# INFORMAL EQUITY INVESTMENT

SMALL BUSINESS RESEARCH PROGRAM

INFORMATION PAPER

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**Inquiries:**

Media and Publications Officer
Industry Commission
Level 3 Nature Conservation House
Cnr Emu Bank & Benjamin Way
PO Box 80
BELCONNEN ACT 2616

Telephone: (02) 6240 3200
Facsimile: (02) 6240 3300
Internet: maps@pc.gov.au

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# FOREWORD

Many observers have raised concerns about the availability of funds from *formal* capital markets for small and medium sized enterprises. At the same time it is known that in some other developed economies, *informal* investment by individuals in these businesses is quite substantial. However, there has been little information available in Australia about the current size of such investment, its potential, and its impact on business performance. The latter is of interest since in other countries these investors often provide businesses with valuable skills to assist in developing the business, as well as an injection of capital.

This study was undertaken to address the information gap. It presents estimates of the size of informal investment in Australia, describes how the market operates to bring businesses and investors together, and also looks at relevant policy issues. The initial idea for the study developed from the stream of research on small business issues which was undertaken by the former Bureau of Industry Economics in cooperation with the Small Business Unit of the (then) Department of Industry, Science and Technology. We gratefully acknowledge the receipt of some financial sponsorship from the Department, which helped to cover the costs of a small survey of businesses, conducted under contract by the Yellow Pages Small Business Index.

We would like to thank all those business operators, investors and operators of business introduction services who have provided information to assist in the study.

This paper was researched and written by Barbara Martin, with short-term assistance from Andrew Bradly. The work was supervised by Dr Ralph Lattimore, an Assistant Commissioner of the Industry Commission.

April 1997

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# GLOSSARY

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|---|---|
| Business angel | An individual who invests equity capital directly into a business, usually a small or medium-sized business. These investors often also work in some capacity with the business, alongside the original owners, and often become a director of the company. However, neither of these features is considered essential for an investor to be classed as a business angel. Business angels may provide loan finance and other assistance in addition to equity investment. |
| Business introduction service | Any service which arranges or facilitates the meeting of private investors and businesses seeking external capital. Various methods may be used, including newsletters, public advertisements, or matching of registered clients by the use of computer software. Some introduction services also provide or arrange advice services for business clients to assist them to become investment ready. |
| Informal direct investment | Equity investment by a person (a business angel) in a small or medium-sized business, where the investment is not made through any intermediary such as a managed investment fund. As an equity partner the investor shares the profits and the risk of business failure, as do venture capital firms which provide equity to businesses. The investment usually involves direct contact between the investor and the initial owners, at least initially for the investor to assess the business and decide whether or not to invest. The investor may also have a continuing involvement with the business, as described under *Business angel*.<br><br>Also referred to as informal venture capital or angel investment. |
| Informal venture capital | See Informal direct investment. |
| Venture capital | May be used as a generic term for investment in businesses which are not well-established. The risks and potential rewards of such investment are generally high in comparison to investment in more established businesses, or other asset classes such as property. The term may also be used to refer to the investments made by venture capital (VC) firms. In recent years most VC firms have tended to invest in medium-sized, relatively well established businesses which are seeking funds for expansion or restructuring. In Australia investments of this type are sometimes described as not being true venture capital investment, but rather as development capital. |

# OVERVIEW

Equity investment by private investors in small to medium-sized enterprises (SMEs), known as informal direct investment, has been of interest to many economic researchers and some governments. One reason is that the supply of funds to SMEs from other financiers may be restricted due to relatively high transactions costs. Thus, there is a potential for informal direct investment to fill a ‘gap’ faced by SMEs seeking finance for growth.

Research in the USA has suggested that informal investment is a major source of capital for SMEs. Indeed, it is now the largest source of external equity for the SME sector. In the UK, informal investment is rather less developed in relation to the size of the economy than it is in the USA, but it is still an important source of outside equity for SMEs.

Important features of informal investment are:

- the contribution of the investor’s skills in business management, which is generally considered to be valuable to the businesses concerned; and
- the provision of patient capital, which matches the needs of many entrepreneurs who are planning for growth in the longer term.

In Australia, there has been some interest in informal investment from researchers, government and other groups, but there has been little comprehensive information about its size or other characteristics. This study included a small survey of small business operators and some interviews with investors, business operators and the operators of business introduction services, to provide a picture of informal investment activity.

The main results from the survey are:

- It is estimated that about 6800 businesses in Australia have received informal direct investment. With an estimated average investment size of around $150 000, the total of such investments is about $1 billion.
- Businesses which have private investors (known as ‘business angels’) are on average a little larger than other small businesses; they are also more likely to be aiming for significant growth, and are somewhat more confident about their business prospects.

Limited information about the investments made by venture capital firms shows that, on average, businesses with angels are significantly smaller than those which obtain equity from venture capitalists.

Total informal investment in Australia is presently modest compared with its importance in the UK and, more particularly, in the USA. However, the rapid expansion in the activity of business introduction services in Australia, and the comments of some of the services' operators, suggest that the flow of informal investment may be increasing quite strongly.

Private investors in Australia appear to have similar motives to those identified in overseas studies. They are seeking high financial returns, but often are also interested in this form of investment for other reasons, such as the pleasure or challenge of making a success of the businesses chosen. Both investors and business operators find the process of searching for a partner difficult and sometimes prolonged. One major reason is the costs, first of locating a prospective partner, and then of learning enough about the other party to make a decision on whether to proceed. However, in Australia as in other countries, business introduction services are developing and have helped to improve information flows in the marketplace.

The introduction services operating in Australia are mostly new, and changes may be expected as they develop. However, the results so far in attracting clients, and in bringing about some deals, suggest that these services could become well-used and improve the efficiency of the market.

### *Policy issues*

Government subsidies were provided to business introduction services in Australia from 1994 to 1997, partly on the basis that it was expected to take a substantial time for such services to become established and self-financing. However, at present it appears that some business introduction services are performing well without public subsidies, and are likely soon to be providing services in all major cities. These prospects, combined with the theoretical weakness of the arguments for assistance, suggest that there is no reason to consider further financial assistance to these services.

Presently, government regulation in Australia may restrict business operators' actions in searching for suitable investors, and also certain activities of business introduction services. However, the relevant authorities are already moving to change these regulations. The proposed changes are intended to remove unnecessary restrictions while still allowing regulators some control over market operations in order to promote other policy objectives, such as investor protection.

# 1 INTRODUCTION

This paper reports on a study of direct investment by individuals in smaller and medium-sized enterprises (SMEs) in Australia. There are various reasons for interest in this topic. Firstly, it is often claimed that SMEs face particular problems in obtaining from banks and other institutions the finance that may be crucial to their start-up and growth, and investment by individuals may be, or become, an important alternative source of finance. In response to these concerns, both federal and state governments have introduced policy initiatives to make finance available to at least certain groups of SMEs. These include several small-scale programs which provide grants or loans to SMEs to develop or commercialise innovative technology, or to expand exports[1], and the payment of subsidies in the past few years to some business introduction services which match SMEs seeking capital with private investors. In addition, the Federal industry department's Pooled Development Funds program, introduced in 1992, is aimed at expanding the availability of equity capital to SMEs, although on a fairly broad definition since the funds are able to invest in businesses with assets of up to $50 million.

Research in other countries has shown that investment by individuals in SMEs can be of great importance relative to other sources of finance. Most notably, in the USA one study suggested that such investment was the single largest source of external equity capital for the SME sector, and almost exceeded all other sources combined (Gaston 1989:225). This type of investment is also significant in the UK, where it easily exceeds the total invested in smaller businesses by the formal venture capital industry.

A further important aspect of this type of investment is that the investors generally contribute valuable skills in business management or the development of new businesses, as well as finance. In this way such investment may make a significant contribution to the development of a nation's SME sector.

To date there has been little information available about direct investment in SMEs in Australia, despite its potential importance. This study aims to provide information about the size and features of such investment, to describe how the

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1 Examples include programs operated by the Queensland Department of Business, Industry and Regional Development and the NSW Department of Energy, and the concessional loans scheme of the Federal Government's Industry Research and Development Board.

market for such investment has been operating, and to analyse any implications for policy.

## 1.1 Background: SMEs and finance for growth

New businesses may finance their start-up and early growth in a variety of ways. It is common for the owners to inject a substantial amount of their own funds, and possibly loan funds secured against their personal assets, to finance the early stages of operations. Many new businesses which do not grow rapidly will have little need for further external finance, being able to cover their needs from retained cash flows. This study is concerned with those firms which do require additional finance – these will often be firms which are aiming for rapid expansion, or those involved in technology-based ventures, where capital requirements are high.

Debt finance is one option for these firms, however there may be some barriers to the use of debt by smaller firms. It is often claimed that the supply of loan finance to SMEs is restricted as a result of transaction costs and information problems facing financial institutions in assessing which firms have good prospects. These issues are discussed in chapter 5, and in more detail in Janissen, Lattimore and Pearson (1996). On the demand side, businesses may be reluctant to take on debt when their cash flows are limited or uncertain in the short term, because of possible difficulties in meeting fixed repayment commitments. Thus debt finance will not always be an optimal, or even feasible, means for SMEs to obtain funding to finance their growth.

The firms in which we are interested here are too small for listing on stock exchanges, and so cannot seek equity funding via a public share offer. The most likely alternative form of finance for them is to attract equity from other outside parties such as merchant banks, venture capital firms or individual investors. In many cases these firms will be seeking ‘patient capital’, in other words, capital committed to the firm for a period of some years. This is because it will be some time before the firm can show a track record of market success or profits, which may be required to attract other investors to provide replacement capital.

### *SMEs and public policy*

As noted above, various government agencies have introduced measures to assist SMEs to access finance, citing apparent problems in the operation of financial markets which tend to produce disadvantages for SMEs seeking funds. There is a further dimension involved in any decision to intervene to assist

SMEs in their access to finance, which is the question of whether SMEs provide any special benefits to a national economy that do not result from the operations of larger firms. This is an issue because any action to correct market problems or otherwise assist SMEs will have economic costs, and may produce distortions elsewhere. For example, if restrictions in the supply of finance from banks and other institutions to SMEs reflected a differential in the costs of smaller versus larger transactions, it might be better for the nation as a whole to accept these conditions as inevitable consequences of real economic factors and not to take any measures to counteract them.

But in fact some economists have argued that SMEs may play some particular and valuable roles in a nation's economy. A review article by Brock and Evans (1989) notes that small firms may have advantages over large ones in terms of the flexibility of adjusting output levels, which is valuable when demand fluctuates over time; also, it may happen that some small firms have superior access to some scarce factors of production, including knowledge or the ability to serve a particular market well. The often-heard observation that some important innovations are developed by talented individuals establishing small firms, is one instance of particular qualities that may reside in small firms. Brock and Evans also describe other research which acknowledges that firms' growth involves significant adjustment costs and also depends on some chance factors, so that even where managers are at least as efficient as in larger firms a business may remain small for some time. That is, they claim that the survival and ultimate growth of well-run firms which are presently small, may produce (spillover) benefits for society as a whole.

However, it is still a considerable step from this observation to a credible argument for government intervention. First, the extent of any spillovers would have to be rigorously assessed — they may not be sufficient to warrant even consideration of any intervention. Moreover in designing any policy instrument to assist such firms, governments would have to have low cost information advantages relative to market players, avoid supporting the wrong sort of firms, use efficient administrative procedures, apply the right eligibility criteria, and meet a host of other requirements for government intervention to be justified.

It is not the purpose of this paper to assess in any detail the arguments for or against *general* policy measures directed at SMEs (though we do critically assess government interventions in informal equity markets in chapter 5). Rather, these broad issues have been canvassed here because they form part of the background to the interest of policy makers in SMEs' access to finance and the costs and benefits of any possible initiatives in this area.

## 1.2 Scope of investment considered

It is important to note that individuals may invest in businesses in different ways and under a range of circumstances. One dimension is whether the investors had any previous close connection with, or personal knowledge of, the business operators. Anecdotal evidence suggests that investment in businesses operated by relatives or people with whom the investor has some other prior close connection may comprise a significant portion of total direct investment in SMEs. This type of investment is believed to be of particular importance among certain ethnic communities in Australia.[2]

The aim of this work was to study investments which are made on a fully commercial basis, in other words, where the investor chooses whether or not to invest strictly on the basis of the expected returns and the risks of business failure. Investment in businesses operated by relatives or close friends was excluded from the scope of the study, in part because for these investments the decision will often be influenced by other factors as well.[3]

Another important reason for this decision is that there appear to be few barriers to such investment which are of any concern to policy makers, while the same is not true for investments where the parties had previously had little contact with each other. For example, within a network of family or other close contacts, business operators may have efficient means of locating potential investors, whereas in other circumstances it is often difficult for business operators to identify any potential investors. As discussed in later chapters, this factor may be inhibiting informal investment.

The approach taken here in excluding investments where the parties were previously well known to each other is consistent with that of other researchers. However, it should be noted that such investments may be quite large in total, and that information about the extent and characteristics of such investment would be of considerable interest in any detailed study of small business finance.

Another aspect of informal investment is that the investors may provide finance in the form of debt or equity, or a combination of instruments. Investors may

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[2] Interestingly, this sort of investment does not face the same problems of asymmetric information that arise for banks or other 'unrelated' investors. Here, the investors have acquired virtually free much of the information needed to evaluate whether to invest or not, and they also have some additional sanctions against dishonoured claims.

[3] Anecdotal evidence suggests that there are also many cases where investments made within family or ethnic community contact networks are made on a fully commercial basis, after a careful appraisal of the business.

also provide other financial assistance such as loan guarantees. Partly because of limitations arising from data sources, this study measures only equity finance. However, there are good reasons why this is the category of particular interest. Firstly, equity finance generally corresponds to the type of longer-term commitment of finance, and possibly other involvement, which is sought by many younger firms or those planning a major expansion in their business. Also, many firms in this position are reluctant to take debt finance even if it is available, because of the restrictions imposed by strict repayment schedules at a time when cash flows are limited and firms are seeking to apply the maximum amount of finance to their development plans. Again the approach in this study is consistent with the primary interest of many overseas researchers, although some have also estimated the additional contributions that are made by investors who provide debt to SMEs.

For these reasons, the estimates in this study refer to an important segment of investment by individuals in SMEs, rather than to every such investment.

## 1.3 Structure of the paper

In the following chapter, we look at important aspects of informal investment in other countries, particularly the USA and the UK. This includes, as background, an examination of patterns of investment by the venture capital (VC) industry. It might be thought that VC firms would play an important part in providing risk capital to small or new businesses, but in fact their investments are strongly skewed towards larger and later-stage businesses. The chapter then covers the size and key features of informal equity investment, government initiatives related to SME finance, and the operation of introduction or matching services which assist businesses seeking capital to find interested investors and vice versa.

Chapter 3 presents estimates, based on a small-scale sample survey, of the total size of informal investment in Australia and some characteristics of the businesses which have an individual investor. In chapter 4 we discuss participants' perceptions of informal investment, covering their reasons for being interested in this type of investment, the process of searching for a suitable partner, and some features of the actual deals. Chapter 4 also covers the operations of business introduction services now operating in Australia.

In the following chapter we look at how government impinges on informal investment, in the form of regulation of businesses' fundraising, and critically assess arguments that government financial assistance is required to ensure the continued operation of useful business introduction services in Australia.

# 2 INFORMAL EQUITY IN OTHER COUNTRIES

This chapter presents some key results from the large amount of research that has been done on investment by individuals in SMEs in other countries, principally the USA and the UK. This serves as background for the results of our estimates of activity in Australia, discussed in the next chapter, and may also to some extent fill in for the limitations resulting from constraints on the present study.

To begin with, we look not at informal equity but at the role of the formal venture capital (VC) industry in financing those SMEs which seek external equity. This is of interest firstly because the VC industry is often thought of as the major source of risk capital, which certainly includes funding of small or early-stage businesses. However, in recent years VC firms in at least the USA and the UK have invested the great majority of their funds in more established businesses.

After this, section 2.2 covers the size of informal direct investment in other countries, its role in relation to the VC industry, and how the markets operate. Section 2.3 describes how some other governments have assessed the problems facing SMEs in accessing suitable finance, and describes some measures they have taken to address the issues, including some which promote or facilitate informal direct investment. Finally, section 2.4 examines one way of addressing what some perceive as inefficiencies in the market for informal investment, namely services which assist entrepreneurs who are seeking finance to find interested investors.

## 2.1 Venture capital and the 'equity gap'

In the USA, venture capital funding has existed as a distinct and recognisable activity of significant size only since about the late 1960s. While investments of a similar type were undertaken earlier in more informal ways, at this period specialist firms emerged which raised funds for investment and performed the functions of assessing applicants, monitoring the investee businesses and often assisting their management, and ultimately liquidating the investments to obtain a return for those who provided the funds.

The venture capital industry developed somewhat later in the UK, with a surge of activity in the later 1970s. In other countries formal venture capital remained very small until after 1980 (OECD 1995:6).

In the early stages, venture capital firms were quite active in financing small or new businesses in addition to other later-stage financing deals. However, UK data shows a significant shift in the pattern of VC investments during the 1980s. The amounts invested as seed or start-up finance and other early-stage finance declined as a share of the total funds invested by VC firms, from around a quarter in 1983 and 1984 to 12 per cent at the end of the decade[1], and 6 per cent in 1993 (Mason and Harrison 1993:34). In addition, the average size of investments in these categories almost doubled over the same period, and the proportion of smaller investments fell dramatically. Deals under £200 000 declined from one third of total funds invested to under 2 per cent, and those in the range from £200 000 to £500 000 fell from 39 per cent to just 2 per cent.[2] Thus, VC firms shifted away from supplying the capital needs of the majority of SMEs, which seek smaller amounts.

The US venture capital industry showed a similar shift in its activity around the 1980s and early 1990s. Later figures show a rise in the share of seed and start-up funding in 1993 and 1994, to reach 19 per cent of the total in 1994 (OECD 1995:8). However a typical venture capital investment in the USA is a later-stage deal for an amount over $1 million (Freear, Sohl and Wetzel 1994:7). As in the UK, the US venture capital industry for the most part funds companies which have been established for some time and are seeking finance of at least one million dollars.

This development may partly reflect cyclical or transitory influences, including the effects of some poor investment decisions by VC funds in the early 1980s, and the economic downturns which may have adversely affected the prospects of smaller firms more than those of large businesses. However, there are also some intrinsic factors which may lead venture capital companies to prefer larger or later-stage investments. Some important factors are:

- The risks associated with early-stage investments, which are generally agreed to be much higher than those for companies that are more established.
- The costs of assessing proposals and monitoring investments are largely independent of the size of the investment.

1 Bannock and Partners (1991:24). These data were derived from a review by Venture Economics, which covered approximately half of total venture capital activity.

2 These figures are not adjusted for inflation, which as measured by the GDP price deflator over this period (1983 to 1990) was 46 per cent, or approximately 5.5 per cent annually. Clearly, the effects of inflation account for only a minor share of the changes described.

- Investing in early-stage ventures will generally require the investment to be held for a long period before there is a prospect of successful exit. Some analysts have argued that because the failures in a portfolio of these ventures will become apparent before the investor can realise any profits by exit from the successful firms, this type of investment is likely to produce a poor apparent return for some years, and that most managers of VC firms are influenced by these short-term perceptions of performance (Bannock and Partners 1991:44).

It has also been claimed that, at least in current times, venture capital firms are more risk-averse than individual investors (Freear, Sohl and Wetzel 1995:90).

In summary, UK and US studies suggest that small or new businesses generally have poor prospects of receiving equity finance from venture capital firms. It appears that other potential sources of finance have shown little interest in providing equity for these firms. The term ‘equity gap’ has often been used to describe this situation, in which firms seeking finance in relatively large amounts commonly face little difficulty in obtaining it, while there are significant constraints facing firms which seek smaller amounts.

The difficulties facing SMEs seeking finance have been the subject of considerable discussion, with many observers expressing concerns that they pose an unjustified constraint on the development of the small business sector. For instance, in 1990 the UK’s Advisory Council on Science and Technology expressed concern at the limited availability of external equity capital for SMEs, noting that it had the potential to reduce business experimentation and the stimulus for firms to be competitive (ACOST 1990:30,31). In the USA, the Small Business Administration and some state governments have also expressed concerns about problems in the availability of capital for small businesses.

It should be noted here that while some SMEs appear to face difficulties in accessing capital, these may reflect rational responses by market players to risk and transactions costs rather than market failures — there should be no automatic assumption of a case for government intervention. This issue is taken up in chapter 5.

Governments in North America and the UK have introduced various measures to increase the availability of outside equity for businesses which are not well served by other capital markets. In some cases it appears that the programs are also motivated in part by a desire to promote goals such as employment creation, technological advancement or regional development. These measures will be discussed in section 2.3. First, the following section discusses the experience in some other countries (principally the UK and USA) of direct investment by individuals in SMEs, in terms of its potential to fill the 'equity gap'.

## 2.2 Informal direct investment in other countries

The USA has a well-developed informal venture capital market, which according to various estimates provides substantially more finance to businesses than the venture capital industry does. One study estimated that at around 1987 the annual flow of informal direct investment was US$33 billion (Gaston, 1989).[3] This was eight times the annual investment flow of venture capital firms at the time. Further, it was estimated that business angels provide new finance for some 87 000 firms each year (42 times more than the number financed by the professional venture capital industry), and that there were about 446 000 firms which had some informal equity at the time. The latter figure represents almost 9 per cent of the total number of businesses in the USA.

Since the bulk of funds invested by the VC industry goes to larger and more established firms, it is clear that informal investment provides vastly more funds to smaller businesses than does the VC industry. In fact Gaston's estimates suggest that for US small incorporated businesses, informal equity is almost as large as all other sources of external equity combined.

Research in the UK also indicates that the informal venture capital market provides significantly more finance for small and entrepreneurial companies than the VC industry. It has been estimated that at around 1990 the VC industry had some £1.25 billion invested in SMEs, while more recent figures suggest that SMEs have raised about £2 billion from the informal venture capital market (Mason and Harrison 1995:38).

In the remainder of this section we consider some important features of the informal venture capital market in other countries.[4]

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3 This study had a sound statistical basis in that it was based on a sample survey of smaller businesses, selected from a comprehensive national register. However in order to produce the final estimates, the author had to combine survey estimates with information from other sources, so that the estimates quoted should be taken as giving an approximate indication of magnitude (Gaston 1989:226-7).

4 The remainder of this section draws heavily on a summary in Mason and Harrison (1995) of the results of research into informal investment in the USA, Canada, the UK and Scandinavia.

### *Who are the investors?*

Research in several countries has produced similar pictures of the characteristics of business angels. They are predominantly male (over 95 per cent in several studies from four countries), and most are educated to at least the first degree level, generally in the fields of business or engineering. Angels have substantial wealth but few are classed as super-rich – for example in studies done in the early 1990s just 19 per cent of UK angels were millionaires. A great majority of business angels have experience in business, as entrepreneurs, senior managers in large companies, or in related professional occupations such as accountancy and legal work. Mason and Harrison (1995:35) interpret this information as indicating that most angels did not inherit their wealth but are financially self-made.

These studies also find that the majority of angels are experienced investors, able to make a good assessment of the risks and advantages of prospective investments.

Informal investors are motivated primarily by the prospect of financial gain. They expect high rates of return: one study found median figures for the minimum returns sought of 40 per cent for start-up businesses, declining to around 25 per cent for established firms. This compared with a return expected on investment in ‘blue chip’ stocks of around 15 per cent (Harrison and Mason 1992:471). These estimates vary quite significantly between different studies (probably due in part to changes over time in general economic conditions). There is some evidence that UK investors have higher expectations than those in the USA.

Some non-financial factors provide important secondary motivations for the decision to undertake this type of investment. Many investors like to play a role in SMEs, either to apply the business skills they have gained in their previous careers or for the challenge of guiding a company through a development stage. Some investors also cite altruistic motives as contributing to their decisions. For example, they may want to contribute to the successful development of ideas which are expected to produce benefits for the community at large, or they may feel that they have gained personally through their success in business and would like to ‘put something back’ into the system. Some studies have indicated that for these reasons, angels are sometimes willing to accept lower rates of return than a VC firm would require for investing in the same business (see Freear, Sohl and Wetzel 1995:91).[5]

The frequency of investments varies widely. The greatest number would typically make two or three investments in a three-year period, however there are a small minority who are much more active. Some angels invest rarely, possibly only once in a lifetime.

### *Features of angel investment*

In considering the economic significance of informal investment it is important to note that:

> business angels invest precisely in those areas in which institutional venture capital providers are reluctant to invest (Mason and Harrison 1995:40).

This observation refers principally to two key features of angel investment. Firstly, angel investment typically involves relatively small amounts of finance – that is, below the minimum investment thresholds of most VC firms. In the UK, angels generally invest less than £50 000 in each deal. In the USA the average investment by an angel is about $US60 000 (although because many deals involve syndicates of angels the average amount of finance received by a firm is much larger).

Secondly, business angels invest principally in start-up and early stage ventures. Indeed, taking into account these two aspects, some US analysts have argued that there is a strong complementarity between informal and formal venture capital investment, with the former playing the role of enabling new firms with high growth aspirations to grow to the stage where VC firms may be interested in investing in them. A similar opinion was recently expressed by the chairman of the British Venture Capital Association (cited in *Australian Venture Capital Journal*, November 1996, p 12).

Business angels are a source of 'patient capital', apparently more so than VC firms. Almost half of UK angels were either prepared to invest their funds for more than five years or else had no specific holding period in mind, whereas most VC firms seek to realise their investments in a shorter period.

Informal investors generally play an active part in the affairs of the businesses they invest in. It is common for them to take a position on the board, and many provide management assistance as a consultant or through working part-time for

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[5] The study cited here found lower required rates of return for business angels than for VC firms within a particular region and time period, but the angels may not have been considering the same types of projects as the VC firms.

the company. Venture capital firms also commonly provide management assistance to the firms they invest in, and studies have indicated that in both cases firms generally find the investor's contribution valuable. One difference is that, compared with VC firms, angels make a greater contribution to strategy and market development, but are generally less involved in monitoring and control of the business' activities.

Linked to this practice of active involvement, most investors show a strong preference for investing in businesses that are close to their home or work. One large study found that 52 per cent of angels invested in ventures that were within 50 miles of their home, and for almost another third the businesses were between 50 and 300 miles from their home (Freear, Sohl and Wetzel 1994:10). Since some of the high net worth individuals who are potential informal investors live outside major cities, this suggests that most businesses have a chance of attracting finance from these investors. Mason and Harrison (1995:43) contrast this aspect of informal investment with a 'geographical prejudice' on the part of VC firms in various countries, which invest predominantly in core regions.

### *How does the market operate?*

Some investors engage in an active search for businesses in which to invest, using a range of approaches to locate prospects, while others do not seek out prospects but rely on their contacts to bring them to their attention. Studies in the countries mentioned above show that most information on investment opportunities comes from informal networks of business associates and friends. Researchers in the USA have also found that prospects referred by business associates, friends and the lead investors of syndicate groups were more likely to result in an investment, compared with those which were brought to an investor's attention by venture capital funds or directly by entrepreneurs.

Other sources of information which are regularly used are lawyers, accountants, commercial bankers and stockbrokers. Each of these accounts for only a small percentage of the number of proposals received by angels, but referrals from stockbrokers in the UK and lawyers in the USA have a high probability of resulting in an investment being made.

It is often noted that entrepreneurs find it very difficult to identify an informal investor. Business angels are certainly not as easily found as venture capital firms, since they are not listed in directories. Many apparently do not wish to be too visible to the business world, because this might lead to their being flooded with requests for funding. Nonetheless, at least some entrepreneurs are able to make contact with investors quite rapidly. Based on a large sample of new technology-based firms in New England, Freear, Sohl and Wetzel reported that the median time required to find and meet an angel, for entrepreneurs who had successfully sought funds, was only one month (1995:91).

Many commentators note that it is very difficult for entrepreneurs to find the 'right' investor, who will have the skills to realise the potential of the business and to assist its progress after investment (for example, Blatt and Riding 1996:78).

Such information raises the issue of the efficiency of current market structures in allocating resources to valuable projects. For example, how difficult and time-consuming is the search for suitable investors or businesses to invest in? Are there impediments in the market which prevent some valuable deals from going ahead, or result in some inferior outcomes? Could informal investment be significantly larger if the market operated better? What are the costs of organising information better in the market and are these costs worth the gains?

A high degree of *informational* efficiency would require 'an unrestricted and timely flow of reliable information about financing sources and investment opportunities and relative ease of market entry and exit' (Freear, Sohl and Wetzel 1994:9). With the majority of informal investment activity presently relying on informal networks of friends and business associates, it seems likely that the flow of information has some limitations.

As far as investors are concerned, there appear to be two sides to the story. It seems likely that investors working through local networks often have difficulty in finding the sort of companies that they would prefer to invest in. Some research studies have found that a high proportion of investors are dissatisfied with the effectiveness of their sources of information (see Brown and Stowe 1996:102). Also, various studies have found that many active investors have substantial amounts of additional funds which they are willing to invest in this way, but they have not done so because they cannot find enough prospects that meet their criteria.[6]

Local networks do, however, provide some features that are valued by many investors. Most importantly, the use of networks of friends and business contacts means that investors do not only receive information about businesses which are seeking funds: they also have the opportunity to discuss aspects of these businesses with their contacts. For example, they may share ideas about

6 It should be noted that other factors may be at least partly responsible for this. For example, it might be that a lack of management or other skills in the SME sector results in many companies seeking funds for projects that are not well thought out and may have small chances of success (see Industry Commission, 1991).

the product or market concerned, or the qualities of the company's management. This is an important part of the decision-making of many informal investors (Blatt and Riding 1996:77-8, 82-4). Some investors may act as mentors for others, and in many cases investors like to invest with others in syndicate groups. It appears that in some cases of syndicate investment, some of the co-investors are drawn in on the basis of the opinions of the more seasoned investors in the group.

For entrepreneurs, the major hurdle associated with informal direct investment appear to be the difficulties in locating suitable potential investors (and subsequently the time costs involved in the parties learning about each other in order to make a decision on whether to proceed).

But the question of the *informational* efficiency of informal equity markets needs to be set against the economic costs of easier information flows. There is a tradeoff between the gains of more systematic information flows and the costs of organising such flows. Existing, generally informal and ad hoc, information flows may pose problems for entrepreneurs and angels alike, but the gains from ameliorating these problems have to be set against the costs of doing so. An economically efficient market will not typically be one in which information flows are unrestricted (simply because organising and creating information flows is costly).

The optimal tradeoff between informational and economic efficiency influences the form, and the success, of any private or public initiatives to increase information flows in informal investment markets. However, technological developments and organisational innovation can alter this tradeoff. Developments in information technology, and the formation of new institutions and agents as intermediaries for information flows appear likely to lower the cost of information exchange in the future. As discussed in chapter 4, the Australian informal equity market is already evolving in a way that is likely to increase the ease of information flows. In turn, this might lead to an expansion in informal investment with a consequent easing of the financing problems facing SMEs. Overseas experiences with business introduction services, which also attempt to facilitate more efficient information flows, are discussed in section 2.4.

A related issue is that of how informal investors exit from their investments. An equity investment in an SME is often a difficult asset to liquidate, although if investors are prepared to hold their investment for some years and the business does well it will often be easy to dispose of their interest at a fair price. There is some evidence that the anticipated difficulties of exit from this type of investment create a disincentive for some potential informal investors

(Landström and Olofsson, 1996:280). The existence of markets for trading in the shares of unlisted companies could improve the operation of informal investment.

## 2.3 Public policy and SME finance in other countries

As noted earlier, a number of governments have expressed concerns about the difficulties facing SMEs in accessing finance for start-up or growth, and about the economic consequences of such restrictions. This section presents a brief summary of measures taken by governments in the UK, the USA, Canada and Sweden, to address problems affecting finance for SMEs and some related issues. It includes, but is not limited to, measures that facilitate direct investment by individuals in SMEs. The material indicates the problems as seen by these governments and their policy responses, and also provides background for the discussion in the following section of business introduction services in each country, many of which have been established with some public sector involvement.

### *The United Kingdom*

UK governments in recent times have sought to provide an economic climate which is favourable to the growth and development of all types of business. Within this context, governments have acknowledged the difficulties facing smaller businesses in raising equity finance, and since the early 1980s a number of measures have been introduced to address this issue specifically. The major initiatives have involved the use of tax incentives, a method which has not been widely used in other countries.

The Business Expansion Scheme (BES), introduced in 1983, provided significant tax concessions for individuals who invested up to £40 000 per year in unlisted companies, originally mainly in the manufacturing sector. Investors were required to hold the shares for at least five years, apparently to ensure that the scheme resulted in the supply of 'patient capital'. During the first three years some £410 million was invested under the scheme in 2200 companies – a significant amount in comparison to the total investment of the venture capital industry over the same period, of about £480 million.

However, after the early years many investors and finance brokers devised means of using the scheme to obtain tax reductions for other, less risky investments. The amounts of finance provided grew very rapidly, but an evaluation concluded that very little went to the early-stage trading enterprises for which the scheme was originally intended (ACOST 1990:39, Mason and

Harrison 1995:51). In 1994 it was scrapped and replaced by another tax incentive, the Enterprise Investment Scheme (EIS).

This scheme offers smaller tax deductions, with the important change that investors under the EIS are permitted to take a position as a paid director of the company. The minimum holding period of five years was continued, and there is also now a limit of £1 million on the amount that can be raised by a company in one year. These restrictions seem to be aimed at ensuring that the scheme supports active investment by individuals in SMEs. However, the response to the scheme in the first year was apparently below expectations (OECD 1995:25).

Tax incentives are also provided for investment in smaller unquoted companies (gross assets of less than £10 million) through funds known as venture capital trusts (VCTs). This program was announced in November 1993, and the early interest has fallen short of the government's estimates. This has been attributed to various restrictions on the operations of the VCTs, including the limit of £1 million per investment (*ibid*.).

In addition, the UK government promotes the availability of finance to SMEs through a loan guarantee scheme, under which banks obtain guarantees of between 70 and 85 per cent on eligible loans to SMEs.

### *The United States*

Small business programs at the Federal level are administered by the Small Business Administration (SBA), which was established in 1953 to represent the interests of SMEs and provide assistance and advice to individual SMEs. The SBA itself offers loans tailored to suit start-up firms, and also works with intermediaries, banks, and other lending institutions, to encourage and promote loans and venture capital financing to small businesses. It runs two programs which assist SMEs to obtain finance and management advice:

- The *Small Business Investment Company (SBIC) program*, which addresses the problems in access to venture capital for new or growing small firms. The program licenses privately owned and managed investment firms called SBIC's, which make capital investments in small businesses using their own funds plus other funds which may be either borrowed at concessional rates with an SBA guarantee or obtained by a sale to the SBA of preferred equity in the SBIC. Funds are provided to the investee businesses as either long-term loans or debt-equity instruments. SBIC's also provide the businesses with management assistance. The program covers businesses in the manufacturing and service sectors.

- The *Commercialisation Matching Service* (CMS), available for firms which are accepted into the Small Business Innovation Research (SBIR) program, is designed to link these high-technology firms with potential sources of capital. The service is free to clients, and allows investors and entrepreneurs to search a database using criteria of location, size of investment and industry or technology, to find parties that they may be interested in dealing with. In this service the investors are venture capital firms, but the names and fields of interest of those VC firms (numbering around 600) which participate in the scheme are not public knowledge. Thus the service provides both sides of the market with a convenient source of information that is not available elsewhere, to facilitate funding of a certain class of SMEs.

In addition, the SBA sponsors a program which is intended to increase the management skills available to SMEs. Under the program, called the *Service Corps of Retired Executives* (SCORE), people with business management and technical expertise register to serve as volunteers, to use their expertise to assist the owners or managers of small businesses. About 13 000 volunteers are registered, mostly retired executives. The SBA's role is to match the skills of the volunteers with the needs of the businesses seeking assistance. This program has something in common with informal direct investment, in that the skills of people with considerable experience in business are applied to raise the standards of management in SMEs.

### *Canada*

The Federal government provides a range of measures to assist the growth of SMEs, apparently motivated by the objectives of encouraging economic and employment growth and of stimulating the less economically developed regions. In contrast to the UK approach which is based on improving SMEs' access to private sources of finance, in Canada there is an emphasis on the provision of finance by the public sector through the Business Development Bank of Canada (BDC) and Community Business Development Corporations (CBDCs).

The BDC provides both finance and management assistance through a range of programs designed to suit the needs of businesses at different stages of growth. Many of the programs provide loans, including long-term loans or loans with flexible repayment terms, which the bank describes as long-term quasi-equity financing. The amount of finance provided depends on the program. For the smallest businesses, including start-ups, the Micro-Business program provides term loans of up to $CAN50 000, combined with an in-depth study of the business' needs, customised training on aspects of business management, and assistance in developing a business plan. Two further programs (Patient Capital and Working Capital for Growth) provide larger loans (up to $CAN500 000) with flexible repayment terms, and also offer management support to help the business' development.

BDC also operates as a venture capitalist, making investments in promising small and medium-sized firms (in sectors other than the media, real estate, restaurant, oil and gas, forestry, and mining industries). Initial investments are in the range of $CAN500 000 to $CAN2 million, as equity, options, convertible debentures or various other instruments, and BDC can co-invest with other venture capital funds. BDC can also make follow-on investments, bringing their total commitment to as much as $CAN5 million. The expected life of these investments is in the range of 3 to 10 years, and BDC aims to exit through public offerings of shares, or by the sale of its interest to a third party. After investment, the BDC provides management assistance and monitors the progress of the firm by participating on its board of directors.

A separate program offers quasi-equity finance called Venture Loans, which are loans with flexible repayment arrangements, to companies with strong growth potential which do not have the owner equity or asset backing that they would need to get other forms of finance.

Other initiatives to assist SMEs are provided by various combinations of federal government agencies, provincial governments and private sector business organisations. Many have a strong emphasis on regional development. For example, in rural Atlantic Canada a network of autonomous, not-for-profit corporations called Community Business Development Corporations (CBDCs) provide business counselling and finance to assist in the start-up and growth of businesses in their regions. CBDC finance is targeted to businesses which have difficulty in securing capital through traditional sources of funding. The amounts available range up to $CAN75 000, and finance is usually in the form of a loan, but may include equity or loan guarantees.

### *Sweden*

In Sweden the difficulties facing SMEs in accessing capital for development have been seen as an important policy issue for a number of years. In particular, it is thought that SMEs have faced barriers in accessing sufficient equity capital, which has restricted entrepreneurs from taking some of the risks involved in setting up new businesses or planning for growth. These issues have been of concern because the development of young, innovative businesses is seen as an important part of overall industrial development (Landström and Olofsson 1996:273).

Policy measures taken to address these problems have included the provision of capital to SMEs through the National Swedish Board for Technical and Industrial Development and the Swedish Industry Development Fund. Both institutions provide funding which is formally loan capital, but on flexible terms that make it effectively part of the businesses’ risk capital. It appears that the venture capital sector in Sweden is also expected to play a greater part in financing small and new businesses, especially those based on new technology, than is the case in some other countries (*ibid*.).

The Swedish tax system has also contributed to the limitations on the use of equity capital, as it was difficult for owners to increase equity by retention of earnings. Recognising this, the current Government has introduced some changes to reduce the tax burden on equity capital, and further changes in this direction have been proposed.

## 2.4 Business introduction services

Services which assist businesses seeking informal equity to make contact with suitable individual investors, termed business introduction services, apparently have the potential to offer improvements in the efficiency of the market. Such services have been established in a few countries, principally the USA and the UK. This section presents a brief description of these services and illustrates some important issues that have arisen.

Mason and Harrison state that the USA has a number of regionally-based services, ‘the vast majority of which operate on a not-for-profit basis and are affiliated to universities, government or economic development agencies (eg. chambers of commerce, small business development centres), and rely on financial support from their promoters, business sponsorship and charitable foundations’ (1995:46). The fact that many of these operate on a non-commercial basis appears to reflect fundamental features of the operation of these services, at least in their early years; this issue is explored below.

Some points about one early and important experiment are worth noting. The Venture Capital Network (VCN) was established in 1984 as a not-for-profit corporation affiliated with the Center for Venture Research at the University of New Hampshire, with the aim of facilitating informal investment in the region. An important feature was that it sought only to provide information to interested parties, and was not in any way involved in the assessment of investment proposals, which was left entirely to the investors. The service also did not perform any screening of entrepreneurs or investors. This was essential to the service obtaining permission under various securities regulations to operate without registering as investment advisers or brokers (Freear, Sohl and Wetzel 1994:11). VCN’s operations comprised the registering of clients and the use of software to make initial ‘matches’ of businesses with investors based on information provided by the entrepreneurs about their businesses, and the investors' registered preferences. Following an initial match each party was supplied with basic information about the other, and either could request an introduction. Beyond this point VCN took no part in the parties' discussions or dealings.

VCN naturally sought to build a client base of entrepreneurs and investors that was sufficiently large to represent a valuable source of information to both sides of the market. Its founders expected that it would take some time to build up the organisation and the client base so that it would become viable, both in terms of having the desired client numbers and in generating sufficient income from fees to cover the costs of the operation. To help them reach this stage, the initial organisers were active in promoting the network through presentations to a range of professional and civic groups, and also offered free registration to investors during its first year. Despite these initiatives, during the three years 1988 to 1990 (that is, four to six years after its establishment) client fees amounted to only 60 per cent of the service's operating budget. During its early years it received significant assistance from the University of New Hampshire, and several public and private organisations (Freear, Sohl and Wetzel 1994:11). VCN has continued[7] and become one of the USA's more successful services, but its experience highlights the fact that such services often require liquid reserves, however financed, during the start-up phase.

It is noteworthy that 21 other regional services were established along the same lines as VCN but half of these had ceased operations by 1995. An analysis of the reasons for these failures indicated that many had insufficient access to funds to enable them to advertise effectively and attract a client base sufficient to make the network viable, or to employ staff to provide the required services.

Another important factor was location: networks needed to be located in an area with a large population base and in close proximity to a business community with strong venture capital operations and many high-technology businesses (Brown and Stowe 1996:107-114). The authors reason that these elements are associated with the presence of large numbers of knowledgeable investors and viable entrepreneurs.

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[7] In 1990 the service moved to Massachusetts Institute of Technology, and in 1992 it was renamed Technology Capital Network.

In the *United Kingdom*, there are five national business introduction services, in various stages of development, and many small regional operations. The latter are mainly operated by various public, private and non-profit organisations; five of them were established with some initial financing from the Department of Trade and Industry (Mason and Harrison 1995:46).

Of the national organisations, four are private-sector commercial operations. One of the oldest is Venture Capital Report (VCR) which was established in 1978. This business was sold at the end of 1995 by its founders, to an American entrepreneur who aims to expand it both within the UK and in other countries (*IIVCRN*, Summer 1996, p.6). It is worth noting that the purchaser was interested in the business' potential although it had never returned a profit, being cross-subsidised by its operators' related activities, such as publishing investment guides (Cary 1996).

In view of VCR's comparative success, it is worth describing its operations as it worked until 1995. Rather than using computer-based matching, VCR distributed information to subscribers by means of a monthly bulletin containing full descriptions of investment opportunities. Projects were only listed if VCR was satisfied that they are viable, following at least one meeting at which the entrepreneur and VCR staff examine the proposal in depth. About one third of the proposals received were rejected.

In 1994 this service had about 630 investor subscribers, down from a peak of 975 several years earlier. Subscribers pay an annual fee of £350, and entrepreneurs are charged £350 for listing. If they raise finance through VCR, there is a success fee of £1 000 plus 2.5 per cent of the funds raised. In the first 14 years of operation, 15 per cent of the projects listed in the bulletin received an offer through VCR for all of the funds sought, and 11 per cent received an offer for part of the amount sought. This performance was regarded as encouraging, although the previous operator considered that performance could be better if there were more subscribers, if it had sufficient funds to provide a higher level of service, and if there were more cooperation between VCR and other business introduction services.

A much more recent venture is the NatWest Angels Service, operated by NatWest Bank. This service was launched as a pilot scheme in three regions in 1994, and expanded in 1996 to a national service. A unique feature of this service is that it is free of charge to both investors and entrepreneurs. The bank presumably considers that it will receive indirect benefits sufficient to justify the costs of this operation. A bank with nationwide operations will clearly have some advantages over other current or potential operators in so far as entrepreneurs will easily learn of the service's existence, whereas some other services have apparently not achieved a high level of awareness among entrepreneurs despite their marketing efforts. The same factor may also apply in the case of investors.

A potential problem for this service, however, is that some entrepreneurs or investors may think that a service operated by a financial institution lacks the independence which they see as crucial in a matching service. This was apparently a significant issue in the case of one failed service in the USA.

The other two privately operated UK services are: Capital Exchange, formed in 1992, which also operates by publishing a national listing of businesses seeking finance; and VentureNet, established in 1994, which is operated by a business consultancy firm and provides a computerised database of investment opportunities which private investors can access directly and search using their own investment criteria (Mason and Harrison 1995:46).

The fourth national service is LINC, a non-profit organisation established in 1987, which is funded by business sponsorship. It is operated by a federation of ten independent local business agencies and economic development organisations in various parts of the country. LINC publishes an investment bulletin, undertakes computer-based matching for registered investors and entrepreneurs, and also runs investment forums at which entrepreneurs make presentations about their businesses to a group of investors (*ibid*.).

In *Canada*, the federal government agreed to provide initial financial support for a service on the expectation that it would facilitate the flow of informal investment, and that through charging client fees the service would become self-sufficient. The service, established in 1986, was initially intended to serve only the Ontario region, but it later expanded to become a national network known as Canada Opportunities Investment Network (COIN). It is a computer-based service which matches investors and entrepreneurs on the basis of unspecified investment criteria. Little information about the service has been published, but an analysis of data for 1990 indicated that it had not achieved its target of around 1000 investors, and had not become financially self-sufficient (Blatt and Riding 1996:80-1).

### *What impact have business introduction services had on the flow of informal equity?*

Studies of business introduction services show that to date they have not made a major impact on informal capital investment. For example, in the first six years of its operation VCN, at the University of New Hampshire, served about 800 investor clients and 1200 entrepreneurs. The organisers estimated that within their geographical market, the six New England states, there were at least 10

000 active investors, and 80 000 individuals with high net worth who might be considered potential investors (Freear, Sohl and Wetzel 1994:13). Thus, while VCN was successful in the sense of arranging on average four or five introductions to investors for the majority of its entrepreneur clients, it is also noteworthy that it had attracted only a small proportion of the investors who might have become clients.[8]

Other evidence, cited by Mason and Harrison (1995), shows that to date many US computerised introduction services have been less successful than VCN. Data for 10 of these services showed an average of only 42 investor clients and 73 entrepreneurs. This was attributed partly to the fact that most had been in operation for only a short time, but perhaps more significant was the fact that most had limited budgets which had restricted their efforts in promoting themselves.

A study of the Canadian service, Canada Opportunities Investment Network (COIN), provides some more interesting information. In 1990 it apparently had between 200 and 400 entrepreneur clients, and 80 to 100 investors. A survey of participants in the Ontario informal investment market indicated that it had not achieved a high profile among investors. Just over half of a group of investors who were not contacted through COIN were unaware of COIN’s existence. Less than 20 per cent of those who were aware of its existence had used COIN. One possible reason for this was that COIN is closely identified with a major accounting firm, which may make many other financial advisers reluctant to refer clients to it. However, there appeared also to be a level of dissatisfaction with the services provided by COIN (Blatt and Riding 1996:82). These authors conclude that, in the case of COIN, many investors have found an impersonal nationwide business introduction service unsatisfactory in comparison with local and personal contact networks.

In the UK, a recent evaluation of LINC found that it has had a limited impact on informal venture capital activity. Its client base had stabilised, after some 8 years of operation, at around 200 investors and 200 entrepreneurs:

> This reflected LINC’s low awareness amongst informal investors, small business owners and professional intermediaries (eg accountants, bankers, solicitors) which is, in turn, a function of its lack of financial resources which has limited its marketing and promotion efforts, allied to its patchy geographic coverage (Mason and Harrison 1995:47).

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8 Systematic data on the number of investments arranged by VCN are not available because, as described earlier, it took no part in clients' dealings after arranging the initial introductions. It is known that through VCN some $US12 million was raised from about 50 investors, but this is likely to be a substantial under-estimate of its total impact.

Given this, it is not surprising that the total investment activity organised through LINC is modest: between 1987 and 1993, only about 80 businesses raised finance from informal investors as a result of an introduction through LINC, with the amounts totalling about £3.75 million.

From the above it is clear that two important issues affecting the usefulness and the prospects of success of business introduction services are:

- sufficient access to financial resources during the start-up phase, which has a major influence on a service’s prospects of surviving and growing to a useful size; and
- the level of service that is or can be provided, which for many investors is an important influence on whether the use of a service will be preferred to the use of local contact networks. One influence on the level of service provided is the legal or regulatory environment. In particular, this may determine whether introduction services find it worthwhile to evaluate business proposals, or merely pass information through to potential investors without screening.

## 2.5 Summary and comments

The material reviewed in this chapter has showed, at least for the USA and the UK, the limited interest of VC firms in funding the SME sector. Some governments have considered the apparent restrictions on finance for SMEs to be a policy concern, and have taken measures either to boost the availability of finance to SMEs or to facilitate informal investment.

In some developed economies, informal direct investment is now providing quite large flows of funds to the SME sector. The actual potential for such investment may be affected by many features of a national economy, such as the business environment and the presence or absence of a strong culture of private investment in industry, the distribution of wealth, and the existence of markets for subsequent trade in the equity of unlisted businesses. The size of informal investment in the USA provides some indication as to its potential importance in other countries, including Australia.

Other important features of informal investment are:

- most investments are associated with a contribution of the angel's skills in business management, which are generally considered to be valuable to the businesses concerned; and
- it is a source of patient capital, thus matching the needs of many entrepreneurs who are planning for growth in the longer term.

Observers in the USA and the UK have claimed that the markets for informal investment currently operate quite inefficiently, with time wasted in the search process by both investors and business operators. Researchers in both countries have expressed the opinion that such inefficiency is reducing the volume of informal investment. Most information about current market operations relates to the USA, and it shows that many investors rely on informal contact networks for all or most of their information about investment prospects. These networks do offer some advantages, such as supporting cooperation between investors who wish to invest in syndicates. However, it should be noted that some of these advantages could presumably be duplicated using other institutional arrangements which might at the same time provide investors with superior information flows. On the other hand, the evolution by the market of new institutions for mediating information flows will depend on the extent to which they can achieve this objective at sufficiently low cost.

Business introduction services may be one such institutional innovation with the potential to improve information flows and so reduce search costs for both investors and entrepreneurs. The first such services commenced in the mid 1980s, but rapid change is still being seen, including the appearance of new entrants and different types of operators, and at least one takeover. In the USA and the UK, most services for which information is available are operated by, or in association with, universities, government agencies, business chambers or local economic development groups. Many are non-profit ventures, whose operators aim to facilitate informal investment at least partly to promote other objectives, such as technology transfer from universities, or stimulating business in the local region. There are also private sector introduction services, though the available evidence to date indicates that none is yet producing a commercial rate of return. This partly reflects the fact that most are quite new ventures. It is apparently difficult to develop a service to the point where it is financially self-sustaining, and large enough to provide a useful service to investors and business clients.

# 3 ESTIMATES OF ANGEL INVESTMENT

Information about the size and characteristics of angel investment is of interest to policy makers, industry associations, providers of business advice and business introduction services, many business operators and others. However, there has been little information available other than ‘guesstimates’ from various observers.

This study commissioned the collection of data from a sample of some 1200 small businesses, by the inclusion of additional questions in the regular telephone survey conducted by the Yellow Pages Small Business Index. This chapter reports the results, covering firstly estimates relating to the total size of investment, and then various characteristics of businesses that have received equity from angels. Some comparisons with estimates for the UK and USA are included.

## 3.1 The size of business angel investment in Australia

The estimates reported here are derived from a sample survey of small businesses, as described in Box 3.1. The survey covered businesses employing up to 19 people, which must cover a very large proportion of all businesses which have informal equity investment.[1]

As discussed in chapter 1, the focus of interest in this study was on investment from people not previously associated with the company, and who were neither family members nor close friends before the investment was made. The estimates here are based on this approach, which is in line with that of leading UK researchers.

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1 This is true firstly because such a large proportion of businesses (some 85 per cent of all private sector businesses in Australia) are in this size category, and also because larger businesses – those with more than 20 employees and with correspondingly higher turnover – are less likely to be seeking funds from a business angel rather than from banks or other financial institutions.

## Box 3.1: The Industry Commission's survey data on angel investment

These data were collected from the inclusion of four special questions in one of the regular quarterly surveys of small businesses conducted by the Yellow Pages Small Business Index. This survey is based on a list of small businesses compiled from telephone connection records. In principle, all small businesses with a telephone service in their own name are included on the list, although there may be delays between the birth of new small businesses and their inclusion on the list. The survey covers only those businesses which employ fewer than 20 people.

Businesses are selected at random for each quarterly survey, until the operators reach quotas which are set at the level of industry divisions and geographical regions. This produces a sample which reflects the actual distribution of the small business population across these groups. In the estimation process, weights are calculated for each group, using the Australian Bureau of Statistics business register.

The Commission's questions were included in the August 1996 survey, which had a total of 1208 respondents.

The questions used were as follows:

In the last few years which of the following types of business finance have you obtained:

- Bank loans
- Other loans
- Leasing finance
- None of the above?

And in the last few years have you obtained any outside equity finance from outside people investing their own funds in the business?

(If the respondent answered Yes to the last question):

Prior to the investment would you describe the person or people who invested in your company as:

- Family
- Close friends
- Acquaintances or business colleagues
- People you didn't previously know?

How much time, if any, does this person or persons spend each week in helping or advising the business:

- None
- 1-5 hours
- 6-10 hours
- 11-20 hours
- Over 20 hours
- Can't say?

And would you mind telling me roughly how large the equity investment was:

- Up to $20 000
- $20 001 to $50 000
- $50 0001 to $100 000
- $100 001 to $500 000
- $500 001 to $1 million
- Over $1 million
- Can't say/Don't wish to say?

### *Measures of the size of angel investment*

Analysts are interested in a range of size and activity measures, including the total dollar size of angel investment, the average deal size, the number or proportion of businesses which have an angel, the number of active angels, and measures of their activity such as the number of investments they hold at one time and the holding period for each investment. Information on the former group would preferably be obtained by means of a random sample of businesses, while studying the latter quantities requires identifying a representative group of angels and conducting some form of survey of their activities.

Even in the UK and the USA, where most research has been done, there are few reliable estimates of any of these quantities. In fact leading US researchers have recently commented that all of the estimates that have been produced so far should be regarded as only 'ball-park figures' (*IIVCRN*, Summer 1996, p.4). This is partly due to the difficulty of identifying angels – as noted in chapter 2, there are no directories of angels as there are for banks or VC firms, and many angels prefer not to publicise widely that they are active in such investment, in order to avoid being inundated with proposals from businesses.

Since constraints on this study prevented a survey of angels, the estimates here cover those measures of informal investment that can be obtained from businesses.

### *Total informal equity investment in Australia*

Based on our survey, it is estimated that 1.7 per cent of all businesses with less than twenty employees have received equity investment from a business angel at some time in the last few years. The number of firms above this size with such investment is not zero, but it seems certain to be very small.

The figure of 1.7 per cent could be applied to the total population of businesses with less than 20 employees, to estimate the total size of angel investment. But this is likely to result in an over-estimate, because the sample under-represented businesses which have no employees apart from the (self-employed) business operator. Fifty-four per cent of all small businesses fall into this category[2], compared with only 12 per cent of the survey respondents. Many such businesses are not aiming for significant growth and are unlikely to ever seek outside equity capital – for example, they are businesses like newsagencies, or

2 Based on the ABS definition of small businesses.

professionals who sell their services through a private company. In the survey, none of those businesses who had angel finance were non-employers.

For this reason it is better to apply the survey estimate to the total population of small businesses which are employers. The survey estimate must then correspondingly be adjusted to a proportion of all survey respondents which are employing businesses: this gives an estimate of 1.9 per cent. That is, our preferred estimate is that 1.9 per cent of small businesses with employment (including the operator) in the range from two to 19, have received equity investment from a business angel.[3] There are 360 000 such businesses (ABS 1996), thus the estimated total number of these businesses which have angels is 6800.

Business operators were only asked to nominate the size of these investments within specified dollar ranges, in order to reduce non-response. The survey results are shown in Table 3.1.

Table 3.1 Distribution of informal equity investment amounts

| *Range* | *Number* | *Per cent* |
|---|---|---|
| 0 to $20 000 | 3 | 18.8 |
| $20 - 50 000 | 6 | 37.5 |
| $50 - 100 000 | 2 | 12.5 |
| $100 - 500 000 | 4 | 25.0 |
| $500 000 - $1 million | 1 | 6.2 |
| Total | 16 | 100.0 |

*Source*: Industry Commission survey, conducted by Yellow Pages Small Business Index.

The average investment size, calculated using the mid-points of these ranges, is estimated at $150 000. Multiplying by the figure of 6800 businesses with investors gives an estimate for total informal equity investment of approximately $1 billion.

### *'Testing' the survey estimate*

Since these estimates are based on a fairly small survey with a correspondingly high sampling error, it is worth considering whether other data support or cast

[3] The standard error of this estimate is approximately 0.4 percentage points, thus there is a probability of 95 per cent that the true figure lies in the range from 1.1 to 2.7 per cent. In terms of the number of businesses with angels, the corresponding confidence interval is from 3900 to 9600.

doubt on their plausibility. There are no direct measures of equity holdings which classify investors such as to allow even an approximate identification of business angels. But the plausibility of the above estimates can be tested in one way by looking at what they suggest about the number of active angels in Australia.

If 6800 SMEs have a business angel, the number of angels would be substantially less than this, since many individuals who are actively engaged in this form of investment will have invested in more than one business. One US study suggested an average portfolio of about 3.5 businesses (Gaston 1989:225). The small number of interviews conducted for this study suggest that the upper limit for many Australian angels is about five or six, since the actual number of investments is limited by the investor's desire to be actively involved in each one. However, both in Australia and elsewhere, many investors prefer to make fewer investments. It also appears that there are presently in Australia a number of investors who are just commencing in this form of activity and who to date have made deals with perhaps only one firm, although they intend to expand their portfolios in the future.

If we 'guesstimate' the average number of investments per angel at two or three, then our data implies that there are between 2300 and 3400 people in Australia who have invested as an angel in at least one business. Is this plausible? First, some support for our figure comes from the operator of one business introduction service with substantial nationwide contacts. Based on his observations in this role, he estimates that there are some 2500 active business angels in Australia. Second, we can try to assess whether our estimate of the angel population is consistent with other data. As discussed in chapter 2, overseas research identifies typical angels as individuals with high wealth who have spent much of their career in the corporate sector as either executives or operators of smaller businesses. Information about wealthy Australians is limited to some data about the very wealthiest individuals, such as the Business Review Weekly's Rich 200 list, or to estimates of the total assets held by the wealthiest 5 or 10 per cent of the population. Neither of these is particularly helpful, however information about the highest-income households provides some pointers since most people with the wealth required to be a business angel will also have at least moderately high incomes.[4]

Data from the Australian Taxation Office show that in 1994-95 there were 2432 individuals with taxable incomes of at least $500 000, including 571 with

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[4] But many people with high incomes would not be, or wish to be, business angels. Many would lack either the funds available for investment, or the required interest, skills and knowledge of business.

taxable incomes of $1 million and over. A further 92 000 had taxable incomes from $100 000 to less than $500 000.[5] A breakdown of the total incomes of the first group (over $500 000) reveals that many have substantial equity investments. Most income is received in the form of salaries and wages or partnership and trust distributions, but dividend income is almost as large as each of these categories, at an average of $226 000 per person.[6] Almost certainly the bulk of these investments are in large corporations, while businesses of which these taxpayers are the principal owners may also provide a substantial share of these dividends. But these figures do indicate that there are a substantial number of people in Australia with sufficient means to invest as business angels if they wished, and also that many high-income individuals do have substantial investments in business.

This does not tell us how many of these people have the interest and the required business skills to invest directly in small and often new businesses rather than in other ways. However these figures are not inconsistent with the above estimate of the number of active business angels, provided that many angels have taxable incomes of less than $500 000. This is not implausible: a recent Australian study identified 36 angels who had a wide range of household incomes, with a weighted average of $179 000 (Wenban 1995).

The best available test of the estimate of average investment size is comparison with the estimates of other researchers, and the observations of business introduction service operators. The principals of two of these services provided informal estimates of the average size of deals arranged through their services; these figures were $300 000 and $400 000. This may well reflect a tendency for firms with larger growth plans and capital requirements to be more likely to use introduction services than those firms which have more modest plans, or are seeking an angel for the sake of their business knowledge or contacts as much as for finance.

Other recent research suggested that Australian angels typically make either one or two smaller investments in a year, of $20 000 to $50 000 each, or else a single investment of between $200 000 and $500 000 (Wenban, 1995). Although our sample was small, it probably provides a more representative picture of informal investment activity in Australia than the information on which the other figures mentioned here are based.

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5 ATO (1996), Table P18.

6 In fact partnership and trust income would also include the distribution of some income from investments, where the investments are held by trusts rather than individuals.

### *Total angel investment in context*

Total informal equity investment of around $1 billion is small considering the experience in the USA and the UK. As discussed in chapter 2, in those countries the total of such investments is larger than total investment by VC firms, by a factor estimated at possibly six to eight in the USA and around two in the UK. In Australia, the best estimate of total investment by VC firms appears to be $4.0 billion, reported in a 1996 survey of the industry by *Australian Venture Capital Journal*.[7] Thus, informal equity investment in Australia in 1996 was only around one quarter of the size of total VC investment, in contrast to the situation in the other two countries.

One point that should be kept in mind here is that figures for the VC industry include the full range of their investments, including those associated with management buy-outs and buy-ins, and other later-stage deals. It appears that in the USA, the VC industry devotes a smaller proportion of its investments to such later stage deals. Thus, in a sense the total figure for VC investment in Australia may be somewhat inflated relative to that in the USA, which affects this comparison.

Turning to the number of firms receiving equity funding from angels, it seems likely that this is much larger than the number which are funded by VC firms. Only fragmentary information is available about the individual investments of VC firms in Australia. The best source appears to be a survey undertaken by ADCAL, published in 1996. This presents information on 14 VC firms whose activities are mostly limited to direct investments in SMEs, where the definition of SMEs included some companies with turnovers of at least $100 million.

Together these VC firms had invested in 108 companies with turnover of $100 million or less. Any use of this figure to estimate the total number of companies which have received equity from the VC industry is problematic in the absence of knowledge about how these 14 firms differ from others in the industry. To provide a first approximation, we scaled up the figure of 108 companies on the basis of the amount of funds controlled. The 14 firms had total venture capital funds of $868 million, out of the total of $4 billion. On this basis it appears that around 500 SMEs would have received equity from VC firms. However, this is likely to be an overestimate, since the funds in this group of 14 mostly invest directly in SMEs (on the broad definition mentioned above), while many other

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7 The figure quoted here is the total reported by *AVCJ* for direct investment by VC funds in industrial and resources businesses, but excluding those funds whose operations are principally in New Zealand. It includes amounts available for investment as well as funds presently invested.

funds direct their investment into other areas such as the larger unlisted companies.

On these figures, at least five times as many SMEs in Australia have received equity from business angels as have received equity from VC firms. Furthermore, since the figures for investment in SMEs by VC firms apparently include some rather large firms, it is likely that, as in the USA and the UK, angels are already playing a particularly important role in the financing of the smaller businesses. This topic will be taken up in the next section.

### *Angels' non-financial contributions*

Our survey found a wide variation in the number of hours of assistance provided by angels to the businesses they invested in (table 3.2). In almost half of the businesses, the investors were not currently providing any help or advice, while in another quarter of cases they spent more than 20 hours per week in providing advice or other assistance. This variation may well reflect the comments of some investors we interviewed, to the effect that the time spent assisting businesses varied during the life of the investment, being typically higher in the early stages; however, the survey data did not permit any testing of this hypothesis.

Table 3.2 Hours worked by angels in assisting investee businesses

| *Hours per week* | *Number* | *Per cent* |
|---|---:|---:|
| None | 9 | 45.0 |
| 1 to 5 hours | 5 | 25.0 |
| 6 to 10 hours | 0 | 0.0 |
| 11 to 20 hours | 1 | 5.0 |
| More than 20 hours | 5 | 25.0 |
| Total | 20 | 100.0 |

*Source*: As for table 3.1.

In any case, these results provide some support for other evidence that in at least a portion of cases, business angels play an important role in providing substantial non-financial assistance to the SMEs in which they invest.

## 3.2 Features of business angel investment

In this section we look at the characteristics of firms which have received equity from business angels, as compared with other small firms. Since the firms in the

Yellow Pages survey which had angels were all employers rather than single-person businesses, they were compared with all those other firms which were also employers.

Because of the comparatively small sample size, care is needed in drawing inferences from the tables that follow. In many instances the differences between some of the estimates for single categories within the table are not statistically significant, but in all cases the tables still show a significant difference in the distribution of firms with angels across the categories as compared with the distribution for the other small firms.[8]

As shown in Table 3.3, more firms which have angels are in the finance, property and business services and manufacturing divisions in comparison with the other firms. Firms with angels are less likely to be in the construction and recreational, personal and other services divisions.

### Table 3.3 ASIC division, firms with angels and others

| *Division* | *Firms with angels* | *Other firms* |
|---|---|---|
| | (%) | (%) |
| Manufacturing | 30.0 | 18.1 |
| Construction | 5.0 | 18.3 |
| Wholesale and retail trade | 15.0 | 18.3 |
| Transport and storage | 10.0 | 10.8 |
| Finance, property and business services | 35.0 | 17.8 |
| Recreational, personal and other services | 5.0 | 16.6 |
| Total | 100.0 | 100.0 |

*Source*: As for table 3.1.

Firms with angels are generally larger than the other small firms (table 3.4). Only 15 per cent have less than four employees, compared with 38 per cent of the other firms, while 30 per cent of firms with angels have more than 10 employees (compared with 13 per cent).

8 As shown by chi-squared tests. Except for table 3.6, the chi-squared tests show a difference in the firms' characteristics which is significant at the 0.1 per cent level; for table 3.6, the difference is significant only at the 10 per cent level.

### Table 3.4 Total employment, firms with angels and others

| *Total employment* | *Firms with angels* | *Other firms* |
|---|---|---|
| | (%) | (%) |
| Two | 5.0 | 23.1 |
| Three | 10.0 | 14.6 |
| Four | 15.0 | 13.7 |
| Five | 15.0 | 12.0 |
| Six to seven | 10.0 | 14.0 |
| Eight to ten | 15.0 | 9.6 |
| Eleven to fifteen | 25.0 | 8.1 |
| Sixteen to twenty | 5.0 | 3.6 |
| Over twenty | 0.0 | 1.2 |
| Total | 100.0 | 100.0 |
| Median employment (persons) | 6.5 | 4.5 |

*Source*: As for table 3.1.

Data on respondents' annual turnover (table 3.5) also show firms with angels to be bigger. In 1995-96, 15 per cent had turnovers of $6 million or more, compared with only 1 per cent of the other small firms. Only 30 per cent of the firms with angels had turnovers of $500 000 or less, compared with 58 per cent of the other firms.

### Table 3.5 Turnover 1995-96, firms with angels and others

| *Turnover* | *Firms with angels* | *Other firms* |
|---|---|---|
| | (%) | (%) |
| Under $100 000 | 5.0 | 14.2 |
| $100 000 to $500 000 | 25.0 | 43.7 |
| $500 000 to $1 million | 30.0 | 21.1 |
| $1 million to $5 million | 25.0 | 18.1 |
| $6 million to $10 million | 5.0 | 1.0 |
| Over $10 million | 10.0 | 0.2 |
| Not stated | 0.0 | 1.8 |
| Total | 100.0 | 100.0 |

*Source*: As for table 3.1.

In contrast to this result, firms with angels are very much smaller than those in which VC firms invest. Data from the ADCAL survey mentioned above shows that, for a sample of 29 investee companies with revenue of less than $50 million[9], average employment was 168. The average employment of angel firms in our sample was eight. The average revenue for a sample of 82 VC investees was $22 million, compared with about $2.6 million for the firms with angels.

Over the preceding year about one-third of the firms in each group in the Commission's survey had increased their workforce (table 3.6). Among these, the firms with angels had somewhat larger increases.

## Table 3.6 Change in employment over last 12 months, firms with angels and others

| *Change in employment* | *Firms with angels* | *Other firms* |
|---|---|---|
| | (%) | (%) |
| Increase in employment: | | |
| Five or more | 0.0 | 2.1 |
| Three or four | 20.0 | 5.5 |
| One or two | 15.0 | 24.4 |
| Total firms with employment increase | 35.0 | 32.0 |
| No change | 35.0 | 46.0 |
| Decrease in employment: | | |
| One or two | 15.0 | 17.0 |
| Three or four | 5.0 | 3.3 |
| Five or more | 5.0 | 1.3 |
| Total firms with employment decrease | 25.0 | 21.6 |
| Not stated | 5.0 | 0.4 |
| Total | 100.0 | 100.0 |

*Source*: As for table 3.1.

There are no marked differences between the age distributions of the two groups of firms (table 3.7). This indicates that while informal investment may play an important role in the development of new and young firms, business angels are also involved with older businesses that have sought capital and/or additional business management expertise. This observation is also supported by some evidence from the interviews conducted for this study (discussed in chapter 4).

9 This sample therefore represented the smaller investee companies of the reporting VC firms.

## Table 3.7 Age of business, firms with angels and others

| *Age of firm* | *Firms with angels* | *Other firms* |
|---|---|---|
| | (%) | (%) |
| Two years or less | 5.0 | 5.0 |
| Three to five years | 15.0 | 17.0 |
| Six to 10 years | 35.0 | 26.1 |
| Eleven to 15 years | 15.0 | 18.1 |
| Sixteen to 20 years | 15.0 | 13.1 |
| More than 20 years | 15.0 | 20.4 |
| Not stated | 0.0 | 0.2 |
| Total | 100.0 | 100.0 |
| Median age (years) | 8 | 11 |

*Source*: As for table 3.1.

The firms with angels were somewhat older than the VC firms' investee companies. Fifteen per cent of the latter were 1 to 2 years old and 12 per cent were 3 to 4 years old (compared to 5 and 10 per cent respectively among the firms with angels). The fact that the VC investees, as a group of firms with fairly large employment, included so many young firms is worth noting. It suggests that many of these firms are not businesses built up from a small base by a small management team, which is a common profile for firms seeking business angels. The VC investees may include, for example, subsidiaries established by overseas businesses, or companies created by some restructuring of older businesses.

As noted in chapter 1, in general only firms which are growing rapidly or planning for strong expansion will need external equity finance. The survey results illustrate this association. About two-thirds of each group of firms was seeking to expand their business (table 3.8). But a quarter of all firms with angels were aiming for significant growth, compared with only 8 per cent of the other firms. This result tends to confirm the importance of business angels for firms which are planning for strong growth – although many firms with angels do not fall into this category. Either angels also often invest in firms with more modest growth plans, or some firms with angels have already achieved much of the growth that they planned.

### Table 3.8 Growth plans, firms with angels and others

| *Growth plans* | *Firms with angels* | *Other firms* |
|---|---|---|
| | (%) | (%) |
| Actively seeking significant expansion | 25.0 | 8.2 |
| Seeking to grow moderately | 40.0 | 54.3 |
| Seeking to stay the same size | 30.0 | 35.5 |
| Seeking to become smaller | 5.0 | 1.7 |
| Total | 100.0 | 100.0[a] |

**a** Total includes two firms which had no stated plans.
*Source*: As for table 3.1.

Firms with angels are rather more confident about their business prospects, as shown in table 3.9. This may reflect a greater effort put into business planning by firms which have sought an investor, or it may be a reflection of the fact that angels, as sophisticated investors, select those firms with realistic plans showing high growth potential, and also of the greater range of business management skills available to firms with angels to help them to achieve their plans. While there are apparently no comprehensive figures on which to judge the actual success of businesses which have attracted angels, this confidence is consistent with the satisfaction about the performance of investee businesses, on the whole, which was expressed in interviews with some experienced angels.

### Table 3.9 Confidence about business prospects, firms with angels and others

| *Confidence about business prospects* | *Firms with angels* | *Other firms* |
|---|---|---|
| | (%) | (%) |
| Extremely confident | 15.0 | 10.5 |
| Fairly confident | 70.0 | 52.2 |
| Neither confident nor worried | 15.0 | 18.2 |
| Fairly worried | 0.0 | 16.4 |
| Extremely worried | 0.0 | 2.7 |
| Total | 100.0 | 100.0 |

*Source*: As for table 3.1.

This confident outlook is reflected in the firms’ expectations regarding changes in their sales revenue, profitability and employment over the next 12 months, presented in table 3.10. In each case, firms with angels have somewhat more positive expectations.[10] In particular, more firms with angels expect to increase employment, presumably reflecting the operators' expectations of strong growth in their business in the medium term.

Table 3.10 Expectations for the next twelve months, firms with angels and others

| *Business expectations* | *Firms with angels* | *Other firms* |
|---|---|---|
| | (%) | (%) |
| *Expected change in sales revenue* | | |
| Increase | 75.0 | 64.8 |
| No change | 20.0 | 24.9 |
| Decrease | 0.0 | 9.4 |
| Not applicable | 5.0 | 0.9 |
| Total | 100.0 | 100.0 |
| *Expected change in profitability* | | |
| Increase | 80.0 | 61.0 |
| No change | 15.0 | 27.3 |
| Decrease | 0.0 | 11.1 |
| Not applicable | 5.0 | 0.6 |
| Total | 100.0 | 100.0 |
| *Expected change in workforce* | | |
| Increase | 50.0 | 25.5 |
| No change | 50.0 | 69.4 |
| Decrease | 0.0 | 4.8 |
| Not applicable | 0.0 | 0.3 |
| Total | 100.0 | 100.0 |

*Source*: As for table 3.1.

## 3.3 Summary and comments

Results from a small survey suggest that roughly 1.9 per cent of small employing businesses in Australia have received equity from a business angel in the past few years. This is equivalent to 6800 such businesses; combined with

[10] Both groups include a significant proportion of firms which expect to increase revenue or profitability without increasing employment, suggesting that these business operators saw demand as being subdued during 1995-96. The table shows a difference in expectations between firms with angels and others after taking this factor into account.

an estimated average investment size of $150 000, this suggests a current investment in the SME sector by angels of around $1 billion.

Total informal investment is presently rather small in comparison with that in the UK and more particularly in the USA. However, the rapid expansion in the activity of business introduction services in Australia and the comments of some of the services' operators, as discussed in the next chapter, suggest that the flow of this activity may be increasing quite strongly. It would naturally take some time for such a change to be reflected in a change in the stock of businesses with angels, as was estimated here.

SMEs which have business angels show some differences from small employing businesses as a whole. On average the firms with business angels are a little larger, more likely to be aiming for significant growth, and somewhat more confident about their business prospects. Some limited evidence indicates that firms with angels are significantly smaller than those which obtain equity from venture capitalists.

# 4 HOW INFORMAL INVESTMENT IS WORKING

## 4.1 Investors and business operators

In this study we interviewed a small number of investors and business operators who had entered into informal equity deals, and also some investors and entrepreneurs who were seeking a partner for such an investment but had not yet been successful. The numbers involved were too small[1] to be seen as providing a statistical profile of either party, however these interviews provided useful insights into certain aspects of informal investment in Australia, as seen by some of the participants. Rather than characteristics of the investors and entrepreneurs, we focussed on motivations for being involved in informal equity investment, on people's perceptions of the search for a suitable partner, and on how the deals had been working. The following discussion also draws in part on the observations of some operators of business introduction services, based on their extensive contacts with parties on both sides.

### *Reasons for informal investment*

For the business operators who had or were seeking angels, restrictions on loan finance from banks were an important factor. Five out of six either had been refused a loan or, based on their knowledge of banks' criteria for loans to smaller businesses, expected that they would be refused. The sixth business was in an early start-up phase, and its operator considered that any use of loan finance would involve difficulties in meeting a fixed schedule of repayments from small and uncertain cash flows.

The skills that could be brought by an outside equity investor were also a very important reason for seeking this type of deal. Half of the business operators expressed a positive desire to introduce additional skills as part of the deal; the skills sought were in financial management, administration and marketing, and

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1 We interviewed 5 angels, 3 businesses with angel finance, 2 prospective angels and 3 businesses seeking an angel. Numbers were limited by resource constraints on this study, by the difficulties of locating businesses which had angels, and by the reluctance of some investors to participate. The latter problems are described by overseas researchers as intrinsic to studies in this field, and reflect in part the preference of many business angels for keeping knowledge of their activities restricted to relatively closed circles in order to avoid receiving an enormous volume of approaches from businesses.

also general commercial experience. Others saw the skills that might be brought by an angel as useful rather than essential. In one case the operator also sought and had found an angel with contacts that would assist the business to expand into new markets.

Of the investors, all but one spontaneously mentioned high financial returns as an important motivation for making informal investments, but other motivations were also quite prominent. These included the interest or pleasure of being involved in business (frequently in a particular type of business, of which the investor had some particular knowledge or experience), or of applying the skills and knowledge that they had acquired during their earlier careers. One investor also saw informal investments as an interesting activity to follow his retirement from running his own business.

Many observers have pointed out that both parties may have significant concerns about this form of investment. Angels are putting their funds and time into a business venture with people of whom, typically, they have only limited knowledge; also, their stake in these small ventures is not easily sold or otherwise realised, at least in the short term. Business operators must accept a new party who will generally have a vote on the major decisions about the business.

The interviewees in this study did not give high weight to these concerns. Certainly all of the investors were aware of the risks of this form of investment. However this group of investors generally did not speak of risk as a concern, but rather they mentioned it as a factor to be assessed in conjunction with the other aspects of each potential investment. This assessment was a central part of the application of an investor’s skills. Notably, several of the investors mentioned the connection between the level of risk and the business’ stage of development, but only one preferred to invest in businesses which already had some record of success in trading as a means of reducing the risk. Other investors explicitly stated that they considered other factors more important. Some experienced investors, who had made several such investments over a number of years, also mentioned that they had earned good returns on the whole even despite some failures among investee businesses.

Although many observers of small businesses say that their operators are generally hostile to the idea of giving up a share of the equity, or the control, of their business, the business owners interviewed did not see this as a concern in relation to their decision to seek a business angel. This is hardly surprising in itself, since the sharing of equity and control is an intrinsic part of their chosen plan to develop the business. But it is worth noting that these owners had specifically considered the issues associated with sharing the equity and addressed them either by placing an upper limit on the share of the company that would be sold, or by detailed discussions with their potential investors on how major business decisions would be approached.

### *Features of deals made*

In all of the deals reported on, the angels had played some active role in the business. In one case this was limited to helping to establish the business plan at the time of investment, followed by a passive investor role thereafter. The angels' roles in the other cases included being the finance director, continuing contributions to developing the business strategy, and assistance with business management and marketing. These contributions reflected the skills and business backgrounds of this group of investors. Most of them had tertiary qualifications in either accounting or some field of engineering, and their work experience included providing financial or other advice to businesses, running their own successful businesses, and work in a merchant bank assessing business applications for funding. Five out of seven had experience in getting companies through the early growth stage, either as a business adviser or as owner of their own businesses.

The investors generally spent around one day per week in assisting the business. In some cases their involvement was greater at the start of the arrangement, when the business needed more assistance in starting up or developing its strategy. The angels mostly rated their contributions to the businesses as moderately or very important; the three entrepreneurs who had an angel thought that their investors' contributions were highly valuable.[2]

While the investors often indicated that capital gains on the value of their interest would be the major financial return, it was quite common for them to receive some returns during the life of the investment. This sometimes took the form of a director's fee, such as would be paid to all directors including the original owners; this arrangement was more common where the angel provided specific services to the business, such as being the finance director. In some other cases dividends would be paid to all shareholders. The amounts of these payments were not guaranteed, and often it was expected that they would not be paid in the early years, but only later when the company's cash flow could more easily accommodate it.

The important issue of the angel's ultimate exit from the business had generally received considerable thought before the deal was entered into, but quite often

[2] These entrepreneurs were not the operators of the same set of businesses in which the angels quoted here had invested.

the timing and manner of exit were not specified in any written agreement. This was due to uncertainty about how the business might change over a period of some years, and a common feeling that the preferred method of exit would depend on the outcome. One investor commented that exit was typically quite easy if the business had gone quite well, but difficult otherwise. In some cases the parties thought it likely that offers would be made for the business, but the source and timing of these offers could not be foreseen.

Where exit was mentioned in written agreements, this was sometimes seen only as establishing a basis for future negotiations between the equity holders. Any written agreement often took the form of a typical shareholders' agreement, which established some rules regarding exit, for example, requiring any shareholder who wished to sell his or her shares to offer them first to other current shareholders.

In those cases where the deals had been in place for some time, both investors and business operators were all quite satisfied or very satisfied with the performance of the business and with how the arrangement had worked out.

### *Searching for a partner*

The business operators and angels we interviewed were contacted through a variety of sources, including one introduction service. Most were based in Melbourne, where one introduction service, the Business Finance Support Program, has been working to create a high awareness among potential clients of its existence and services. Almost all of our interviewees had used at least one business introduction service in their search for an investor or a business to invest in, but under the circumstances this is not a valid indicator for investors or business operators in general.

It is noteworthy, however, that almost all had also used other means of searching. For business operators these included approaching other companies or contacts within their field of business, merchant banks, and accountants or investment brokers. Other sources of information that had been used by these investors were bankers, finance brokers, and accountants, and reading advertisements in the business section of newspapers. Two of the investors were currently working in business consulting roles and found that many business prospects reached them through this work. For another two, their personal networks in relevant business circles were sufficient to provide them with information about many prospects and they stated that they did not need to search actively, but only to listen for those that might be of interest to them.

Most of these investors did not rate a business introduction service as a very important source of proposals for them. However, it should be noted that several were experienced investors who also had the strong contact networks just described. These opinions probably also reflect the current state of development of introduction services. As noted elsewhere, most observers feel that these services need to achieve a fairly large pool of active participants on both sides of the market in order to be valuable to a majority of their clients or potential clients; and it is also true that most of the services presently operating in Australia are quite young and probably still growing towards the threshold of a useful size. (The introduction services operating in Australia are discussed in the next section.)

Business introduction services appeared to be somewhat more important to the entrepreneurs. Two had found angels through an introduction service, and one through personal contacts. Three businesses had not succeeded in finding an angel despite using various search methods over a period of several months.[3] The difficulties experienced by these business operators are similar to those reported in the overseas research summarised in chapter 2. As discussed there, the difficulties facing entrepreneurs, in the absence of well-developed market structures such as introduction services, reflect the lack of information about how to get in touch with private investors.

In contrast to business operators, investors may have access to good information about business opportunities in their own geographic region, and many prefer to invest within that region. This does not amount to an argument that introduction services cannot be of high value to investors. Since the investors' time is valuable, the services could be very useful if they allowed investors to find the most interesting proposals more quickly than with the use of personal contact networks. It should also be noted here that using an introduction service need not compromise investors' preferences for privacy. In fact, in Australia, most services either operate such that each party receives only a brief description of the other and both must consent before any identification is revealed, or alternatively give investors the opportunity to make the first move by circulating details about the businesses to the list of registered investors rather than the other way around.

Finally, both investors and entrepreneurs almost unanimously reported finding the processes of searching for a partner in informal investment either difficult or very difficult. Both sides gave as a major reason the time costs of the search,

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3 Clearly the introduction services had been no more successful in these cases than had the other search methods, however this reflects the still limited size of most introduction services, which reduces the likelihood of finding a partner (or increases the time taken to do so). The services' performance to date does not suggest that they cannot become efficient search methods for business clients.

reflecting the existence of a large number of potential partners and the need to put effort into learning about and providing information to a number of prospects, before they could be sure of whether they would like to make a deal. Another important factor for investors was that, in their opinion, many business plans are poorly thought out, or that business operators frequently over-value their own intellectual property and under-value the potential contribution of a business angel, making it difficult to reach agreement on an investment.

All of these factors are intrinsic to the process of searching for a partner in business, and no interviewee claimed that their search had been made more difficult by any regulation of company or investor behaviour. The Corporations Act does in fact place some restrictions on companies in their fundraising activities; this issue is taken up in the next chapter.

### *Expectations of business introduction services*

Most of the interviewees saw the main value of an introduction service as being in the potential for finding a suitable business partner from a relatively large pool, rather than in services such as advice or assistance to prepare for informal equity investment. For the investors, since most of those interviewed had significant experience of this type of investment, this is a natural response. There is also some reason to think that the small group of business operators interviewed had put more effort into business planning and into thinking about making a deal with an outside investor, than many others. Most already had some form of business plan when they approached an introduction service. Those who had had their plans reviewed by an introduction service mostly reported that they found this service to be of moderate rather than high value, with one commenting that they had received more valuable feedback from potential investors than from the introduction service. This experience presents a contrast with general comments from introduction service operators, and some investors, criticising the general standard of business analysis and planning by firms commencing a search for an investor.

Most of the investors wanted an introduction service to provide only a limited degree of screening of businesses, either to reject those whose plans had obvious failings or to help them to improve their plans. Beyond this, they considered that it was up to the investors themselves to determine what was a good prospect. This view seemed to be based in part on the obvious difficulties for a service operator of making a thorough assessment of the merits of a diverse range of businesses. Investors, on the other hand, may quickly reject many prospects as not being of interest to them, and devote more effort to a detailed study of those that survive the first stage. In doing this investors will often be applying their particular skills and knowledge of certain types of business, which are not available to the staff of an introduction service.

On the whole these opinions suggest significant potential for business introduction services in Australia. They can ease the search process facing business operators, and it appears that many investors would use them to some extent if they grow enough to offer a large pool of business prospects.

The services are also probably of particular importance to inexperienced investors, who may seek advice or mentoring while starting out in this form of investment. Some new investors may also lack substantial contact networks. In addition, introduction services could become a valuable channel for investors who wish to invest in syndicates to locate others, if personal contact networks were not large enough to be useful in this way.

## 4.2 Business introduction services

There are now several services in Australia which can facilitate informal direct investment by introducing businesses and investors. Over half of these have commenced within the last two years, and there is now at least one service located in each mainland capital city.

There are considerable differences between the services. Some essentially provide an inexpensive means of circulating a brief summary of a business opportunity to many potential investors, for example through a newsletter, while others provide more services in the areas of screening businesses, assisting them to plan for working with a new equity partner, and in making initial ‘matches’ between registered clients. The involvement of some services ends with making an initial match between parties based on their investment preferences, while some go further and act as mentors to the parties if they wish to negotiate. Some are actively involved in the making of a deal between the parties, and this involvement may be the final stage of a process of advice and assistance to both parties.

Some key features of the services’ operations are summarised in table 4.1.

## Table 4.1 Key features of business introduction services in Australia

| *Service name, office location and age* | *Size indicators*[a] | *Means of information exchange* | *Services to clients and fee structure* | *Major means of attracting clients* |
|---|---|---|---|---|
| Australian Equity Business Exchange<br>Perth<br>Started mid 1996 | About 100-150 businesses and 100 investors are registered. | Business prospects are advertised in a newsletter, on CD-ROM and an Internet site[b]. Investors can request further information on businesses of interest. AEBE also does initial matching by comparing the interests and preferences of registered clients. | Businesses are assisted to become investment ready, and to prepare a suitable written plan. Commerical rates are charged for the advice involved. Businesses also pay $165 for registration; additional charges apply for advertising. Success fees are charged, usually 5% of the amount funded.<br>There is no charge to investors and they receive no detailed advice. | Paid advertising, coverage in the financial press.<br>Staff have liaised with venture capital firms and the state industry department, which will refer suitable businesses. |
| BizEquity<br>Surfers Paradise, Queensland<br>Started June 1995 | Size is largely determined by the number of consultants who work with the business clients, which is presently growing rapidly.<br>A few hundred investors are registered. | Business prospects are advertised in newspapers and on an Internet site[c], interested investors contact BizEquity.<br>Businesses may also hold an information session at their premises for potential investors, and this would be advertised. | Businesses are assisted to become 'investor ready', and a written summary of the business is prepared. Assistance is provided as necessary during negotiations to finalise a deal.<br>Businesses pay a commitment fee of $1500 - 5000 (depending on the complexity of the business), and pay the cost of press advertisements. Success fees apply on a sliding scale: 5% for the first $200 000 and then a declining percentage.<br>No charge to investors. | Advertising of specific business opportunities in the press and on the Internet site. This advertising also serves to create awareness of BizEquity. |
| Business Angels meeting program (Australian Business Chamber)<br>Sydney<br>Started September 1995 | About 80 businesses and 65 investors registered (late 1996). | Newsletter with details of new businesses registered.<br>Meetings in Sydney every 2 months at which 5 businesses make a presentation to a group of up to 20 investors.<br>Group 'expos' at which start-up business clients set up displays and all registered investors may attend. | Investors pay $350 to register for 12 months. Businesses pay $50 for a year, this fee covers some counselling and an entry in the newsletter. Further advice on business planning is given to those who make a presentation, at an additional charge of $200.<br>A seminar is planned to educate new potential investors about this form of investment. | Coverage in the business press.<br>Associated with Australian Business Limited. |
| Business Angels Pty Ltd<br>Melbourne<br>Started 1992 | n.a. | The operator makes initial matches based on clients' listed preferences and skills, and an assessment of their personal compatibility. This matching is assisted by a computer data base. | Businesses are given some assistance to develop a business plan, and referred to professionals if more advice is needed.<br>Businesses and investors pay $300 to join, and receive unlimited referrals until matched. Success fee of 2% of the investment. | Coverage in the business press.<br>Referrals from state industry department, accountants and other business advisers.<br>Reputation and contacts of the operator. |

## Table 4.1 Continued

| | | | | |
|---|---|---|---|---|
| Business Finance Support Program<br>Melbourne<br>Started early 1995 | Approximately 1200 businesses and 400 investors are registered. | Initial matches are made by computer searches of the data base of registered clients.<br>Details of registered businesses and investors are entered on a data base and initial matches are made by computer searches.<br>Mini trade shows are held as an opportunity for investors to meet the operators of registered businesses. | Before registration, business clients are assisted to prepare a business plan in a form useful to potential investors.<br>Workshops are held for businesses and investors, to assist them in learning to make informal investment work effectively.<br>Businesses pay an application fee of $150 and if they are accepted for registration to the program, an annual fee of $200. Investors pay an annual registration fee of $250. | Referrals from state and federal industry departments, other finance providers including banks and Pooled Development Funds, accountants, and through media exposure.<br>Associated with VECCI. |
| Business Angels meeting program (Australian Business Chamber)<br>Sydney<br>Started September 1995 | About 80 businesses and 65 investors registered (late 1996). | Newsletter with details of new businesses registered.<br>Meetings in Sydney every 2 months at which 5 businesses make a presentation to a group of up to 20 investors.<br>Group 'expos' at which start-up business clients set up displays and all registered investors may attend. | Investors pay $350 to register for 12 months. Businesses pay $50 for a year, this fee covers some counselling and an entry in the newsletter. Further advice on business planning is given to those who make a presentation, at an additional charge of $200.<br>A seminar is planned to educate new potential investors about this form of investment. | Coverage in the business press.<br>Associated with Australian Business Limited. |
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a Different measures have been used for different services, reflecting differences in their modes of operation and/or variations in the information available. In some cases the figures may be changing rapidly as the services develop.

b http://www.tradematch.com.au

c http://www.design.net.au/ozequity

d http://ideas.on.theweb.net

e http://www.corporationbuilders.com.au

Several features of how these services have been operating are of interest. Firstly, almost all see their role as including the provision of certain advice to businesses seeking investors. A common focus is assisting the entrepreneurs to think about their business operation, and especially its financing, from the viewpoint of a potential investor. The service providers have moved to offer such advice based on their past observations and experience of many entrepreneurs seeking capital, whose businesses were not 'investor ready'. The advice given typically covers matters relating to preparing a business plan, and to the structure of the business (for example, incorporation as a public limited liability company may be recommended).

This advice is provided in different forms, ranging from written advice in information packages sent to new or potential business clients, to group discussions and one-to-one assistance from accountants or other business advisers; the form of the advice varies largely in relation to the resources available to the introduction service, which generally reflects the level of their fees.

Some support from investors for the value of such advice was indicated in the interviews discussed in the previous section. Also, overseas studies have found that the operators of businesses seeking capital are often not well-equipped to analyse their business as it would be seen by a potential investor, or to draw up a realistic business plan.

The provision of advice in these areas by introduction services appears to be a valuable part of their role in informal equity investment. Mason and Harrison (1995:47-8) claim that this is one of the benefits of introduction services for the economy overall, which should be taken into account in any debate over whether the services should receive a public subsidy — a viewpoint we critically assess in chapter 5.

Such advice in many cases will be basic, even common sense, though it may be of real value to small business operators who are not highly skilled in business management. However it cannot be expected that any business adviser, dealing with a wide range of businesses, will be able to provide each business with all of the ideas which might help it to become successful, nor that the adviser will be able to see the weaknesses in every business' plans. For this reason it appears that the optimal role for an introduction service ends with the provision of general business advice, to bring all business clients up to a certain minimum standard of business planning and investor readiness. Inevitably, angels will sometimes see problems in a business referred by an introduction service (as reported by some of those interviewed), even where the business has received such advice, but the investors we interviewed did not see this as a failing on the part of the service.

### *Who operates business introduction services?*

Business introduction services, in Australia and overseas, have mostly not been established as stand-alone businesses, but operated by other organisations which have some interest in assisting investment in SMEs. Different operators appear to have different particular advantages in terms of building up a service to a size which allows it to be of real value to participants. The operator's resources and other related objectives will also typically influence the style of the operation and the fees charged.

In Australia, two of the introduction services (BizEquity and Corporation Builders) are operated by business consultants who were providing other services to SMEs and identified this as a logical extension of their business. One of these services is presently profitable, and while the results for the other have fluctuated since its establishment the operators expect that it will be profitable in the future. Two other services (AEBE and The Equity Portfolio) have been established with matching as their primary activity, though the associated provision of business advice may also be an important source of revenue. These services have only been established recently and are not presently profitable, but their operators expect that they will be able to operate at a profit.

Three other services are operated on a not-for-profit basis. The Business Finance Support Program was established as an industry policy initiative by DIST, though its operational subsidy has since been withdrawn.[4] It is operated by the Victorian Employers' Chamber of Commerce and Industry (VECCI). In Sydney, the Australian Business Chamber funds and operates its Business Angels program, largely as a measure to assist its members and the SME sector generally. As would be predicted during some initial period, the costs of this venture are presently not covered by the charges to clients.[5] VECCI is presently reconsidering its mode of operation and fee structure following the subsidy withdrawal, and this service is also presently not covering its costs. In both cases the business chamber is watching developments and deciding on the future form and resourcing of the service.

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[4] This program received total subsidy funding of $400 000 during the financial years 1994-95 and 1995-96.

[5] The chamber estimated that in late 1996, revenue from fees was running at about half of the costs of the program.

The third not-for-profit service is Ideas and the Investor, which was started in 1989 on an informal basis by a finance broker, Mr Rod McInnes, as a low-cost means to assist inventors and small businesses by facilitating the flow of information between them and investors. Shortly afterwards this service received support from the South Australian Chamber of Commerce and Industry, which saw it as a way of assisting the development of the SME sector, particularly in South Australia, for a fairly modest cost.[6] As noted in table 4.1, this arrangement has recently changed, and the service is now operated by Techsearch, the commercial arm of the University of South Australia.[7]

There are both similarities and differences compared with the development of introduction services in other countries. As discussed in chapter 2, in the USA many services are linked in some way with universities. Apparent advantages of such an arrangement are that the introduction services may be involved in commercialising technology developed within the universities, and also they may draw on the contact networks between university researchers and the local business community. This type of linkage had been absent in Australia until the new association between Ideas and the Investor and the University of South Australia. One factor behind this difference may be the USA’s strong track record of commercialisation of innovations developed in universities; similar commercial linkages certainly exist in Australia, but they are less developed.

The involvement of three business chambers in the operation of business introduction services in Australia is of interest. Similar connections are seen in the UK, where business chambers have cooperated with local economic development agencies to establish services in regional areas, some of which are linked into a network to exchange information about business opportunities. Business chambers may have significant advantages in bringing clients to an introduction service to help it reach a viable size. These include local businesses' awareness of the chamber, which may often direct entrepreneurs seeking capital to it when they might be ignorant of another service's existence. A business chamber's contact networks with various business advisers may also be useful in directing interested businesses, and investors, to the service. In addition, it is clear that some business chambers have been prepared to set up such services even in the face of expected losses, because they see it as a valuable activity to support their members and the rest of the local business community.

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6 Ideas and the Inventor also received subsidy funding from DIST from 1994 to 1996, totalling $850 000.

7 As at late January 1997, Techsearch was expecting to enter into a final undertaking to run Ideas and the Investor on a permanent basis, but had not yet done so.

### *Prospects for the future*

Two recent developments suggest possibilities for a significant expansion of the facilitation of informal investment by introduction services, in cooperation with other business advisers. These somewhat inter-related developments are the prospective increase in the number of business advisers who will be able to offer access to an introduction service, and the use of computer networks including the Internet.

As discussed above, the operations of two introduction services, BizEquity and The Equity Portfolio, are based, albeit in two rather different forms, on the role of business consultants or advisers in assisting business operators to find an investor by putting information onto a network which somehow links other participating advisers. This style of operation has some significant differences from the model of an introduction service with a single central office maintaining some form of register of client. Firstly, it may make it easier for businesses to make contact with the introduction network. Their own business adviser might be an agency of the network, or refer businesses to such an agency. This contrasts with the difficulties presently reported by some business operators, who were not aware of the existence of business introduction services even when they were operating in the same city. The likely geographic spread of these interlinked agencies could also be an important factor in making it easier for businesses to access an introduction service.

Secondly, this ease of access may help to build up a larger pool of investors and businesses who are known to the service. The importance of building services up to a useful size has been discussed earlier.

The use of the Internet and possibly other computer-based networks may tie in with the first development. Some service operators envisage future cooperation between different services, perhaps along similar lines to the cooperation between real estate agents from different companies. This could be facilitated by the expansion in Australia of the use of the Internet, or by using some other more specific computer-based network. At the same time the Internet is already being used to publicise some introduction services, which will raise awareness of them among the business and investor communities. Internet sites also make investment opportunities in Australia known to investors in other countries. Operators report that there have been few serious inquiries to date from overseas investors although many overseas people have accessed the sites. However, some observers believe that in the future there may be significant levels of investment in Australian SMEs by wealthy individuals in other countries, particularly some Asian countries.

These developments suggest that there could be a large expansion in the activity of introduction services.

## 4.3 Summary and comments

Based on a limited number of interviews, the motivations of investors and business operators in Australia, and the problems they face, appear to be similar to those identified in many extensive overseas studies. Investors are seeking high financial returns, but often are also interested in this form of investment for other reasons, such as the pleasure or challenge of making a success of the businesses chosen. Business operators commonly seek skills that are needed in the business, as well as an injection of long-term equity.

Both sides find the process of searching for a partner difficult. One major reason is the time costs of learning about a prospective partner and, particularly for businesses, providing them with the information they require. Businesses also often find it difficult to locate potential investors. For investors, the other main issue was the proportion of business proposals which they found to have some significant weakness.

It is interesting to speculate on how it is that private investors find it worthwhile to pursue this form of investment when venture capital firms and other financial institutions have opted not to do so. Business angels often have specialist knowledge of particular fields of business, which assists them to identify good prospects without great effort; clearly financial institutions cannot have access to such knowledge across the wide range of business proposals that come to them. But this immediately raises two questions: to what extent financial institutions might find it worthwhile to specialise in certain fields of business, and correspondingly what mechanisms might operate to direct business proposals to the most likely potential financiers. Financial institutions do in fact specialise to some extent, and this may be increasing (see for example *The Age*, 9 December 1996, page C3).

It appears from our limited knowledge that some angels presently have advantages in the form of networks which operate to direct suitable businesses to them. The same function could also be provided by introduction services, for example through good design of criteria for initial matching. But financial institutions, to the extent that they specialise, could presumably establish similar arrangements – for example, by publicising their interests, and by mutual cooperation in referring businesses.

Thus the ability to exploit specialist knowledge and skills is probably not a single key factor making investment in SMEs of interest to private investors and not to financial institutions. The explanation may lie in private investors possessing a combination of attributes, including this ability, a willingness to accept risk in return for the chance of high rewards, and finding some interest or pleasure in working to make the chosen businesses successful. In some cases other attributes such as a high level of specialist knowledge of particular fields of business may also come into play.

In terms of efficiency, it seems that many investors would, subject to cost, be interested in any additional information channel which could provide a good flow of business prospects where those with basic weaknesses had been screened out. As in other countries, business introduction services have the potential to improve information flows. Also, where the operators have a good knowledge of investors and their preferences, introduction services may be a suitable point for the delivery of advice and assistance to businesses to improve their business planning and become ready to work with a new equity partner. The ultimate success of such commercial services depends on the extent to which the informational benefits they offer their clients is worth the cost of organising the services.

The introduction services operating in Australia are mostly quite new (table 4.1), and further developments in this type of service can be anticipated. However the results so far in attracting clients, and the modest success in bringing about deals, suggest that these services could become well-used and improve the efficiency of the informal equity market. In terms of advisory services to businesses seeking angels, most of the introduction services now operating provide at least basic advice to bring business clients to some standard of 'investor readiness'. If the opinions of the investors we interviewed are representative of most investors, some level of basic advice is all that is needed, but introduction services should not register businesses which do not meet some minimum criteria of investor readiness. If this is correct, then almost all introduction services presently operating are providing an adequate level of service in this area.

An interesting feature of the development of introduction services in Australia is the presence of private sector services seeking a commercial profit. This model has not been much in evidence in the USA to date, though as noted in chapter 2 there is at least one similar service in the UK. The performance of these businesses to date suggests that they can continue to operate as commercial ventures. It may be noted that the level of fees charged is sufficient to deter some businesses seeking capital; this issue will be considered further in the next chapter.

# 5 POLICY ISSUES

This chapter considers public policy issues relating to informal equity investment. The first section discusses the significance of such investment for the SME sector, in the context of both the broader availability of capital for these businesses and the contribution of business angels to enhancing the management of the businesses they invest in. This section essentially presents reasons why government has an interest in the efficient operation of informal equity markets.

Following this, section 5.2 looks at business introduction services from a policy perspective. Drawing on the discussions with investors and businesses, reported in chapter 4, it considers the significance of these services for informal investment activity and critically examines arguments put forward for government assistance.

The final section considers the other major way in which government may have an impact, intentionally or otherwise, on this type of investment. This is the area of regulation, particularly those federal government regulations which may affect either the seeking of funds from potential investors, or the operations of introduction services. Section 5.3 summarises the current position and notes some recent developments which appear to overcome regulatory impediments in this area.

## 5.1 Informal investment and SME policy issues

Informal investment provides a significant, and probably growing, number of firms with capital for their development, and in most cases the investors also provide some business management skills. Both capital and management skills are essential to the survival and development of most businesses, but for a combination of reasons they appear to be issues of particular interest in connection with SMEs. Firstly, there is reason to believe that some of these businesses face particular difficulties in accessing finance through formal capital markets. Secondly, there is evidence that SMEs are often limited by the range of business skills available to them through their small management teams. Thirdly, if there are any problems hindering the development of SMEs in general, this is an issue worthy of some attention in view of the fact that new businesses represent a source of technological and industry development, which in turn may be a source of spillover benefits.

### *SMEs and access to formal capital markets*

SMEs’ access to capital through financial markets has been the subject of significant debate and policy interest in various countries for many years (some examples were noted in chapter 2). Many observers have expressed concerns that SMEs are not well or fairly served by financial markets. In Australia, such concerns have been investigated in other studies, in particular the Industry Commission’s 1991 report, *Availability of Capital*.

It is not the purpose of this paper to re-examine in any detail the issue of SMEs’ access to capital markets in itself. It is important to note that this is far from being a simple subject, and it is difficult to establish conclusively that there are any market failures affecting SMEs seeking finance.

In particular, while SMEs appear to face some special difficulties in obtaining capital through formal markets, these may reflect rational responses to risk and transaction costs rather than market failures. Firstly, the cost of assessing applications for finance plays a part. As noted in chapter 2 in discussing venture capital finance, it is generally accepted that these costs do not vary greatly according to the amount of finance sought. The same is true for the costs of monitoring the business during the life of the agreement, if finance is provided. This is one reason why financial institutions may use criteria or procedures which mean that SMEs are less likely to receive finance than larger firms, or receive finance only on less favourable terms than would be offered to larger firms. One instance of such behaviour would be the use by institutions of minimum thresholds for finance, which as noted in chapter 2 is common practice for VC firms in the USA and UK; anecdotal evidence suggests that VC firms in Australia also rarely consider deals of less than $2 million.

Related to this, the supply of finance to SMEs may also be restricted as a result of the information asymmetries between financial institutions and firms seeking finance. This is a topic which has been of some interest in recent analysis of capital markets. Finance providers will generally have less information regarding the likely outcomes for firms seeking finance than do the managers of the firms themselves. This means that the finance providers must decide on the terms and conditions on which they will offer finance across a class of firms, while having only limited information to distinguish good prospects from poorer ones. As a result they will offer finance to some firms at a higher price than they would have if they had access to better information, and conversely for some other firms.

Under these conditions, those firms with less risky prospects are likely to consider that the terms offered are unsatisfactory, and they may even withdraw from the market. Those borrowers whose proposed ventures involve higher risk, with consequently greater probabilities of loan default, are more likely to accept the terms offered. This problem is termed adverse selection, and will tend to result in finance providers having a group of clients whose businesses or projects have higher default rates than other ventures. The rational response for financiers is to lower interest rates and then ration finance on the basis of criteria which may for example, reward established customers, or be useful for the lender in the event of default (such as the common requirement for substantial collateral). Thus the end result of information asymmetries is likely to be that less finance is provided to certain classes of businesses, while some finance providers may opt out of certain types of lending altogether.

It seems likely that this phenomenon arises mainly in connection with smaller firms seeking finance. Financiers would generally have easy access to a wider range of information about larger companies (for example, various analysts gather information about the performance and prospects of most companies that are listed on the stock market). Even if such information were not sufficient, financial institutions would be more likely to find it worthwhile to put effort into obtaining the necessary additional information for companies which are seeking larger amounts of finance, and these are generally larger businesses.

For these (and other) reasons, evidence of unsatisfied demand for finance on the part of SMEs does not in itself prove any market failure. Unsatisfied demand might only reflect a rationing of finance in the face of a high total demand, with the criteria for rationing being chosen on the basis of the information and transaction costs facing financial institutions.

Some observers also report that technology-based SMEs have particular difficulties in obtaining finance. Reasons for these problems include the frequent absence of tangible assets which might be used as security for external finance, the managers' need to maintain secrecy over their intellectual property (which may represent a large share of their total assets), and the fact that assessors in financial corporations frequently lack the expertise to judge the merits of such projects if they are still at the start-up stage. If technology-based SMEs face particularly severe problems in accessing finance, this would raise the potential importance of informal investment for these businesses. In the USA, business angels appear to play a particularly important role in financing technology-based businesses, possibly in part because these businesses do not generally fare well in formal capital markets.

It is difficult to assess the significance of information and other transactions costs as 'frictions' within formal capital markets. However, the interviews conducted for this study suggested that a significant proportion of firms seeking equity from business angels were doing so at least in part because they had been unsuccessful in obtaining loans or equity capital from financial institutions (see chapter 4).

### *Informal equity investment and business management*

Both state and federal governments in recent years have seen a need for some improvement in the quality of management skills in business generally, and particularly in the SME sector. A number of programs to assist entrepreneurs to improve these skills are delivered through AusIndustry and state industry departments. In 1995 the federal government considered this issue sufficiently important to establish a task force to examine leadership and management skills in business (the Karpin task force), and some government programs and services have recently been changed in response to the resulting report (DIST 1996:59-60).

There may be a range of motivations for governments to provide such measures. In this study our interest is in knowing whether smaller businesses do often experience problems which result to some extent from a lack of management skills.

Studies have found that the operators of small firms in both Australia and the UK identify limited management and marketing skills as important constraints to the success of their businesses (see Berryman 1994, Storey 1994). Also, the operators of Australian small firms which go into bankruptcy consider lack of business ability to be one of the major reasons for the failure of their businesses (Inspector-General in Bankruptcy 1995).

There may be considerable differences between firms in the reasons behind a lack of sufficient management skills. However, some likely common reasons are that many small firms are established by people whose main skills and interests lie in the product or service being sold, rather than in the management of the firm, and the small size of management teams. Many small businesses are run by one or two principals, who take on responsibility for all aspects of the business' operation. In addition, financial constraints may hinder many firms from using the services of business advisers when this is appropriate. In some cases the problem of financial constraints may be compounded by the inexperience of the business operators. For example, they may not recognise the potential value to the firm of advice which they could readily obtain.

### *Policy implications*

Do these issues have any significance for industry or SME policy? Certainly, any factors which may result in some businesses being unable to obtain finance for worthwhile projects need to be fully understood. We should keep in mind that many innovative business ideas are developed initially by small and relatively new companies. If these companies face some disadvantages in certain markets, this is likely to hinder an important source of economic and technological development.

However, these considerations alone would not establish a case for government intervention to expand the supply of finance to SMEs. Much of the reason for the restricted capital flow to small firms lies in the high relative costs of assessment and monitoring of finance provided to small firms – and it is important to recognise that these are real economic costs. If financial institutions operating in a competitive market devise efficient procedures for allocating finance in the presence of these costs, then it is doubtful that any intervention could achieve a better outcome. Similarly, information asymmetries are intrinsic to the operation of this market and unless the cause can be tackled it is very unlikely that intervention could achieve a better allocation of finance.

However, the question here is *not* one of whether governments can in some way act to improve SMEs' access to finance through formal capital markets. Rather, we are considering a private economic activity, namely informal direct investment, which provides finance to at least some of the businesses which face difficulties in those markets. Based on the evidence in chapters 3 and 4, it appears that angel investment is already playing an important role in providing finance to companies which in many cases have already unsuccessfully sought funding from banks. Essentially, informal investment can fill this 'gap' because of differences between private investors and large financial institutions. Private investors generally do not have the alternative of directly investing very large sums such as those invested by VC firms, and, as discussed in section 4.3, a combination of factors may lead to private investors being better able to identify promising investments in SMEs, or more willing to invest in a given prospect than many financial institutions.[1]

This form of investment can be expected to increase society's total returns from the use of its capital, in comparison with a system where such investment is prevented or restricted in some way. And in comparison with direct government intervention which might be suggested as a response to any capital market imperfections, it has the advantage of introducing no new problems affecting

1 It appears that many investors also have requirements which reduce the potential for moral hazard on the part of business operators, which is another problem that arises for financiers in deciding whether to supply funds.

the allocation of capital.[2] By contrast, direct public interventions almost certainly create new problems. For example, provision of government finance to a particular class of companies on the basis that they were disadvantaged in seeking funds through capital markets would create the need to determine which companies were eligible and to establish criteria for allocating funds between them. Since the government is not endowed with particular expertise in assessing the commercial viability of business projects, the outcome of any such process is problematical.[3] In addition, there are other costs associated with such intervention, including administrative and compliance costs and the costs of raising the revenue needed to finance such support.

These considerations suggest reasons for policy interest in the performance of the market for informal equity investment. If there are significant barriers in this market, it is possible that intervention to address those barriers could produce net gains. The next two sections consider two important aspects of the market's operation, and whether any government action may be appropriate in each area.

## 5.2 Business introduction services

The preceding chapters have illustrated the economic importance of informal investment, and the apparent potential for business introduction services to facilitate it by assisting information flows. In this context, it is worth examining whether there is any need for public intervention to support these services. In fact, from 1994 to 1997, the Federal Government has provided some subsidies to business introduction services, as part of its measures to assist SMEs particularly in the area of access to finance.[4] The Government always intended

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2 It should be recalled here that we are referring to that component of informal investment where the decision is made on a purely commercial basis, after considering alternative uses of the funds, and not in response to any personal ties or other obligations.

3 Some government initiatives of this type have not performed well. Instances include the Australian Industry Development Corporation (AIDC) in its early years, and the Victorian Economic Development Corporation.

4 Subsidy funding was provided initially to the Business Finance Support Program and Ideas and the Investor, but this specific funding was withdrawn during 1996. The funding allocated for this purpose for the financial year 1996-97 was made the subject of a public tender, open to existing and new introduction services.

that this funding was only an interim measure, to assist the establishment of services which were expected to become self-funding after an initial period.[5]

Although it is not a formal evaluation of these subsidies, this study has collected information which is relevant to an assessment of the arguments for any future assistance to introduction services.

Arguments for assistance to business introduction services appear to be based on one or more of three claims:

- Private sector introduction services will run at a loss during their start-up phase. This is claimed to indicate a need for government subsidies if any services are to survive long enough to reach their 'critical mass'.
- Informal direct investment generates valuable spillovers, either by bringing about improvements in business management or through assisting innovative SMEs to conduct more R&D.
- Managers of SMEs may have misperceptions about the value of introduction services, leading to lower than optimal use of the services.

Overall, we conclude that these arguments do not provide a convincing basis for government subsidies to introduction services. Below we explore each argument in turn.

### *Initial losses*

As suggested by the discussion in chapter 2, one argument that may be put forward for assistance is that introduction services will commonly face losses during some initial period, while the operators are still seeking to expand the client base to a point where the revenue from fees will cover the operational costs. Indeed, at least as recently as 1995, some commentators argued that even in the longer term, with a large clientele, it would be difficult or impossible to charge fees that were sufficiently high to cover the costs of running a satisfactory introduction service, including for instance the costs of marketing the service so that at least a large share of potential new clients would become aware of its existence (Mason and Harrison 1995:48-9). For example, there have been many failures of introduction services in the USA, and researchers reported that up to 1995, none of the many services established in the UK and the USA had commenced to run at a profit, although many of them had been established for several years.

[5] Evaluations of the funded programs were planned, but these were cancelled due to financial constraints.

There are two major deficiencies in the argument that early losses or lack of profitability justify government intervention: one based on principle, the other on fact. First, if there are no spillovers, other market failures or misperceptions, the expectation of continuing losses in any commercial venture suggests that it should not go ahead at all. If an early loss is expected, followed by a shift into profits, the venture should proceed only if the net present value of the eventual returns exceeds the net present value of the up-front costs. Many businesses face moderate or high fixed costs on start-up, which they must finance until they receive the later returns. Subsidies can tip the scales for such ventures, so that private investors will choose to go ahead with them – but in the absence of some compensating non-commercial gains it is better for society if no subsidy is paid.

Second, the experience in overseas markets suggests, notwithstanding the failure of some services, that there are still commercial interests which are prepared to commit their resources to operating introduction services — without government assistance. Recently there have been some new private ventures in this field, including the purchase of the British introduction service VCN, and the establishment of a new service by at least one bank in the UK. In some cases, these ventures have proceeded on the basis that the introduction service will operate as a valuable adjunct to some other business activity (such as a bank or the provision of business advice), and may not necessarily be expected to return a commercial profit in its own right; but in considering the arguments about public funding the central point is that some private interests are willing and able to operate introduction services.

In Australia, the development of business introduction services has proceeded rather differently from the experience in the UK and the USA. In particular, in Australia some services are being developed by groups of business consultants as an adjunct to their other activities, and the operators of these services report that they are currently profitable or expect to be running at a profit in the near future. Thus it appears likely that introduction services will continue to be available in the absence of any public assistance, and the basic argument that such support is vital to facilitate informal investment is no longer valid.

### *Spillovers and other market failures*

The private sector introduction services which seem likely to continue in operation, charge fees which are high enough to deter some prospective clients. The charging of commercial fees does not usually represent an issue of concern for policy makers, any more than do the lending practices of banks and VC firms which were discussed above. In most circumstances, prices are an efficient way of allocating scarce resources to the use in which they will be most valued.

However, there may be special circumstances in which this does not apply. The existence of spillovers (and misperceptions on the part of buyers or sellers, to which we turn next) can lead to positions where users choose to purchase either too little or too much, as compared with the socially optimal outcome. Is there evidence of any spillovers which would justify a subsidy to business introduction services?

While most of the benefits of their operation flow to their clients, in theory these services may also provide benefits which are more widely spread across the economy. This could occur in at least two indirect ways:

- They provide one avenue through which the level of management skills in the SME sector is raised. This happens not only through the contributions of business angels to the businesses they invest in, but also as a result of the advice provided (to varying extents) by the services on matters such as business planning. If there are valid reasons for public intervention to promote improved standards of business management, then by the same token this function of introduction services has a potential claim for public support.
- By reducing search and other costs for investors and businesses, the services almost certainly raise the level of investment in SMEs – and to the extent that SMEs are the source of valuable innovation (with its accompanying spillovers) this will produce benefits for the economy as a whole.

This study has not attempted to quantify such benefits. There are a number of subtleties in their measurement but overall it appears likely that they form a weak basis for government assistance to introduction services:

- Assistance to *business introduction services* is a roundabout and uncertain way of achieving these benefits. A useful tool for understanding this is a Venn diagram (figure 5.1). Let us initially consider the role of such services in providing management benefits to firms. The area A represents those firms who would benefit from management advice, and B the subset of these firms, who do not appreciate that fact. The group B is a *potential* target for government action. However, business introduction services do not meet this group's needs efficiently. First, only some angels provide useful management advice (group E).[6] Second, some businesses using a subsidised business introduction service would have otherwise found a business angel, albeit less readily, using informal networks (the group C).

6 Noting that in chapter 4 we find that a significant number of angels spend no time with their businesses.

True, some of these firms need and will receive management advice from their angels — but the existence of a subsidy has not generated this outcome since this group receives angel finance regardless of the existence of the subsidy. This implies that any benefits flowing from subsidised business introduction services relate only to those businesses which would not otherwise have been financed (group D — the lightly shaded area). The diagram reveals that the benefits are realised only for a special class of even these firms — those representing the intersection of B, D and E (the dark area). A similar exercise can be undertaken to appraise the likely benefits from technological spillovers.[7]

- Small firms receiving angel finance (and advice) are not randomly selected. They both self-select (are willing to be recipients of finance) and are chosen by an angel for some set of desirable attributes, including presumably some basic level of management competence. Until more is known about the management attributes (and potential) of this highly selective group of firms it is premature to see them as the appropriate target for management assistance.
- The government already has a range of measures which are more directly aimed at these issues and with a much wider constituency of firms. These include a variety of programs aimed at improving management capacities in enterprises across the economy, and many programs aimed at supporting innovative firms.

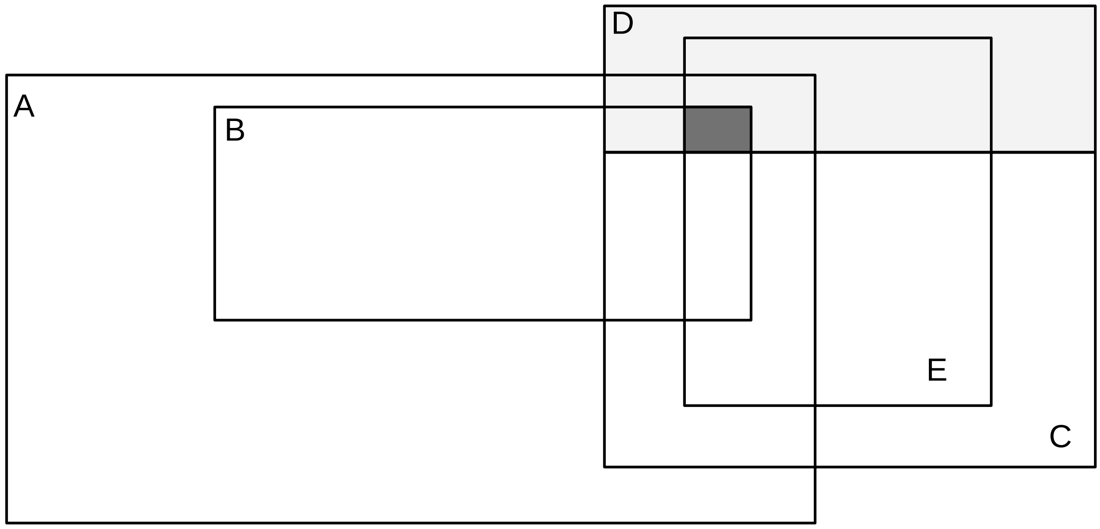
### *Misperceptions about the value of matching services*

Misperceptions by SME managers about the value of business introduction services could lead to their being under-used, with the loss of some potentially valuable growth capital to small business.

7 Here the relevant intersection is between firms which undertake innovation with significant spillovers (group B), firms which would not otherwise attract angel finance (group D) and firms who have no alternative ways of commercialising the innovation other than by attracting external finance (eg cannot sell a license for the technology or be taken over).

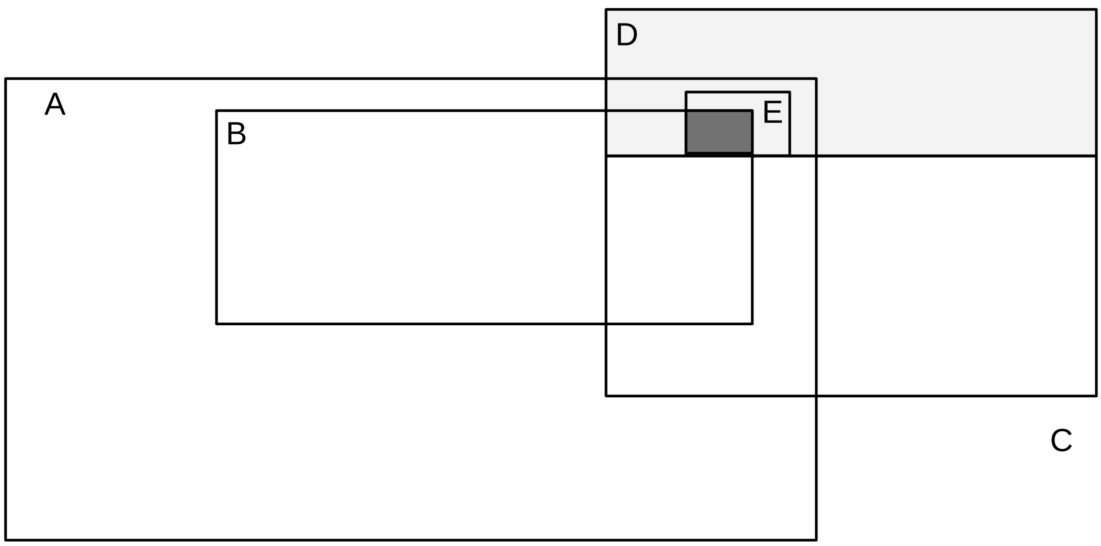
## Figure 5.1 Gains from assistance to business introduction services?

**Management expertise gains from introduction services**




A: the firm would benefit from management expertise
B: and does not know this
C: the firm uses a business introduction service but the investment would have happened anyway
D: the firm uses a business introduction service and the investment was truly additional
E: the angel provides useful management advice

**Innovation spillover gains from introduction services**




A: the firm is an innovator
B: the innovation generates significant spillovers
C: the firm uses a business introduction service but the investment would have happened anyw
D: the firm uses a business introduction service and the investment was truly additional
E: the innovation would be lost altogether without angel investment

As noted previously, the managers of SMEs do not always have the skills to manage their firms optimally. It seems likely that in some cases managers will avoid using business introduction services because they do not recognise the full value to the firm of the services provided. But there is no apparent reason to think that any public assistance directly to introduction services would be a desirable way of dealing with this issue:

- It would be difficult to develop a program which subsidised introduction services only for those managers with such misperceptions. Other firms – quite probably the bulk of users – would also benefit from any subsidy.
- If the problem is one of misperception of the chances of success when using introduction services, then this could be overcome by the services changing their pricing regimes. For example, operators could charge higher success fees and lower initial fees.
- If the problem reflects more general management failures, it would be more appropriate to consider policy to target these, rather than to subsidise introduction services.

Some SME operators might also be deterred from using introduction services with high initial fees, due to liquidity constraints. However, we note that some services charge low up-front fees (no more than $350), and at least two of these (Business Finance Support Program and Ideas and the Investor) offer a service which could be used by SMEs anywhere in Australia, although the prospects of finding an investor may be better for SMEs in the services' home cities.

### *Summary*

Business introduction services in Australia appear to be going through a period of rapid development, and it appears possible that in a relatively short period this development will result in some choice of introduction services being available to most SMEs. The efficiency of these services in facilitating informal investment is of interest just as their availability is; it seems likely that efficiency will increase as a result of several factors, including a greater awareness of informal investment and of the role of introduction services, and of possible developments such as the computer-based exchange of information between services.

These prospects, combined with the theoretical weakness of the arguments for assistance, suggest that there is no reason to consider further financial support for introduction services.

## 5.3 Regulation of fundraising by SMEs

Various government regulations affect investment in SMEs by business angels. Most directly, the Corporations Law regulates the activities of all companies in raising equity, and also contains a general prohibition against the 'hawking' of shares. This section is mainly concerned with the impact of regulation in these areas, including a discussion of changes which are currently proposed as part of the Corporations Law Simplification Program. It also briefly considers the subject of new markets on which shares in SMEs may be traded; the existence of such markets would in many cases assist the ultimate exit of angels from the businesses they invest in, possibly increasing the attractiveness of this form of investment to many active or potential business angels.

### *Regulation of equity raising*

The general thrust of regulation in this area is to ensure a degree of protection for investors by requiring companies seeking to raise funds from the public to provide a prospectus containing substantial relevant information. Section 1022 of the Corporations Law requires that a prospectus must contain 'all such information as investors and their professional advisers would reasonably require, and reasonably expect to find in the prospectus, for the purpose of making an informed assessment of: (a) the assets and liabilities, financial position, profits and losses, and prospects of the corporation; and (b) the rights attaching to the securities'.

It is clear that the preparation of a prospectus involves substantial costs for the company. Requiring a prospectus in every case where a company seeks external equity would almost certainly prevent some smaller companies from seeking to raise funds in this way. Further, to the extent that these companies seek funds not from the public at large but only from private investors with business skills and experience, the prospectus requirement does not appear essential for investor protection. Such investors are well equipped to investigate and assess the companies' prospects in other ways. For example, it appears to be common when business angels are contemplating an investment for them to be granted access by the current owners to company records, allowing them to undertake their own analysis of the company's affairs.

These considerations have been recognised in the Corporations Law through the creation of exemptions from the prospectus requirements, under section 66(3). Two categories of exemption, applying to companies seeking to raise funds by personal offer or invitation directly to potential investors, are of interest here. No prospectus is required if no more than 20 such offers are made within any period of 12 months, nor in respect of any offer or invitation where the amount sought from each investor is not less than $500 000.

The second class of exemption is based on the rationale that persons who would consider such large investments would generally have the motivation and resources to assess the company's prospects on their own initiative. It may also be argued that, in view of the size of their potential investment, they would have sufficient influence over the company to obtain the necessary information (Attorney-General's Department 1995:11).

The former class, known as the '20/12' rule, permits companies to seek funds from individual investors through limited direct approaches. However, there are problems with this particular approach. Firstly, the exemption is framed in terms of the number of offers or invitations made by a company, and it is possible that 20 offers may be made without the company raising the funds sought. In addition, there is apparently some uncertainty as to exactly what constitutes an offer or invitation – for example, it is not clear whether a presentation by the principals of a company before a group of potential investors, such as at the business angels meetings organised by some introduction services, constitutes an offer or invitation to each of the potential investors present. If so, such a presentation could either breach the current regulations (if there are more than 20 investors present and if the company has not lodged a prospectus), or could use up most of the maximum of 20 offers or invitations permitted in a 12 month period.

This issue, among others, is being addressed as part of the government's Corporations Law Simplification Program. The task force has proposed that the law should be changed to permit any number of personal offers provided that no more than 20 issues of shares are made as a result in any 12 month period.[8] The task force's approach recognises the difficulties that would be posed for many SMEs if they were required to prepare a prospectus, and considers that the proposed change would avoid this constraint in many cases, without undermining investor protection (Attorney-General's Department 1995:11).

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8 It also proposes that the term 'personal offer' be defined to mean an offer made to a particular person and which can only be accepted by that person. This would mean that presentations about a company made at any group session, although intended to arouse the interest of potential investors, would not count as an offer. This change would have the advantage of adding clarity and certainty for those associated with company fundraising, although if the proposed change to unlimited offers with a maximum of 20 actual issues is implemented, it would not have any direct impact *per se*.

Change along these lines appears to be desirable, as it would remove a substantial uncertainty presently facing SMEs seeking informal direct investment.

### *Hawking of securities*

The Corporations Law prohibits persons from 'going from place to place' offering shares for sale (s 1078). 'Going from place to place' has been given a very broad interpretation, including for example making two or more telephone calls (Ford and Austin 1995:812). This prohibition was originally intended to limit the activities of unscrupulous people who promoted securities to the public at large, often including people who lacked skills in assessing the worth of securities. This and other sections of the Corporations Law now impinge on the matching of investors and business operators by business introduction services.

Where the activities of an introduction service would be caught by the relevant sections, the service's operators can apply to the Australian Securities Commission (ASC) for exemption from those provisions. Exemption is generally granted provided the ASC considers that no part of the service's operations breaches its policies relating to the issue or sale of equities. But there appears to be significant uncertainty among introduction service operators as to whether their operations do in fact fall within the scope of the relevant provisions. Some have sought and obtained exemptions, while others have obtained legal advice to the effect that their operations did not contravene these sections.

This uncertainty appears to arise in part because the services operate in different ways, with, for example, some relying largely on a bulletin which goes only to registered investors, while others hold meetings for business operators and investors, which are advertised in the press. However, whether a service's operations are caught by the provisions depends to some extent on the purpose and nature of their operations considered as a whole. The ASC advised that any form of circulating information about businesses with a view to attracting investors could potentially be caught by the provisions, and that every introduction service should seek an exemption.

At present the ASC considers each such application individually, and gaining approval may take as little as about one month, but in some instances it has taken considerably longer. However, the ASC is currently working to simplify the approval procedure, by issuing a class order relating to business introduction services. This is expected to provide a set of guidelines relating to their operation; any service whose operations fell within these guidelines would automatically be granted an exemption, and such approval should be quicker than is the case at present. A draft of the proposed class order was released for public comment in January 1997 and it is expected that a final order could be issued around April.

This proposed change is a valuable development, and should encourage the operators of introduction services to ensure that they are acting within the law by applying for exemption if they have not already done so. It is to be hoped that the class order produces certainty for operators as to what sorts of actions they may or may not legally take in matching businesses and investors, and that no unnecessary limitations are placed on these actions. The underlying uncertainty as to what actions are permissible in the absence of an exemption appears to reflect problems in the Corporations Law, similar to those discussed by the simplification task force in relation to other sections of the law.[9] It is not clear whether the effort of reforming the law to remove these uncertainties would be justified if the class order is satisfactory; this would depend on the need for and use of those provisions in relation to the activities of bodies other than introduction services.

### 5.3.1 New markets for trade in SMEs' equity

The issue of investors' ultimate exit from the businesses they invest in has been discussed in earlier chapters. Some overseas researchers have identified difficulties in exit as a factor which may make many private investors less willing to invest in SMEs rather than other assets. The opinions expressed in our discussions with investors and business introduction services varied. Some people in each group considered that informal investment would be more attractive to many investors if they had the option of conveniently trading their equity at a later stage, on some form of organised market. Others felt that exit was presently not a major obstacle if the business had performed well, or even that any investor who had strong concerns about the ability to exit from a business should not be involved in this form of investment.

While it may not be an important issue to all investors, the existence of markets for trading equity in SMEs could only enhance the attractiveness of informal investment. Since the demise of the second board markets, no such market has existed in Australia. However, at present there are at least two groups attempting to establish markets on which the equity in SMEs could be traded.

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9 Some relevant sections of Part 7.12 of the Corporations Law are presently being redrafted to make the intention clearer.

One proposal is that of AUSDAQ, which is intended to be similar to the NASDAQ market in the USA. The plan is for a market which would operate nationally, and could be accessed by any investor through registered brokers. Equity in any corporation could be traded on the market provided that the corporation met the ASC's information disclosure requirements – that is, that it had lodged a prospectus which had been registered by the ASC. Clearly this would in practice mean that access to the market was limited to companies which were large enough to bear the costs of preparing a prospectus, in addition to any other costs of selling or issuing shares on this market. Although it would be used only by a minority of companies, a market along these lines would provide another option for exit by informal direct investors if the investee businesses had grown sufficiently large; it would also be of value to many other SMEs which were seeking to raise outside equity.

The operation of share markets in Australia is regulated by the ASC. In response to recent developments in Australia and overseas, the ASC issued a policy statement in September 1995 setting out the principles which would be applied in deciding whether to approve applications to operate a stock market. The ASC's stated aim is to keep a balance between regulation to protect users of the markets and promote confidence in Australian capital markets, and permitting the operation of markets operations that will allow capital raising by industry and assist Australian businesses to access international capital markets. In assessing applications for new stock markets the ASC will consider: the adequacy of proposed trading rules and procedures for providing participants with market information and for clearing and settlement; proposed supervision of market operations; the competence, integrity and financial resources of market intermediaries; and the expected stability of the market, including whether the operators have adequate financial backing.

It appears that if the ASC is satisfied that the proposal meets reasonable standards on these criteria, then an application to operate a stock market would be approved. Thus it is possible that Australia will soon have new markets for trade in the equity of businesses that are not listed on the Stock Exchange.

## 5.4 Concluding comments

Informal equity investment is a significant source of finance to small business. Our survey results indicate that in mid-1996 the total stock of equity provided to small firms by private investors was around $1 billion.

Various indicators – the growing level of interest in the subject among many business people, the expansion in the numbers of business introduction services and their clients, the probable existence in the community of many potential business angels who could become active – suggest that informal investment may grow quite rapidly in the near future. Moreover, private businesses and other groups are developing services which have the potential to assist the processes of informal investment by reducing search costs.

From a policy perspective informal equity investment has attracted interest because:

- it appears to overcome some of the perceived problems associated with the availability of *formal* equity finance to small business; and
- it can play a role in augmenting the management skills of small businesses — a major focus of SME policy.

In both cases informal investment appears to ease a constraint that can limit the development of some SMEs. There are grounds, therefore, for government to ensure that there are no unnecessary impediments to the efficient operation of informal equity markets. While this report identified some unjustified regulatory impediments to such efficient operation, these impediments are being removed now. This study found no other grounds for government intervention in these markets, including no rationale for financial assistance to business introduction services.

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