negotiate:

"It would be easier to do it within a syndicate because if you are alone investing £10,000 or £20,000 it is less relevant but if you join forces with another five to ten HBA members then the sum of money can be meaningful for them as well so definitely would be an issue to renegotiate" (#11).

Five members adopted a non-compensatory approach, with one commenting that *"if in doubt throw it out"* (#6).

Collective action on due diligence

HBA has a structured approach for due diligence as part of its 9-step funding process (see Fig. 1). Once expressions of interest are confirmed then the way forward is for members to come together as a team to appoint a member who will be the representative for the group to engage with the entrepreneur to collect the information required to undertake the due diligence process. The rationale is that this provides a more efficient process than one in which each member works independently, making their own contact with the company and having to find out what the others are doing. But in practice this process is often not followed because of the difficulties of coordinating people with different agendas and time constraints:

"It's like herding cats! I mean all these people are doing it in their spare time and they all will look at it for different reasons and have different perspectives, so I think rather than trying to corral everyone it's hard enough to find a time to actually have a shared conversation about it let alone sharing up on all tasks" (#16).

In most cases collective action is either limited or does not occur. One member (#1) has never discussed or shared due diligence with other members. Only four members had actually worked on deals where either they or someone else in the group had taken the lead on a due diligence exercise and in only two cases had the work been divided up with specific tasks allocated to individual group members. Another member (#12) who takes the lead on due diligence adopts a structured approach whereby he gathers requests and concerns from the group, discusses these with the company, reports back to members and then re-engages with the company with any further concerns. In all the other cases where members collaborated on projects they carried out their due diligence independently of each other according to their own concerns and perspectives and then subsequently shared their findings. In some cases the lead member may bring in a lawyer involved on aspects of the due diligence. Overall, triangulation of findings through sharing each other's due diligence is the dominant approach:

> *"Whether we're members of Henley Business Angels, Cambridge Angels or whatever it is, everybody knows everybody else typically in this market .... so ... you each do your own due diligence but ... if there's a particular thing that pops up you might email the group and say guys I've been looking at this what do you think? The ones that don't know everybody else are typically the less sophisticated investors and you wouldn't normally be doing much with them (#14).*

Collective action to undertake due diligence is most likely in situations in which angels have got to know other members of the group. These individuals will form informal working relationships to undertake due diligence.

> *"It was a collegiate effort, so it worked very well because at the meetings questions came from all of us, it is much easier of course because then you are joining effort with people that have experience in many different other fields and they have a lot of value in how they look at things differently than I do" (#11).*

The critical driver of collaboration is trust. Eleven members (69%) said that they are prepared to trust the due diligence carried out by other members in their areas of expertise if they respect and rate their work highly:

> *"You get to know people that you think you understand and trust their biases and their judgment and therefore you weight it accordingly and you get to know the expertise of certain people so they will naturally focus on certain aspects whether it's the investor agreement or the technology and then you can decide what weighting to give that view based on your experience of that individual, but any point of view and any input is valuable" (#16).*

Nevertheless, they might still wish to verify the information themselves.

> *"I need to satisfy myself because they (other members) will have different perspectives, they will have different experiences, different connections, different reasons for wanting to invest" (#5).*

Other members prefer to carry out their own due diligence even if others have already done this and shared it with members.

In many cases the decision of a member to invest is influenced by other investors in the company, both other investors from the HBA membership and external investors from previous rounds of financing. Eleven members (69%) said that they place some reliance on the fact that others had invested or were proposing to do so. Members will talk with external investors if they know them and may also look for confirmation from other investors if the sector is outside of their own area of expertise (#10). One respondent commented that what would influence his investment decision was information from previous investors:

> *"Whether [the business] has delivered against the plan that... persuaded you to invest in the first place.... if they haven't why not?" (#5).*

However, two members indicated that they would not place any reliance on investors from earlier rounds as these investors may be biased because they have already invested (#16) and therefore have a vested interest in the company being successful in raising its next round of investment (#14).

Discussion

There has been little prior research on how business angels undertake due diligence despite being a key part of the investment process. This study has investigated the approach to due diligence by members of a leading UK business angel group, Henley Business Angels (HBA), which is part of Henley Business School, University of Reading. We investigated the types of due diligence that members carry out and the processes involved in conducting due diligence, with a specific focus on the extent to which the due diligence process was undertaken on a collective basis.

Individual HBA members carry out due diligence following pitches by founders at company presentation events on those investment opportunities which meet their individual screening criteria. Members adopt a range of different criteria to screen potential investment opportunities with no standard approach on the criteria used. Because of the time required to undertake the due diligence process and the constraints that members have on their own time, members will only select one or two opportunities out of five or six companies that pitch to the members at presentation events. For relatively small investments which they could afford to write-off, if necessary, they either limited their procedures or relied on the work of other members.

We found that members act individually, and not as a collective group, in both screening investment opportunities and in carrying out due diligence. In the screening process the approach of HBA members was to look for reasons to say 'no'. They eliminate investment opportunities that they are not interested in, either because they do not meet their personal investment criteria or they have doubts about their likely success. The investment opportunities that get through the screening process are those that angels are potentially interested in making an investment. These are subject to due diligence, the process that business angels undertake to reduce information asymmetries and thereby lower the risk of making a bad investment, by seeking to confirm information included in the pitch and available in the business plan in order to form a view on the capabilities of the founder and team to start-up, grow and scale the business, assess whether there is a real market opportunity for the company's product or service and discover any important facts or issues which have not been revealed by the pitch or from a review of the business plan.

Due diligence by HBA members does not extend to the verification of the facts and data in the business plan. Other than interrogating online sources of information, due diligence largely consists of asking questions of the founders and seeking comfort from their answers. Members may call upon the resources in their personal networks for opinions on aspects of a product's technology or market potential if it is outside of their own sector experience. They may also ask others for their views on the capabilities of the founder and team and may contact previous investors for their views on a company and to enquire if they will be investing in the current round. This is in contrast to the due diligence carried out by venture capital firms on investment opportunities where independent verification is sought, often involving external advisers and consultants; venture capital firms are of course acting as stewards of third-party funding from external investors whereas angels are acting on their own behalf investing their own personal funds.

HBA members largely act on their own behalf in carrying out due diligence, generally investigating areas of interest or concern independently of other members. It is rare for a member to be appointed to lead the due diligence process on behalf of other members who are interested in the same opportunity (even though this is the procedure recommended by HBA). Whilst there is an element of trust amongst members, many members carry out their own investigation even if another member has already undertaken their own investigations. However, members typically do share and discuss information gleaned from their due diligence process with other members in the HBA network who are considering investing in the same company. Some members are also prepared to accept the due diligence of other members if it is in a sector or area outside of their own area of expertise or simply if they do not have the time to carry out the due diligence themselves.

Conclusion

This study has sought to address two significant gaps in business angel literature. First, most studies have explored the investment decision-making of individual angels. However, although business angel groups are now major actors in the entrepreneurial ecosystem their decision-making– which we suggest exhibit the features of collective action - has been largely ignored. Second, there has been little prior research on how business angels undertake due diligence. This is a key part of the investment process. This study investigated how members of one angel group, Henley Business Angels, carry out due diligence on businesses that have satisfied the screening processes of both the group and individual members following a pitch to one of its company presentation events. Two key findings emerge from the study, both of which challenge conventional views. First, there is a surprising lack of rigour in the due diligence that angels undertake. It does not extend to the verification of the facts and data in the pitch and business plan, being largely limited to a review of an on-line data room and discussion with the founder or CEO. To a considerable extent this arises because of constraints on the time that angels have available for due diligence. Second, the study has revealed limited evidence of collective action in undertaking due diligence. Members largely act independently of other members in carrying out due diligence. This can be attributed at least in part because of the difficulties of coordinating members with different agendas and time constraints. Any collective action to undertake due diligence is most likely in situations in which angels have got to know and trust other members of the group.

The key shortcomings of the study are, first, like other studies of business angel groups (e.g. Mitteness et al., 2012; Gregson et al., 2013; Carpentier & Suret, 2015; Wirtz et al., 2020; Croce et al., 2017) it is based on a single group and second, the relatively small sample size (though the sample did constitute over a third of the total membership). It is therefore unclear the extent to which the findings can be generalised. However, several of the HBA members who were interviewed are also members of one or more other angel networks. Significantly, these members used the same approach to due diligence in all but one of the other groups. The exception is the Green Angel Syndicate[4] (#4) which appoints a member to lead on due diligence and allocates aspects of due diligence to investing members to capture individual members' expertise and reduce duplication of effort. This suggests that within the constraints of the limited sample size, the findings can be applicable beyond this specific angel group to the wider community of angel groups.

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[4] https://greenangelsyndicate.com/.

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