VENTURE CAPITAL FOR SMALL BUSINESSES IN AUSTRALIA: MYTH OR REALITY?

by

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The claim is often made that the Australian capital markets and tax system are stacked heavily against the small rapidly growing private company, particularly those in high technology industries. This claim has been supported in recent times by the fact that six small Australian computer companies have gone out of business in the past twelve months, not because of inferior technology or lack of orders, but because of lack of suitable and sufficient finance.

It is also often postulated that these deficiencies are relatively greater in Australia than in the United States, Canada, Japan or Germany.

To address this claim, the position of a hypothetical Australian company is examined considering the opportunities and problems facing it in the Australian capital market. This is then contrasted with the situation for a similar company in the U.S.A. The hypothetical company is named "High Flying Technology Pty. Limited".

High Flying exhibits many characteristics typical of small Australian companies involved in high technology industries.

- It is a private company founded and owned by an individual who has a background in high technology.
- The company was formed only five years ago but has grown rapidly.
- It employs less than 100 people and designs and manufactures a limited range of sophisticated products.
- To date finance has been provided by the founder, by way of capital, and by his trading bank, which has a charge over the assets of the company plus a general guarantee from the owner.
- The owner has found it difficult to meet the increasing cash needs of the company. This problem has been exacerbated by the company having to make dividend payments under Division 7 of the Income Tax Assessment Act.

High Flying has been successful in selling its products in Australia, but the owner recognises that it must expand into overseas markets to develop economies of scale. Such expansion requires modifications to the product, re-tooling, an overseas sales force and working capital. A total of approximately $2 million is needed. Finally, the owner recognises that such an expansion involves substantial risk as well as rewards.

The owner goes to his trading bank and is told:

- The project is unduly risky for the bank, being specialised and in sophisticated technology.
- The investment does not generate any assets which could be pledged to the bank as security, and
- The project, even if successful, will not generate cash flows for 2 to 3 years and therefore could not service interest payments currently around 20 per cent, p.a.

The company therefore has two courses open to it:

- It can continue with its existing financial resources and possibly stagnate, or
- Obtain additional risk or venture capital to allow the proposed expansion to proceed.

The problem now facing High Flying in attracting such capital from private sources is underlined by a study done by the Bureau of Industrial Economics in its Small Business Survey, 1978.

This survey showed that approximately 80 per cent of small businesses obtaining finance obtained it through loans from banks and finance companies. By contrast only 3 to 4 per cent of small firms seeking finance obtained additional equity from new partners or shareholders, (as shown in Table 1).

The enquiry into the Australian financial system, the "Campbell Enquiry", listed a number of weaknesses in the financial system regarding the ability of small businesses to raise such finance:

"Firstly, the over-conservatism or undue risk aversion on the part of lending institutions, coupled with a trend towards institutional-isation of savings and a decline in the importance of banks relative to institutions such as merchant banks and superannuation funds which traditionally do not lend for small business.

Secondly, limited market facilities for the sale of equity shares in small business, compared with the facilities available to public companies.

Thirdly, a dearth of institutions specialising in finance for newly established and innovative small businesses.

Fourthly, the limited scope for investment risks to be spread in a small market like Australia's, and

Fifthly, the discrimatory effects of Division 7 Tax, which is designed to deter high income shareholders of private companies from deferring or avoiding personal income tax".

Despite these negative factors there are sources of venture capital in Australia, successful entrepreneurs with a proven track record in management and product exploitation are able to readily attract additional equity funds through personal contacts, the

TABLE 1
SOURCES OF FINANCE FOR SMALL BUSINESS

	% of firms obtaining finance June 1976 - June 1978	
Source of Finance	*Non-Manufacturing*	*Manufacturing*
Existing shareholders/partners	31.0	35.0
New partners/shareholders (incl. institutional partners/shareholders)	4.0	3.2
Trade customers and/or trade suppliers	5.0	5.0
Commonwealth Development Bank (either direct or through a trading bank)	2.5	9.6
Trading Bank	53.8	54.6
Finance Company	33.0	26.9
Personal Loan (from a person not associated with firm)	10.5	6.5
Solicitor and/or accountant	4.3	3.2
Assurance society and/or superannuation fund	4.8	5.1
A government department or agency	0.5	3.6
Savings bank and/or building society	3.1	2.8
Stock broker and/or merchant bank	1.0	2.5
Other	3.7	4.3

(Represents the number of firms offered finance by a particular source as a percentage of the total number of firms successfully obtaining finance. Where firms obtain funds from more than one source total will exceed 100%).

Source: Bureau of Industry Economics, Small Business Survey, 1978.

"old boy network" or stockbrokers. The situation here is remininscent of the unstructured but substantial intercompany market for short term loan funds which existed in Australia until the early 1970's prior to the development of more sophisticated financial intermediation.

In addition to these informal sources of venture capital there are institutions which provide such finance as part of their normal business activities.

These include:

- Life insurance companies, finance companies and banks. Several such institutions have been involved in this activity but the involvement appears to be related to the personal interest of particular executives rather than the result of conscious corporate policy. A notable exception to this is AGC Limited which has participated in a number of significant new ventures.
- Stockbrokers and accountants. Only a few stockbrokers are active in a formal way in this area, possibly for fear of introducing clients to an unsuccessful venture. Accountants and solicitors are equally cautious though some accounting firms do provide brokerage services for acquisitions.
- Industrial companies. Large companies in Australia appear generally slow to support unproven venture capital activity by others either through joint venture or directly. There are some rare examples of course, of large companies getting involved in new activities or new technologies by investments outside their own companies, such as BHP's interest in the Sarich engine, Shell's involvement in solar research and Amatil's acquisitions in food technology. On the other hand there is no lack of interest in Australian companies in the acquisition of smaller companies that have a record of success and where the acquisition is of a business either in the acquirors line of business or in a complimentary line.
- The fourth source of private venture capital are specialised venture capital companies. In the U.S. venture capital is often provided through specialised firms, comprising a dedicated team of professionals with adequate capital backing. These firms marshall funds from various sources and invest in small, rapidly growing enterprises. Often the company specialises in particular industries such as computers or biological engineering.

  During the 1970's a number of venture capital companies were formed in Australia in an attempt to emulate this U.S. model. Of the six that this writer is aware of, all but one has either ceased business or become moribund. Their demise seems to have been the result of a number of factors, including poor management, the taxation system, lack of capitalisation and impatience.

A comparison can be made by turning to the U.S. capital market and considering the chances that "High Flying" would have in raising venture capital in that market.

According to "Venture Capital Journal", a monthly industry publication in the U.S., there are approximately 600 firms in the United States involved in the venture capital industry. Of these approximately 50 specialist firms dominate the market.

The size of this market is adequately summarised by the Harvard Business Review of January 1982 . . . "Thanks to a reduction in 1978 in the capital gains tax rates and a resurgence in the new issues segment of the stock market, such investor groups as wealthy families, insurance companies and pension funds have become interested in small business. During 1980 nearly $1 billion of new funds flowed into venture capital firms for such investment, while five years earlier less than $100 million had been available".

Another major contrast with the U.S. is the willingness of some of these venture capital companies to be involved in start up situations.

- In the U.S. equity investment is encouraged by the effective absence of double taxation on dividends received by a domestically qualified corporation. These are called Small Business Investment Companies or SBIC's, and dividends received by them are 100 per cent tax free. For other corporations 85 per cent of the payment is tax free.

  The financing of SBIC's is encouraged by government as they can borrow up to four times paid in capital from the U.S. Treasury at concessional rates of interest.
- The U.S. has a more liberal treatment of the transferability of tax losses which means that unsuccessful ventures can be sold for the value of their tax losses. Thus even an unsuccessful investment has some value.

According to a study by Harvard Business Review half of major venture capital companies said that 30 per cent or more of their investment were in start up ventures. Furthermore, 90 per cent of the firms reported that they would consider start ups. Leading the trend were eight venture capital firms that specialised in start ups and very early ventures. The study concluded ... "Never before have so many investors been interested in start up ventures, and this trend is expected to continue during 1982". Adverse economic and stockmarket factors have precluded the continuity of this trend in the first half of 1982.

The obvious question is why does such a difference exist between the two capital markets? Apart from the relative sizes of the economies a number of structural and legislative differences exist:

- In the United States there is an over-the-counter market for non-publicly listed equities which allows a venture capitalist to sell investments and generate liquidity as well as "lock in" its profit or minimise its loss.
- Both the U.S. and Canada provide impetus to technologically based companies in the form of taxation policies. For example, corporate tax is progressive, allowing small companies to retain cash for growth. No equivalent of Division 7 exists in the U.S. or Canada, which requires a private company to distribute profits rather than retain them for growth. In Canada research and development expenses are allowed a 10 per cent tax credit for the increase over the previous three years.
- In Australia the high level of tariffs for certain imports makes it extremely difficult for local companies to import components which are then used for the re-export of finished goods.

The growth and success of the U.S. venture capital market cannot be attributed solely to legislative, taxation and structural differences. There are also major philosophical differences between the U.S. venture capitalist and his Australian counter-part. The entrepreneurial spirit is much more accepted in the United States and to a less extent in Canada than it is in Australia.

The following characteristics summarise the attitude of both the U.S. venture capitalist and the user of such capital:

- expansion is more important than control
- reinvestment can lead to expansion
- risk taking is rewarding
- failure is accepted
- outside partners can contribute, and
- service the customer.

It is believed that the growth and development of small high technology businesses will benefit Australia. The venture capital market will have to become far more developed and sophisticated. To achieve this end it will be necessary to implement a number of initiatives:

- progressive taxation for small high technology businesses, so that small companies can retain cash and pay greater levels of tax when they are successful;
- the removal of anomalies in the tax system which allocate resources to certain areas of the economy (such as real estate or the film industry) and, at the same time, penalize small companies in high technology industries (such as Division 7 of the Income Tax Act);
- the development of an over the counter market for the sale of equities in small business;
- transferability of tax losses be allowed in certain instances, and
- that overseas venture capitalists be encouraged to invest in certain sectors of the Australian economy by the relaxation of Foreign Investment Review Board Regulations for such investors.

In addition there is substantial scope for governments to promote Australian technology in their procurement policies. The classic case of this failing to occur is where an Australian company recently had to establish a U.S. subsidiary before a Federal Government department was willing to acquire computer hardware from it!

Because of the ad hoc and unsophisticated nature of the venture capital market in Australia, it is particularly important for a seeker of such capital to approach it in a way which will maximise his chances of success.

Let us therefore assume that, despite all the barriers against it, our intrepid seeker of venture capital — "High Flying Technology" — has been able to identify a potential provider of funds. The approach must recognise and meet the objectives of the investor, rather than vice versa.

The investor objectives are likely to be:

- that the venture capitalist is not willing to accept an unreasonably high risk. The proposed investment must have a reasonable chance of returning 30 to 50 per cent with a payback within 10 years, otherwise it will not be considered.
- that the investor is likely to be highly selective. Citicorp, which is one of the largest SBIC's in the United States generally accepts 5 per cent or less of proposals reviewed.
- that, whilst the investor will generally leave control of the company with the present owner, the

venture capitalist may want some influence on policy decisions.

The Campbell enquiry pointed to the attitude of Australians in this respect, by saying "it has been put to the Committee that the failure of small business to obtain finance may often be ascribed to factors unrelated to deficiencies in the financial system. Such factors include a reluctance of many proprietors of small businesses to surrender or even dilute control, even where the existing equity base is inadequate".

There appears to be a strong negative attitude by the Australian sole proprietor towards dilution of his own equity for the sale of growth.

- that the investor will require a professionally produced business plan.

  The business plan must show
  (a) a high growth rate
  (b) a competent, proven management, and
  (c) a good product.

  The best mechanism for communicating ambitions, strategy and competence is through the business plan.

- that the investor will need to feel confident with the individuals concerned. Often proposals are submitted without any personal follow up. A verbal, as well as written presentation is often necessary.

It is almost certain that decisions on such venture capital investments will be taken at the very highest levels of the organisation approached. Therefore the seeker of funds should identify the decision makers and contact them, rather than have the proposal "lost in the system".

If the investor is interested it is likely one or more independent consultants may be appointed to substantiate the proposal. This will particularly be the case where sophisticated technology is involved.

Because of the time involved in reviewing and monitoring such investments it is unlikely that an investor will be willing to invest less than $500,000 to $1 million.

"High Flying" technology is, in fact, an actual case and I am pleased to report that it did manage to raise the required venture capital from a group of private investors. The company is now successfully competing in the United States and Asian markets.

The success of the example, discussed, however, should not mask the fact that the venture capital market in Australia is extremely unsophisticated and ad hoc when compared with the United States. Changes in legislation and taxation as well as investor attitudes will be necessary to provide sufficient funding of this most important sector of the economy.