Business angels, the high-net-worth individuals with money to invest in venture capital, have improved the outlook in the United Kingdom for start-up companies with high growth prospects. The UK government has devised incentives that work, following some near disastrous experiments which turned into tax dodges. Chris Golis argues for an Australian scheme to attract the funds and expertise of the angels.

The equity gap was first postulated by a 1931 UK government report which observed that "great difficulty is experienced by the smaller and medium sized businesses in raising the capital which they can from time to time require even when the security offered is perfectly sound".

While the Macmillan Report did not distinguish between debt and equity, the finance gap has increasingly been defined as a shortage of start-up capital in the form of equity, supplied by either institutional or private sources. Studies of smaller companies have reported that first-stage financing is generally a mixture of creditor and bank debt securitised by the founder's assets, owner's equity, loans from family and friends and retained profits.

Undercapitalisation is regarded as one of the more serious problems facing small and medium-sized firms. It is argued that new ventures, especially those with growth potential, could often benefit from an extension of the capital base through outside equity participation, both to provide a long-term capital base and to provide funding for research and development and early market development. On the other hand, new venture founders are generally reluctant to accept external finance if it involves dilution of their equity, even though there is evidence of a link between external equity participation and growth. This paper reviews several government attempts to overcome the equity gap (particularly the UK experience) and suggests a possible strategy for Australia.

Definitions
The Business Council of Australia, in a recent study of business innovation in Australia, divided Australian companies into four classes according to market capitalisation or value. Each category faces different imperatives and problems but these differences are not widely understood by lawmakers, financiers or even business lobbyists. The four categories are:

- **Class I**: Listed companies, operating internationally, with a value of $750 million or more.
- **Class II**: Regional companies by international standards but generally with a listed value of $75-750 million.
- **Class III**: The middle market, value $7.5-75 million.
- **Class IV**: Value below $7.5 million.

which includes small family-owned companies and represents most of the 700,000 companies operating in Australia.

This division explains the paradox of capital need on the one hand and resistance to equity dilution on the other. The capital need surveys typically have as their sample base middle-market companies — Class III and aspiring entrants to Class IV — while the anti-diluent surveys generally have a sample base wholly of Class IV companies.

It is most important when discussing measures to aid small companies to distinguish between small-and-stable (corner stores) and small-but-growing companies.

**Why bother?**

An immediate reaction by some, particularly economic rationalists, is to ask why small, fast-growing companies should be aided. The answer usually is that small fast-growing companies are major sources of employment, competitive exports and efficient economic growth.

The creation of jobs was long considered the preserve of large companies. Indeed, it was the major justification for the policy of tariff protection implemented by most developed countries for most of this century. It is only in the past 15 years that economic planners have realised that the theory is wrong.

Perhaps the best evidence comes from the US, where in the Fortune 500 companies employment has declined from around 22 million in 1980 to just over 11 million in 1993. Over the period this loss was compensated for by the growth in employment generated by small business. However, it was not a case of every small business putting on one employee, as was argued by one former professor of economics and former leader of the opposition. It is more the operation of a fiercely modified Pareto's rule, where a few companies (2 per cent) provided most of the job generation (90 per cent). Thus it is important that government policy aims at helping not all small business, but the high-growth companies.

The second argument for aiding high-growth companies concerns exports. Elaborately transformed manufactures (ETMs) are the rapidly growing segment in exports worldwide.

While exports as a whole in Australia have shown a compound growth of around 8 per cent per year over the past 10 years, ETMs have shown a rate twice that. A recent study by McKinsey called new high-growth ETM manufacturers the "emerging exporters".

The third argument for supporting high-growth smaller companies is the efficiency of capital allocation. Numerous studies have shown that the asset intensity they need to generate sales is around three-quarters that of large companies. Thus, it is argued, it is more efficient for capital-short countries to promote the creation of high-growth companies than to protect large companies.

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Given that these arguments are increasingly accepted by economic planners, the next issue to consider is how to promote the formation and development of high-growth companies. There are effectively two methods, attracting either individual or professional institutional support.

**Institutional support**

The evidence to date (in Australia the MIC program and the State Development Corporations provide convincing confirmation) shows that attempts to promote professional institutional support for the formation of high-growth businesses are doomed to failure. Start-up investments are rightly perceived as higher-risk than existing business, although the compensating expected return is higher. For example, one rule of thumb used by the US venture capital community for expected returns from start-ups is "ten times the investment in five years". This implies an expected internal rate of return of 50 per cent. Very few investments can realistically show this rate of return.

Start-ups will, of course, in many cases survive. But for professional investors, survival is not good enough. They need growth, otherwise the exit routes, and hence the ability to realise the investment, will be limited.

Moreover, the relatively fixed administrative costs of screening potential investee ventures and managing and making an equity investment are disproportionately high in a start-up relative to the size of the investment.

For these reasons there is a noticeable shift to later-stage investments by professional investors. In Australia this mind-set has even led to a change in language: venture capital now means seed and start-up financing, while development capital usually refers to later-stage investments. (Overseas, "venture capital" is the generic term for all forms of unlisted equity capital investments.)

Hence, in some countries, particularly the United Kingdom — although not in Australia — government policy has been to promote the supply of private equity capital from high-net-worth individuals, sometimes known as "angels". One should not underestimate the size of this source of capital. Contrary to the myth, nearly all the success stories of the US venture capital industry have had their seed and start-up financing provided by individuals.

**The UK experience**

The UK government has been the most active in developing schemes to increase the flow of new equity finance by providing income tax relief for investment by individuals in unquoted trading companies. The first scheme attempted in 1981 was the Business Start-Up Scheme (BSS). This was dogged by restrictive legislation and only £40 million was raised in the first two years. The BSS was then replaced by the Business Expansion Scheme, or BES, introduced in 1983.

The BES originally allowed UK residents to invest up to £40,000 a year in companies at the time of share issue provided they met certain rules of
non-association. The maximum tax refund allowable under the scheme was £16,000 so, as the highest marginal tax rate in the UK at the time of the BES introduction was 60 per cent, the maximum investment provided the investor had other income was £26,667.

The key non-association rules were that the investor must not own directly or indirectly more than 30 per cent of the company and that the investor must be neither an employee, partner nor paid director of the company. The relief was for investments in new, genuinely additional full-risk capital, and investors had to hold their shares for at least five years. In 1986 the shares were also free of income tax on their subsequent disposal. Individuals could invest directly into a business or channel their investment through an approved investment fund or an investment syndicate.

Additional limitations placed on the investee company were that the shares would not be traded on the full stock exchange for three years after being issued. The company had to be independent and not a subsidiary of or controlled by another company and there were limitations on the nature of the investee company's trading. Originally, BES investee companies could not deal in land, shares or commodities, leasing and hire-purchase financing, or legal, accountancy and financial services.

These trading restrictions grew as promoters formed new companies to combine other tax advantages with those of the BES. Farming was made ineligible in 1984, then property development in 1985, and in 1986 companies that had half of their net assets in land and buildings or whose main purpose was to hold goods that were collected or held as investments, such as fine arts, wine or antiques. During the first three years about £410 million was invested in 2,200 companies. The amount was significant: investment by the professional independent venture capital industry in the same period was estimated to be £480 million. Of course, this amount is modest when compared with bank lending to small business, which was estimated at around £23 billion over the same period.

What occurred in those first three years was the development of prospectus issues and investment in tax-effective capital-growth schemes. In the first year of operation direct investments at £28.6 million nearly matched prospectus issues at £36.5 million. By the third year direct investments had fallen to £8.3 million while prospectus issues had more than tripled to £111.4 million. Individuals were investing in pooled entities, not directly into companies.

Also, the scheme failed to achieve its original aim of promoting investment in high-growth manufacturing industries. Only 261 of the 2,192 companies that obtained BES funding were in manufacturing. The majority, 1,444, were in other activities (agriculture, property development, etc.) that were gradually eliminated as eligible activities.

It is fair to say that the BES became a tax-dodge reminiscent of the Australian film scheme, while the EIS seems to be firmly aimed at attracting business angels.

In 1988, Nigel Lawson, then chancellor of the exchequer, decided to change the underlying purpose of the scheme. The UK had, and still has, both rent control and legislation that restricts the eviction of tenants for non-payment of rent. As usual, the good intentions of government had a perverse effect in that these laws, introduced to help the poor, caused the supply of private rental accommodation to dry up.

The secondary effect of this lack of rental accommodation is that it restricts labour mobility, particularly of the unemployed. Lawson, to increase the supply of private rental accommodation, allowed private renting companies to operate under the BES. Not only that: he capped the amount that trading companies could raise at £500,000 while letting private rental companies raise up to £5 million.

Thus individuals could invest money in a company that would buy houses and rent them for five years. Then the investors could obtain any capital gain tax-free.

This was attractive in a booming property market, even when the top marginal tax rate had been reduced to 40 per cent. The financial services industry then developed bank guarantees and put options which increased the attraction. The BES turned into the best tax shelter available in the UK. Not surprisingly, the flow of funds rose dramatically.

In the first five years the BES raised £780 million, of which only a small amount went to assured tenancies. In the next six years, total funds raised equalled £3.4 billion, of which only a small amount went into trading companies. The government, recognising that the BES had gone completely awry, terminated the scheme at the end of 1993.

In January 1994, the British government introduced a BES replacement known as the Enterprise Investment Scheme (EIS). Investors are able to get relief at only 20 per cent, rather than at their marginal tax rate. The maximum deduction is £20,000, which leads to a maximum investment of £100,000. Capital gains are again tax-free but this time any losses may be set against capital gains or income tax.

Also, while investments are limited to 30 per cent of the equity, the investor may take a position as a paid director. There is a limit on raisings of £1 million per company per year and similar minimum holding periods (five years) and trading restrictions.

It is fair to say that the BES became a tax-dodge reminiscent of the Australian film scheme, while the EIS is not. The maximum to be raised per company appears to put a limit on professionally raised funds. The EIS seems to be firmly aimed at attracting business angels.
Lessons for Australia

High-growth companies have two difficulties — lack of access to finance and management inexperience. Indeed, that is why the intermediaries recommended by the Espie report were called management and investment companies; the MICs were to provide both management and equity finance.

Until the 1990s the major source of funding for Class III companies was the trading banks. This source is now set to decline for two reasons. First, there is the major shift in long-term savings caused by the introduction of the superannuation guarantee levy. The other is the change in risk ratings for bank loans — loans to businesses must be allocated twice as much tier-1 capital as loans for housing.

Even more unsurprisingly, central banks are attempting to use moral suasion to persuade banks to increase their lending to small businesses and moral suasion is having its usual impotent effect.

In time, the industry funds will probably provide some compensatory financing through intermediaries but, for the reasons outlined, professional private equity investment will always favour later-stage financing.

Concurrent with the increasing lack of finance has been an increasing lack of management advice. While this was never institutionalised, before the 1970s Australian brokers and merchant banks established long-term relationships with small high-growth enterprises. The models were provided by John Marks who set up Development Finance Corporation, Ian Potter with Australian United Corporation and Stamforth Ricketson with J.B. Were and Capel Court. These organisations provided finance and management expertise, either directly or by putting experienced people on the board. The objective was to nurture the small business through to listing, when significant sums were made from the underwriting and the broker commissions.

The demise of large, fixed commissions to brokers, combined with the increasing specialisation of the industry, has led to a communication gap between growth businesses and the financial services industry.

Another factor that will restrict the flow of capital to high-growth businesses is the nature of the capital gains tax regime introduced by the Labor government in 1985, followed by the secular decline in inflation. The reason is shown in Table 1. The table shows the capital gains tax rates for a 47 per cent marginal rate taxpayer on a $100 investment that is sold for $300 at some future time. It also shows the percentage tax take on the capital gain of $200 at different time periods and different rates of inflation.

As the table shows, if the sale occurs in 10 years’ time and the underlying rate of inflation is 2 per cent, then the tax take is 42 per cent. However, if the underlying inflation rate is 10 per cent, then the tax take will be 95 per cent. When the capital gains tax was introduced in 1985, the inflation rate was around 8 per cent. Now it is 2 per cent. The decline in inflation has had a dramatic effect on increasing the expected real capital gains tax rate.

The effect on investment will be even more significant. Overseas experience has shown that a real capital gains tax rate of more than 30 per cent usually eliminates the majority of private individuals as a source of capital.

An Australian EIS?

Given the above, there does appear to be a compelling argument for the introduction of some form of “angel” scheme. In time, no doubt, the market will compensate. But the major distortions to capital flows produced by the superannuation guarantee charge and indexed capital gains probably mean that some form of concessionary scheme is needed.

The new UK scheme has some attractive features, particularly the ability to write off capital losses against income tax but at the same time have some form of concessionary scheme is needed.

The other EIS feature to be emulated is to allow the investor to become a director of the company. The thrust of any new scheme should not be just to get the angel’s equity but also to get the angel’s business experience.

REFERENCES


