

HOW TO MAKE RISK IRRESISTIBLE

INCENTIVES FOR VENTURE CAPITAL



By CHRISTOPHER GOLIS

Australia's MIC program has failed to meet high and unrealistic expectations—but that does not mean there is no better way to encourage investment in new, fast-growth companies.

IN the past nine months there has been considerable debate about how the super funds can be persuaded or forced to invest in venture capital. A \$1 billion fund proposal advanced by the federal government has been sharply rebuffed by the institutions.

One of the first problems that venture capital poses is its definition. A typical description, common in the venture-capital community, is that it is equity, or equity-related finance, in potentially high-growth, privately owned companies over a relatively long term and with continuing active involvement.

I have always regarded this definition as unsatisfactory because it does not consider what should be the overriding determinant in any investment decision—the trade-off between reward and risk.

A better definition may be that venture capital is an equity investment in which investors expect significant capital gains in return for accepting the risk that they may lose everything. The investment is typically in a privately held company or a new publicly listed company with no record of producing dividends for investors.

While this definition is true, it still does not go far enough. The significant gains for venture capital investors come from two sources. One is the organic growth of the company; the other is from managing to list the company. The process

of listing and having the company meet its forecast results brings a higher price-earnings (P/E) valuation.

As a rough rule, the following valuations may be applied to companies:

- **Private company:** one-third of All Ordinaries P/E.
- **Newly listed company:** two-thirds of All Ordinaries P/E.
- **Listed company meeting forecasts:** All Ordinaries P/E.

To list successfully, companies need institutional support. Australian institutions generally do not like to hold more than 5 per cent of a company or invest less than \$500,000. Thus a natural minimum valuation of \$10 million is needed for a company to attract institutional support. In the present environment, with the All-Ordinaries P/E on 12, this means a newly listed company requires a historical profit after tax of \$1.25 million—although a bias against smaller capitalisation companies means the required figure is even higher.

So venture capital could be redefined this way: equity investments in a private company with the expectation that the company will

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achieve after-tax profits of at least \$1 million in three-to-five years, in return for the risk that the investors may lose all their equity.

This definition does not rule out other exit mechanisms such as a merger or sale to a larger corporation. However, the listing is the king-hit and should be the goal.

A useful analogy would be the Australian cricket team. In a typical Ashes match the Australian objective is to get 600 runs in the first innings, make England follow on and win by an innings. If England does not follow on and Australia wins by only five wickets, it does not invalidate the objective; there is always the next Test. Similarly, a venture capitalist aims at a listing even though the more common exit will be a sale to a larger corporation.

Note that this definition does not incorporate "high tech", "innovative technology" or other buzzwords. One of the myths of venture capital is that it is backing inventors in garages. Nothing is further from the truth. Most start-ups, in Australia as in America, are financed by a combination of government grants and wealthy individuals. Apple, for example, was turned down by more than 30 venture capitalists because it was a start-up; the initial round of finance was provided by a private investor in Silicon Valley.

The terminology is changing. We now hear of *venture* capital being used for start-ups and *development* capital being used for the later rounds of investments.

Why bother?

Why bother to try to set up a venture-capital industry? The Espie Report in 1983 provided what is still the best analysis. The major argument is that a venture-capital industry promotes the formation of new large-scale establishments which grow and replace those being lost over the passage of time through technical innovation.

Further, overseas analysis shows that nearly all new jobs in the private sector come from new enterprises, and that these jobs are economical in the level of assets they require.

Finally, Australia's performance over the past 20 years in exporting high-value-added, elaborately transformed manufactures has been

woeful compared with that of its overseas competitors.

These reasons, provided in 1983, still stand. However, there is now a further reason: "the Clever Country". Currently Australia spends and plans to spend a considerable amount of money on research and development. A number of co-operative research centres have budgets exceeding \$100 million. All this money is wasted unless there is a venture-capital industry.

There are three common ways to commercialise an invention:

■ **Adoption by a large corporation.** By definition, large companies which are commercialising research and development (and so use the 150 per cent R&D tax deduction) will generate fewer franking credits. Large companies also prefer to buy commercialised R&D— eg, Pacific Dunlop's acquisition of Nucleus and BTR's purchase of the Borg Warner gearbox. It is rare for large companies to start outside projects and the present tax system means it would be against the wishes of many of their shareholders to do so. Australia also has the problem that there are few large corporations.

■ **Starting up a new business from scratch.** This is the most difficult task, not because of problems with the technology but because of the difficulty of finding the management skills to take the business to initial profits, especially given Australia's small market and high production costs. It is a tragedy that good technology can become tainted by a commercial failure and shunned by other parties.

■ **Adoption by a small, fast-grow-**

ing corporation: Many products have insufficient potential to support a separate business but are adequate as an extra product line. Indeed, after six years in the venture capital industry, I regard this as probably the best method of commercialisation. The managements of small, fast-growing companies tend to be dynamic and receptive to innovation. In Australia, however, these companies have limited access to equity capital. In the US, where the investment institutions allocate about 1 per cent of their portfolios to venture capital, these companies are courted and find it relatively easy to raise capital.

An adequate return?

The Australian venture-capital industry can be likened to the proposed third runway at Sydney Airport—lots of reports but it is still mainly in the mind. Indeed, at least three major reports have been produced on the venture capital industry.¹

The most recent report, produced in August 1989 by an 11-person committee which included two Management Investment Company (MIC) Board members and two MIC licence-holders, contained a justification for venture-capital investment in the form of Table 1. The table showed average returns and standard deviations of average returns and then focused solely on the returns. What is illuminating is to compare venture capital on a risk-adjusted basis with other forms of investment. Such an approach is not unusual, as it is now the preferred method of comparing the performance of superannuation

Table 1: Risk-adjusted returns (US data 1978-87)

Assett (%pa)	average returns (%)	Std. Dev. (see note)	Risk-adjusted relative performance
Venture cap. funds 3 yrs +	17.5	37.6	22.1
Venture cap. funds 6 yrs +	24.4	51.2	29.7
S & P 500	15.9	12.3	54.5
Small Stocks	20.4	18.9	59.3
Real Estate (S.D.estimated)	12.8	15.0	24.0
Treasury Bills	9.2	2.7	0.0
Long Govt. Bonds	10.5	16.2	8.0
Long Corp. Bonds	10.7	16.4	9.1

Note: Sharpe Index based on Treasury Bills x 100
ie. = (Ret. on Asset - Ret. on Treasury Bills)/(S.D. of Asset)

Table 2: Target rates of return

Stage	Description	Sales	Profits	multiple
Listed	Blue Chip	Yes	Yes	1.5
Listed	Green Chip	Yes	Yes	2
Unlisted	Development	Yes	Yes	3
Unlisted	Second Stage	Yes	No	4
Unlisted	Seed/Start-up	No	No	5

fund managers.

A common measure for risk-adjusted return would be the Sharpe index. It is possible to calculate a Sharpe index using the figures quoted in the report (except for property standard deviation, so I have used estimates based on figures provided by Jones Lang Wootton). As the figures clearly indicate, on a risk-adjusted basis venture capital is an inferior investment. So it is important for any investor in a venture-capital fund to evaluate carefully the management and track record of an individual fund and not expect an indexing approach (as implied by a fund-of-funds structure) to work.

On this data, while there is a diversification argument in favour of investing in venture capital funds, it certainly cannot be made on the grounds of risk-versus-reward. It is for this reason that the institutions will need some form of inducement to invest in venture capital.

Are there enough quality investments?

The task of an investor is to compare the risk/reward ratios for various investments. As a rough surrogate, the riskless rate for long-term investment can be regarded as the 10-year Commonwealth bond rate. Equity investments which have a higher risk should be expected to make a return which is some multiple of the bond rate. It is possible to set up Table 2 which indicates target rates of return for equity investments.

An Australian investor, for example, with bond yields at 11 per cent, would look for an annualised compound return of 16.5 per cent from Pacific Dunlop and 55 per cent from a start-up.

The start-up entrepreneur thus needs to convince investors that the business can achieve after-tax prof-

its of \$1 million in the small Australian market. If he manages to convince investors the goal is achievable in five years, and the investors agree the company will then be worth \$10 million, the entrepreneur must provide a compound return to the investors of 55 per cent.

In this example, \$750,000 would have to grow to \$6.7 million in five years: that is, the entrepreneur seeking \$750,000 would need to give up 67 per cent of the company to the investor. This explains why investment in high-growth companies which have already established themselves is preferable. It is worth comparing Australia with Japan, where the long-term bond rate is around 5 per cent. There, a start-up needs to show only a 25 per cent return to be acceptable—hence the long-term view taken in Japan towards the development of new products such as the video cassette recorder.

Another problem in Australia is the lack of understanding of how equity operates, compared with debt. One of my standard questions to budding entrepreneurs is how much of TNT does Sir Peter Abeles own? The guess is typically between 30 and 51 per cent. There is always disbelief when I announce he owns less than 1 per cent. Most budding Australian entrepreneurs do not understand that their protection comes from having a spread of investors.

The MIC mistakes

As part of financial deregulation the Labor government licensed three types of entities in the financial services industry. Two of these, the forex dealers and the trading banks, must be judged successes; the third, the MIC program, failed.

Most independent observers, and some not-so-independent, have criticised the MIC program². Some participants have suggested that

there were structural difficulties:

- changes in taxation over the life of the program;
- the requirement that MICs be companies; and
- the types of investment permitted.

I disagree. I think the problems were twofold: "agency capture" and lack of understanding of micro-economics, either at the MIC Licensing Board or at the Department of Industry, Technology and Commerce.

Any licensing agency faces the problem of building a market which may tend to support inefficient competitors. This is because licences, if the supply is restricted, will have some element of monopoly value. The original licensees argue strongly against allocating further licences and, by persistent lobbying, "capture" the licensing agency.

I remember clearly the first luncheon meeting of the original seven MICs, held in July 1984. It was straight out of Adam Smith. Within five minutes the licensees were discussing how to prevent the issue of any more licences. What they failed to realise is that in a new market it is important to have as many new members as possible who act in an educative role and expand the size of the market.

The MIC program was based—but not closely enough—on the Small Business Investment Corporation program in the US. The SBIC program started in 1958 and had an open-door licensing policy. By 1964 there were 649 licensees. The competent ones survived, although the numbers declined 248 by 1973 and rose again to 360 in 1981. The program still operates after 33 years. Any equivalent Australian scheme should be designed to enable a constant stream of new investor companies to replace those that will fail.

The criticisms of the MIC program highlight its failure to do this. The MIC Board appeared to have changed its objective from developing an industry to trying to protect the original licensees. It appeared that the number of licences had been limited to 11 and that most of the tax-free capital was being allocated to the original members. This resulted in a non-competitive, insulated air about the MICs. Only in

the final year did the board open applications, but by then the MIC program had such a poor reputation that no-one of quality bothered to apply.

A further problem for the MIC program was that its incentive, a 100 per cent tax deduction, did not appeal the Australian investment institutions, which account for about 85 per cent of the investment on the Australian stockmarket (foreign investors represent around 10 per cent and the few private investors who were still active after October 1987 around 5 per cent).

The institutions' investments in Australian equities are now driven largely by the need for franking credits. They allocate a portion of their portfolio to Australian equities and invest all the allocation in high-yielding stocks, not in fast-growth, innovative companies which by their nature will pay few franking credits in the foreseeable future.

What should the government do?

The government should emulate its success in the forex market, where it licensed 40 foreign-exchange dealers instead of the expected 10, and so caused a rapid expansion in the market.

In the venture-capital sector, it should ensure that as many funds are seed-funded as possible and then let the markets decide which funds should receive further support.

One approach might be to set up a new class of company, say a DCC (development capital company), which is licensed automatically if it has an underwriting agreement from a reputable stockbroker or bank. The amount should be for \$10 million, which should attract a 100 per cent franking credit, making the DCCs attractive to the institutions.

The DCCs should be restricted in their investments, as were the MICs. The burden of foreign debt is the major problem facing Australia and investments should lead to either exports or import substitution.

To contain the cost to revenue, the government could license, say, 10 DCCs a year on a first-come, first-served basis. The quality of entrants could be ensured by requiring a \$50,000 bond to be lodged with the DCC Board and for-

Superannuation funds should support this venture capital scheme.

feited if the share capital is not subscribed within six months of issue.

I have discussed this concept with the managers of several large super-funds. Their standard response is that such an incentive distorts the level playing field. While one could argue that development capital should not get any special benefit, this response seems hypocritical.

Governments use policies to achieve what they consider worthwhile aims. Superannuation is promoted with a low rate of tax and equity investment is now favoured with dividend imputation. The superannuation funds should support this venture-capital scheme. Otherwise, to be consistent, they should lobby for superannuation taxation to be increased from 15 per cent to 39 per cent and for other fiscal concessions to be removed.

Optimal fund size

One argument made against the above proposal is that \$10 million lacks critical mass and that a \$50-\$100 million fund is needed. I take the opposite view that creating mega-funds and maintaining a small number of players will make the situation worse.

Besides the usual criticisms of oligopolistic structures in any industry, such as management indifference, indifference to the requirements of investors and customers, featherbedding and lack of innovation, there are others peculiar to the venture-capital industry.

One is that the insufficient number of players has led to a lack of independent syndications and follow-on investors. The venture capitalist faces two critical investment questions:

- At the time of the first investment is the price too high?
- Should an investor continue with

follow-on financing?

Syndication is useful to the venture capitalist not only because of risk diversification but because it provides a method of independently pricing and testing a deal. If several contemporaries refuse for sound reasons to invest, then perhaps the deal should be reconsidered.

Again, when refinancing or the next round of investment is due, the earlier investors should look to having at least one new party in the round. If the investors cannot induce a new party to join the deal, they must reconsider and ensure they are not throwing good money after bad.

Conclusion

If a market-driven approach, as proposed, does not evolve, then we may well see a regime of compulsion, as has been introduced elsewhere. In Canada, for example, super-funds are allowed to invest outside of Canada only if they invest venture capital onshore. For every dollar invested in venture capital, they are allowed to invest \$3 overseas. This approach is gaining support both among the Canberra bureaucrats and the left wing of the ALP. In my view, it would be detrimental to the capital-allocation process.

The actions I propose do not depart much from the recommendations of the 1983 Espie Report, which remains the best report on venture capital produced in this country.

The problems with the MIC program were that the financial incentive did not attract the institutions, and "agency capture" artificially limited the size of the market. Correct these two faults and a major impetus to the Australian economy would result. □

NOTES

1. The three key reports are: *Developing High Technology Enterprises in Australia* (known as the Espie Report), Australian Academy of Technological Sciences, April 1983; *Review of Venture Capital in Australia and the MIC Program*, Bureau of Industry Economics, AGPS, 1987; *Strategy for Australian Venture Capital Industry: Facilitating the Innovation Process*, DITAC report, AGPS, August 1989.

2. See, for example: Chairman's comments, 1990 Annual Report, BT Innovation Limited; "What happened to the MICs?", *Australian Business*, 8 May 1991; TPF&C Superannuation Pooled Funds Survey, May 1991.