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FINANCING METHODS - EQUITY AND OTHER FORMS OF RISK CAPITAL

The adequacy of the supply of equity capital to small businesses has long been the subject of debate. The Bolton Report was the first formally to draw attention to this problem. (though the special difficulties of these small businesses needing to bridge the gap between private and public sources of equity finance was looked at by the Macmillan Commission just after the war) Almost 10 years after Bolton the Wilson Committee addressed itself to this among other problems in the financing of small firms. The Wilson Committee expressed concern about the lack of suitable data in this area, a difficulty which is not confined solely to the funding of small firms. In its report it gives the results of a survey of some 300 companies for the accounting year 1975. Unincorporated businesses were not covered in this analysis

Tables 8.1, 8.2, 8.3 about here

Table 8.1 is taken direct from the Wilson Report. In this form it is not easy to draw conclusions on owners capital, funding and gearing. Tables 8.2 and 8.3 are extracted from Table 8.1. One obvious conclusion from Table 8.2 is that the percentage of ordinary and preference shares is slightly larger in large companies than small. However, if we include loans from directors, owners capital, as a whole, is of much the same weight.

There are three possible reasons for the popularity of loans from directors for small businesses. First, funds invested in the business, by way of loans, are more secure than share capital, since in the event of bankruptcy they may rank for repayment even before trade creditors. Therefore, this method of funding by the owners reduces the riskiness of their investment. Second, there are possible tax advantages (see Chapter 9). Finally, there is the traditional reluctance of the small businessman to relinquish control and ownership of his company by bringing in other shareholders. Loans to directors are of course prohibited by section 330 of the Companies Act 1985 (except for loans of small amounts).

The Wilson Committee also noted that small businesses were more dependent upon the banks finance than large companies, particularly in manufacturing industry. However, until fairly recently banks have lent predominantly short-term funds and, even now, do not normally directly get involved in taking an equity stake in a business. This problem is highlighted in Table 8.3 which shows the very low long-term capital gearing ratios of small businesses compared with large companies. The gap narrows when short-term loans and bank overdrafts are included in the definition of external funds. The gap reverses when we include trade creditors in our definition. Similar results were found in a comparison of small business financing in the USA, Japan, France and Israel carried out by Tamari¹. However, because of 'demarcation' problems between short and long term loans, conclusions must be drawn with care.

More recent figures for the funding of small and medium companies are equally sparse and difficult to come by. The UK government publication MA3 does give summarised Balance Sheets and Profit and Loss (Income) Accounts from a sample of companies of different sizes. There are, however, considerable drawbacks and limitations to these figures. In particular:

1. They relate to limited companies only.

2. The sample for small companies is very limited in scope. At best there are some 360 companies only in these samples.

3. The definitions of Sizes for the groups and of Capital and Profit are not quite consistent with those in the Wilson Report. More specifically, for the 1982 MA3 figures:

<u>Size</u>	Large Companies :	Capital greater than £4.16M
	Medium Companies:	Capital between £100,000 and £4.16M
	Small Companies :	Capital less than £100,000

Capital itself is defined as:

Shares, Reserves, Minority interests, Deferred Tax, all loans and overdrafts. (This definition does tie up with the 1975 Wilson figures).

Tables 8.4, 8.5

The problems of size notwithstanding it is still possible to make some useful comparisons between the MA3 figures and those in the Wilson Report. Tables 8.4 and 8.5 set the latest (1982) figures from the 17th edition of MA3 against the figures in the Wilson Report for both 'all industries (excluding oil) and 'manufacturing industries'. A common form basis, with total assets, and total current liabilities and financing, each at 100, is used for ease of comparison.

The 'all industries (excluding oil)' figures show that both MA3 and the Wilson Report indicate that small companies have, in relation to large companies:

- smaller net tangible assets
- greater debtors
- greater bank loan, overdrafts and short term loans
- much greater creditors: the MA3 figures showing a larger gap than the 1975 Wilson figures so that the difference is increasing
- less shareholders interests - and again the difference is increasing
- less debentures, mortgages and long term loans: the 1982 MA3 figures show a clear gap; the 1975 Wilson figures are less clear because of problems in definition and the grouping of these items

The Wilson Report did not include comparable figures for large companies, as such, in manufacturing industries. Table 8.5 nevertheless does confirm, so far as it goes, that much the same differences apply when the companies in the sample are restricted solely to those in manufacturing. In particular smaller companies show smaller net tangible assets and shareholders interests, and higher debtors and creditors.

From the point of view of the use of funds it is evident that small businesses put a much higher proportion into working capital (mainly stocks and debtors) than do large businesses. They invest a correspondingly smaller proportion in net tangible assets (mainly fixed assets).

This situation finds an almost exact parallel in the supply of funds. The 1982 MA3 figures for 'all industries (excluding oil)' show that small businesses have some 15% more of their total funding from current liabilities (mainly creditors) than large. There is, of

course, a corresponding reduction in the funding from other, long term financing (mainly shareholders interests). Much the same comments apply when we restrict the firms in the analysis to the manufacturing industry only.

In this chapter we are not concerned with the disparity between the use of funds whether in fixed assets and in working capital. The UK Census of Production figures year after year confirm that the investment per employee in fixed assets rises with size of firm. Many larger firms obviously do have a high investment in plant, machinery and other fixed assets. Only large firms can produce large products such as ships, cars and machinery. To do so they do need to have massive investment in plant. Small firms tend to operate more in the service sector and such firms do not need much fixed asset investment. In saying that small firms proportionate investment in working capital is high we are merely reflecting this obvious fact. In Chapter 19, on the management of working capital, we go into the operational control of stock and debtors in small firms in some depth.

The disparity between the supply of funds through long term capital and through creditor financing as between small and large firms is, however, very much a matter to which we need to address ourselves here.

For many years now, small businesses have been the subject of much interest and research. Survey after survey has shown that when small business managers are asked to say what business problems they regard as the most important they have placed adequate long term funding very high in their list. At one time the bank manager was seen as the villain: when he did lend them money it was typically at rates of interest some 1% or so higher than for large corporations and he was often loathe to lend money even at these rates. The MA3 figures do not show any great disparity between the short term money (bank loans, overdrafts and other short term loans) supplied to small or large firms. Debenture money is supplied in slightly larger proportions to large firms but the disparity is not great. In our book, 'Small Business in Europe' we quoted extensively from the 'Economist Intelligence Units 10 nation survey of small businesses' among other sources and concluded that no longer can small businesses in the UK see themselves as inadequately funded by external bank or equity capital. So for an explanation of the greater creditor financing of small businesses than large we need to look beyond the simple explanation that if small businesses cannot get other adequate external funding it must be from creditor money. Perhaps the corresponding imbalance between shareholders interest funding of small and large businesses is the reason. Certainly we need to look at the provision of share capital to small businesses. Initially we need to consider briefly the forms and types of share capital and the institutional and other sources of supply of this capital.

SHARE CAPITAL

Any business, whatever its legal form, requires 'permanent capital' of some sort principally to finance its 'permanent assets'. However, as the scale of operations expands, sole traders and partnerships will increasingly be attracted towards the formation of a limited company, not only for the reasons outlined in Chapter 9, but also because most providers of outside finance prefer to lend to companies. This is for two reasons. First, the scope of action of the directors will be restricted by the Companies Acts in the interest of safeguarding all creditors; and second, it is a convenient vehicle for lending. It is a legal entity with unlimited life, the liability of whose shareholders is limited to the amount of capital they have subscribed.

FORMS OF SHARE CAPITAL

A limited company, whether 'private' or 'public' will normally have share capital. The amount of share capital that a company is 'authorised' to issue is set down in its Memorandum of Association. The amount of 'issued' share capital is limited to this amount, though even when shares are issued not all of them may be paid for (called 'paid up' or 'subscribed'). It is the issued share capital, whether paid up or not, that is the extent of the shareholders' liability in the event of the company going into liquidation.

There are basically two forms of share capital:

ORDINARY SHARES

These are fixed units or shares of the common fund of the company. They give the holder a proportionate interest in the dividends declared by the directors from the residual profits of the company after paying interest, taxation and any preference dividends. They also give the holder a proportionate interest in the net assets of the business - in a liquidation ordinary shareholders get what is left after all creditors and preference shareholders have been repaid in full. It used to be the practice occasionally to issue non voting shares but all shares now will normally carry with them the right to attend and vote at all meetings of the company and in theory elect the board of directors, approve the dividends proposed, approve auditors, and even the policies of the board.

PREFERENCE SHARES

These are shares that have a preferential claim on the profits and assets of a business over and above those of the ordinary shareholders. The dividend on a preference share is limited to a fixed percentage of the face-value of the share (the amount stated on the share certificate). Preference shareholders have no legal right to a dividend if the directors choose not to declare one, but they always have priority over ordinary shareholders if dividends are paid. Most preference shares are 'cumulative', which means that unpaid preference dividends must be accumulated and made good before any ordinary dividends can be paid. Preference shareholders also have priority over ordinary shareholders in the event of liquidation, but they will only be paid the face-value of their shares. Some preference shares are 'redeemable', normally at their face-value at a stated date. Others are 'convertible', which allows them to be converted into ordinary shares, normally at the shareholder's option.

There is a hybrid form of share called the 'convertible preferred ordinary share'. This carries the right to either a fixed or a variable dividend and allows a company to pay dividends on this class of share without obliging the ordinary shareholders to take a dividend which might, for tax reasons, be unattractive to them. These shares are most commonly issued to institutions such as Investors in Industry which have special dividend requirements. When converted into ordinary shares, the right to these fixed dividends is lost and the shares become the same as ordinary shares.

Preference shares are legally another form of share capital but, as can be seen they are very similar to debt or loans. However, unlike interest on loans, the fixed dividend is paid out of 'after-tax' income and therefore suffers a tax disadvantage, making it a relatively expensive form of finance. Large companies no longer issue preference shares to the public: indeed over the years existing preference shareholders have been offered debenture capital as a substitute. Some institutions such as Investors in Industry are still keen on taking up preference capital, because preference shares normally carry no voting

rights unless dividends are in arrears. Thus the institution can obtain a large equity stake without taking control of the business from the hands of the businessman. Of course, it also improves the security of their investment, compared with ordinary shares. However, while ordinary shares are riskier than preference shares, and fixed loans, they are potentially more profitable, generating dividends and capital gains.

SOURCES OF SHARE CAPITAL

The first source of any share capital will be the entrepreneur himself and perhaps a friend of his or a relative or both. If the company grows, the shareholders may think about subscribing more capital. This is an obvious first consideration for additional funds since the individuals concerned may well already be heavily committed to the company and may benefit directly from the investment through salaries, dividends or capital gains on their shares. However, there may be disadvantages. It could mean that the individuals become too tied to the company and its fortunes; if it fails, their wealth could disappear overnight. It could cause capital transfer tax problems.

The next possibility is to seek new shareholders, but since a 'private' company may not offer shares to the general public, this will probably entail approaching relatives or friends. Many of the arguments about spreading risk apply equally to family holdings. We must again bear in mind that much of this family wealth and backing is drying up - the Wilson Committee's 'Aunt Agatha is dead' problem. Also, the problem with friends is that they often don't remain friends. As Shakespeare put it in Hamlet, 'Neither a borrower nor a lender be: for loan often loses both itself and friend'. An almost inevitable consequence of getting another backer will be that he will require a seat on the board and a say in the running of the business. He may even require a director's fee, an expense account and a company car!

There are two further possibilities. The first is to sell shares directly to institutions such as venture capital institutions, merchant banks, equity subsidiaries of clearing banks, or insurance companies. These provide long-term loan and equity finance for both start-up and existing businesses. They will normally take a longer-term view than the banks themselves and will be willing to invest in riskier opportunities, if the return is sufficient. We deal with these institutions in a following section.

The other possibility is to sell shares to institutions or individuals through some form of share quotation or stock market listing. Until 1980 this was prohibitively expensive for small businesses. It was reputed to cost at least a quarter of a million pounds for a public company to make a share issue. It had to pay investigating accountants' fees, bankers' fees, underwriters' fees and advertising expenses - and this ignored the cost to the company of its own managers' time. The cost is now likely to be £300,000 or more. Although the stock exchange minimum size for a listing is a market capitalisation of £0.7 million, in practice the economic minimum is over £5 million, equivalent to pre-tax profits of over £1 million. In addition there was and still is an accounting requirement of a minimum of five years audited and unqualified accounts. Clearly, a full listing on the stock exchange has never been a serious possibility for a small business.

In November 1980 the Unlisted Securities Market (USM) was set up to allow small businesses access to a method of obtaining a share 'quotation' at relatively low cost. The cost of a USM listing has been around £180,000 for a placing, and some £220,000 for an offer for sale. There are over 350 companies on the USM now. With it came the possibility of offering either existing shares or new shares to the public or to institutions. In the USM only 10 per cent (a guideline figure only) of the company's shares needs to be made available to the public (not 25 per cent as with a full listing)

and substantial private companies wishing to raise share capital can arrange to place minority stakes with institutions such as investment trusts or pension funds for fees of around 1 per cent of the amount raised. Such institutions are unlikely to interfere in the day-to-day running of the company.

Although there has been no minimum size requirement for the USM, most companies must have had a trading record of three years and no audit qualification. A profit of around £300,000 is usually regarded as a necessary pre-requisite. The stock exchange has said that it would also be prepared to accept companies seeking finance to put fully researched projects into production - thus suggesting a limited venture capital role. Once listed, USM companies have had to sign an undertaking, which contains some 20 provisions; these are virtually identical to the standard stock exchange listing agreement, most of which are designed to enforce a minimum standard of regular disclosure of the company's affairs.

Clearly the USM has only been a real option for the larger small company. The Stock Exchange's own idea of a 'small' company is one with a capital of at least £100 million! This neither corresponds to the definitions discussed used in this book, or the conventional view held by most people. The USM has had a limited success. For some businesses however it has only served as a means by which the proprietors have tried to realise the money tied up in their firms. Many proprietors have become paper millionaires! We use the term 'paper', because the share price, and with it the value of their holding, would fall dramatically if they tried to get their money out by selling all their shares!

The USM has not been of much use for greenfield ventures or very young companies. It also has failed to stop the growth of the Over the Counter¹ (OTC) market. The Stock Exchange has been anxious to curtail the unregulated activities of part of this market for a while. In 1983 the arrival of the Business Expansion Scheme (BES) was another unwelcome factor. A company loses its BES status if it is traded on the USM, but an OTC quotation is of course still possible. For some while it had been evident that there was a need for a third tier on the investment market. In January 1987 the Stock Exchange's third market opened.

A company proposing to raise equity capital on the third market requires only one year's accounts (which must not have been qualified). No expected level of pretax profits is required. The costs of raising the issue are typically of the order of £50/100,000. However, wide variations in this cost figure do occur. No minimum percentage of equity is currently laid down for a third market company. Since tax relief is available under the Business Expansion Scheme many new investors may find this third market to their liking.

Third market shares are classified as Delta shares by the Stock Exchange. This means that on brokers TOPIC screens no market price is likely to be available for immediate dealing. For the investor it is questionable if the Third Market provides a genuine forum for trading. One of the main problems of the USM was the lack of an easily accessible market in the shares. The same problem of illiquidity is likely to haunt the investor in the Third Market. If there is no clearly available exit route the private investor must have many doubts. Institutional investors are unlikely to be much interested in the Third Market. They do not deal in small amounts of equity and they, too, like to be able to get out fairly quickly if they want to.

¹ See Appendix 1 for some estimates of the costs of an offer for sale and a placing on the OTC market.

The 1986 Financial Services Act requires that share transactions on the open market are carried out by a Recognised Investment Exchange (R.I.E). The Stock Exchange (R.I.E), has as we have noted, for a long while been concerned to curtail or regulate OTC activities so far as possible. The OTC market in the UK - unlike the corresponding OTC Market in the USA, which is both widespread and, on the whole, well run - does contain some undesirable elements. Private investors can be pushed by unscrupulous operators into buying shares they do not want, and which they then cannot sell. The aim of the Stock Exchange's Third Market is to provide a genuine market for both the company and the investor. We have already seen that there are some problems for the investor. For the company it is most important to choose the right sponsor. Around 30 to 40 brokers and members of the Stock Exchange are prepared to act as sponsors for new companies wishing to issue new shares in this market. Sponsors have heavy responsibilities connected with the issue. These include:

Assessing the suitability of the company.

Ensuring that the company complies with the advertising and other requirements for entry: one of the main savings in the costs of a floatation in the third market is that only one box advertisement in a national daily paper is required.

Arranging the issuing of a circular to the shareholders with details of directors shareholdings, options and other specified information.

Complying with the legal responsibilities required under the Financial Services Act and making other administrative arrangements.

Maintaining a file on the company.

Ensuring that the spread of ownership of the company's shares continues to be adequate to allow an effective and orderly market in them.

It is evident that for a growing small company requiring equity finance from the Third Market it is essential to 'shop around' for a suitable sponsor. The costs of a floatation, though less than those for the USM, are still substantial and may be out of reach of many medium sized small companies. For such a business, still requiring equity finance it may still be necessary and desirable to look to venture capital organisations for direct funding.

VENTURE CAPITAL

Venture capital is a term coined in the USA, but its origins are much older. In the fifteenth century Queen Isabella of Spain provided venture capital for Columbus, an investment that paid off handsomely! A century later Shakespeare provided a definition of a venture in his Merchant of Venice: 'a thing not in his power to bring to pass, but sway'd and fashion'd by the hand of heaven'. Fortunately, venture capitalists these days are more approachable than the Queen of Spain and do not demand their pound of flesh at not least in quite the same way as did Shylock! In essence, venture capital is finance for new or relatively new, high-risk, high-profit-orientated projects or companies. Banks, pension funds and investment trusts and other major financial institutions have now all set up their own specialist venture capital organisations.

The market has been dominated by the Industrial and Commercial Finance Corporation (ICFC). Formed in 1945 ICFC is now part of the Finance for Industry (FFI) group,

itself renamed more recently as Investors in Industry (3I's). Investors in Industry is owned by the clearing banks and (15%) by the Bank of England. Investors in Industry (3I's) provides small firms with both equity and loan finance and through it is prepared to lend between £5,000 and £2 million or more is really looking for growth companies that will earn profits of £100,000 or more. Typically the finance provided takes the form of a package combining equity capital with preference or medium, or long-term loan capital - always at fixed rates of interest and often convertible into equity. Investors in Industry and its subsidiaries insist on keeping a minority equity stake in the companies they invest in, arguing that to do otherwise would destroy much of the incentive and drive required for the businessmen to succeed. They rarely require a seat on the board but have a network of controllers, normally accountants or business graduates, who monitor client's performance. However, they rarely interfere with a client's business. The redemption of a loan is individually negotiable, as indeed is the particular capital structure provided for individual companies. It is their policy never to require personal guarantees from businessmen. Investors in Industry is willing to consider all high-risk ventures, including start-ups. It is often willing to make a further investment, and is fairly flexible about realising its investment. Indeed, it has been noted that Investors in Industry-support companies often have higher than average gearing. Investors in Industry has about 20 offices, and in addition to loan and equity backing can provide leasing and hire purchase, sale and leaseback, and corporate advisory services.

Investors in Industry has one subsidiary, Technical Development Capital, which specialises in providing capital for new or recently established firms engaged in developing entirely new products. Investors in Industry also manages the Estate Duties Investment Trust, which is a listed public company, whose sole function is to purchase minority stakes in unlisted companies to enable shareholders to raise sufficient cash to meet tax and other personal liabilities without having to relinquish control of their company.

The British Technology Group (BTG) is another similar organisation, formed in 1981 by the merger of the National Research and Development Corporation and the National Enterprise Board. It has the aim of providing finance for innovative investment. Rather than provide start-up capital, it has often encouraged independent innovators to have their ideas accepted for development and exploitation by some larger organisation which has the necessary resources. Not all innovators are happy with this sort of arrangement. However, assistance can often be given as joint venture finance, with repayment by a royalty of sales, and this does not threaten an entrepreneur's independence. About half the companies in which BTG has invested have been small businesses within our meaning of the term.

PRIVATE SECTOR VENTURE CAPITAL INSTITUTIONS

If the costs of a third market quotation are too high or a suitable sponsor cannot be found, the small businessman requiring equity finance will probably look first to Investors in Industry or one of its offshoots. If, for some reason, this, too, is not satisfactory he will need to look at private sector institutions.

Merchant banks have been the traditional suppliers of equity capital. They tend to provide funds for larger private companies: A loan of £200,000 is a common minimum. However, they do provide short-, medium- and long-term finance as well as invoice-discounting services and they do have stakes in a number of venture capital institutions. They will handle a private placing of shares to a select number of institutional investors.

However, the costs are fairly high and there are many disadvantages in having no issued share capital available to the public.

Insurance companies are a useful source of funds for some sole traders and partnerships. They provide mortgages (loans secured against property), often linked to endowment policies, secured on the lives of the younger partners or directors. Usually such loans are not renewable, and premiums, unlike interest payments, are not tax-deductible and can therefore prove expensive.

All these institutions are really looking for is a return of 25 per cent or more and an exit route that allows them to get out in some 5 years or so. Their investment - as they see it - is an investment in management.

All the major clearing banks supply venture capital to growing companies either directly or through some of their many financial subsidiaries. The packages that are offered are wide ranging and flexible. Sometimes the main funding is through a 'capital loan'. Typically loans under such a scheme are available for sums between about £25,000 and £250,000. These loans rank only in front of the shareholders/directors interests. They do not normally require security. The package includes an option for the bank to subscribe for shares in the small business. This option is always for a minority of the shares (usually less than 25%), leaving control of the company firmly in the hands of the proprietor. The option arrangements include provisions for the bank to protect its position as a potential shareholder. Typical provisions provide that:

- (i) There will be no changes in the capital structure of the company without the bank's agreement.
- (ii) Transfer of shares in the company will be restricted.
- (iii) The bank will have the right to appoint a director to the board of the company (this right is not usually exercised).
- (iv) Minimum dividends will be paid on the company's ordinary shares under certain conditions.
- (v) The company will furnish such information as to its affairs as the bank requires.

The bank will maintain a relatively close relationship with the company. For a fee of around 1% of the capital loan it will provide guidance in preparing monthly accounts and financial plans and projections. The bank visits the business regularly and generally takes a much more active part in the affairs of the company than it would do if the funding were solely by way of a traditional medium or long term loan.

Many private sector, non institutional, providers of equity finance (such as Equity Capital for Industry) also now exist. Their aim is capital growth. They invest up to around 45% in the equity of the business. They are even more highly involved in the management of the business. This does not mean a day by day interference in management decisions, but does imply a very positive contribution to the development of business strategy, and to medium and long term financial planning.

These private venture capital providers have the management expertise and the financial resources required to back a young business requiring its first round of equity capital. Their skills are based on the commercial and industrial background of their investment

managers gained from experience in this specialist area of finance. They form close relationships with the management of the companies they back, and are prepared to commit considerable time and effort in helping to resolve the organisational and administrative problems that inevitably occur in an expanding small business.

These venture capital providers do not work on predetermined standard packages for their clients. Each package is tailored to each individual proposal. Within the organisation's own aims of achieving a satisfactory return on capital for the perceived risk, small business proprietors and managers personal objectives will be met as far as possible.

As a minority investor in an unlisted company the venture capital provider will require the inclusion of certain standard protection provisions either in the companies articles of association or in the form of a written shareholders agreement. Sometimes board representation for a member of the venture capital providers team, or, if more appropriate, through an independent, but mutually agreed, appointee, will be required. The aim of this representation is more to assist in helping constructively in long range planning and with major investment decisions than to act as a financial 'watchdog'.

Venture capital providers have developed recently considerable skills in arranging and financing management 'buy-outs'. A buy out can give management the opportunity to acquire a significant stake in their own business on realistic terms.

It is evident that there are now many providers of equity capital. Indeed the provision of venture capital is expanding rapidly, particularly since the introduction of the business start-up scheme. It is probably true to say that a suitable project should have no problems finding venture capital backers if it can support the costs of servicing that capital. There are now so many potential backers that a financing package to suit most entrepreneurs can be found if only the trouble is taken to find the right one.

APPENDIX FOR THE ENTREPRENEUR ON THE PRACTICAL PROBLEMS OF CHOOSING AND LIVING WITH AN INSTITUTION

We have already talked about the problems of using individuals as sources of finance for the business. However, there are problems in choosing and living with institutions. Which businessman would choose to have only one, exclusive supplier of some vitally important component? Finance is just another, vitally important, component to your business, and if your supplier has problems, whether of his own making or not, he may pass them on to you. The depression of the early 1970s brought this problem home to a number of companies as banks started to decrease the facilities they offered to customers. The moral is to have a diversified range of funding from different institutions.

Some businessmen may have difficulty in finding any backers at all and they will have to approach a number of institutions to obtain any kind of offer. However, with a property presented case, you ought to be able to shop around and find a 'best buy' to suit your own requirements. Not only do interest rates vary from institution to institution, but so also do lending characteristics. Some institutions have definite policies about how long they wish to be involved with a business. Not all offer equity finance, and those that do have different policies about director representation and intervention. The moral is clear: always shop around.

As we detailed in Chapter 4, the financing requirements of 'stable' and 'growth' (or 'big bang') small businesses, are likely to be very different. The 'stable' small business will

have limited funding requirements, and may never need to seek extra equity or venture capital funds. It will tend to be the 'growth' small businesses that require equity and venture capital funds, and it may be wise for these businesses to approach venture capital institutions at the start-up stage, if the project size warrants it, and build up a good working relationship with them over the years. It is important to remember that, other than for straight loans, long-term venture capital packages can be complicated and difficult to unwind; it is therefore important to choose an institution and a package that you can live with over many years. This involves being clear in your own mind what are your own, personal, objectives and what are the objectives of the venture capitalist - and making sure that the two do not conflict.

You may have strong feelings about sharing ownership and control of your business, in which case it may be wise to promote a venture capital package that involves preference shares. If you wish to regain control of your company at a later date, you may wish to repurchase any shares that you now issue. You could issue redeemable preference shares or come to an agreement over the repurchase of ordinary shares. Often businessmen will not have the personal funds to repurchase shares, but the 1985 Companies Act does allow a company to repurchase its own shares in certain circumstances. If you feel strongly on this point, you will be attracted towards institutions that do not require board representation.

It is well to consider the objectives of the venture capital institutions. They will be interested in generating income from their investment by way of dividends or interest and, over the long run, through capital gains. But will the venture capital institution take dividends or interest, and when will these be paid? Although the venture capitalist may require dividends, it could be in your interest not to take them, because of tax problems. Indeed, it may not be in the interest of the company to pay dividends or interest in its early years. A flexible financing package involving equity and deferred interest terms or convertible loans might be the answer.

How will the venture capital institution realise its capital gain, and over what period? This is a major problem for the venture capitalist, since it may take some time before a company can obtain a quotation, even on the USM or third market. If the institution is not willing to make this long-term commitment, it may be tempted to promote a merger with a larger company once the small business 'takes off'.

Since you will have to live with a venture capitalist for some time, the track record of the institution and the people you deal with are important considerations. The range of additional services that the institution provides might also be important to you. However, there are two sides to any relationship, and you would be well advised to keep the institution informed of the company's progress and problems even beyond the bounds of their written requirements from you. Send them regular financial statements. Meet them regularly to discuss your plans, particularly financing plans. If your business faces problems, let them know.

PRESENTING ONE'S CASE FOR VENTURE CAPITAL

In Chapter 6 we discussed the practicalities on the preparation and presentation of a case to a bank manager for overdraft facilities or short-term loans. Much more is expected in presenting a case for long-term capital or equity finance. Your backer must satisfy himself that you have the qualities to make your business succeed in the long run. The more complex the funding proposal, the more detailed the information the institutions will require. As we noted, the institution will not only be interested in the back-up documentation supporting your case, but more crucially it will assess your personal

qualities, based upon your own track record, and on how you actually present your case to them.

DOCUMENTATION

A FULL 'BUSINESS PLAN'. This is always a complex, lengthy document. We develop the accounting skills required to draw up the financial side of the plan in subsequent chapters. It involves undertaking a 'position audit' and translating this into a plan of action for your business. This means of course giving details of your company, its products and management, details of your industry, the competition and business risks you face. It involves translating market research into a marketing plan and a manufacturing plan, and bringing this all together into a financial plan which includes projected profit-and-loss accounts, balance-sheets and cash-flow statements. This should demonstrate that your venture is worth while, while also indicating the amount of financial backing required. In particular the venture capital backer will be interested in:

- **RECENTLY AUDITED ACCOUNTS**, if available. This adds credibility to your case. A backer will think very badly of a business which does not have up-to-date accounts; it is a sign of poor financial control and inadequate auditing. Backers will require to see up-to-date monthly management accounts, if available.
- **STATEMENT OF ORDERS ON HAND**. Again this adds credibility to your case. Comparisons with past years would be useful.
- **DETAILS OF PATENTS**, etc. This will demonstrate the extent to which the project is protected from attempts by competitors to copy the product.
- **NAME OF ACCOUNTANTS, SOLICITORS, BANKERS** involved with the business. Perhaps your business will already have demonstrated its ability to repay loans. All this adds to the credibility of your proposal.

PERSONAL QUALITIES

There is no question but that the most important factor in the mind of a potential backer is the quality of the management of a business, and for most small businesses this means the qualities of one person. Venture capitalists are looking for motivation and enthusiasm, ability and integrity.

To manage a growth business successfully requires a genuine desire to succeed, amounting almost to a need. It is not enough simply to be frustrated at your present workplace, or threatened with redundancy. You must want to be the cause of success. Success in a growing business is obtained through the efforts of others, and you must therefore be able to motivate and lead. You must be willing to take risks - but only moderate risks that you believe you can overcome. The technical development engineer who has a good product idea but really only wants to build and modify prototypes and is not interested in production and selling will not get venture capital backing without first teaming up with an individual with the other qualities necessary for success. Enthusiasm and drive must, however, be tinged with a strong sense of realism in taking a market view of the business and its potential. Arnold Weinstock once said that all successful companies are run by people who understand the market.

Ability is important, and can be demonstrated to a potential backer through your past experience. Technical ability, along with patents and your own know-how, will protect

the project from attempts by competitors to copy it. Management ability will help with the implementation of your plans. However, no single person can have all the managerial skills and qualities required, and it is essential to take a realistic view of your own personal weaknesses, and where possible compensate for them.

The presentation of your business plan will serve as a vehicle for demonstrating these qualities and convincing your potential backers of your competence. First impressions are important, but demonstrated knowledge of the key area in your business plan will go a long way towards generating the confidence that institutions need to have before lending money.

Finally, two points to bear in mind. First, institutional investors face many of the same pressures as bank managers, and therefore it is usually better to seek more funds than immediate circumstances call for. Good projections are, of course, essential. While it will be disastrous to underestimate capital requirements, it can be expensive to overestimate them. It is often possible to arrange to 'call down' (use up) finance, as you require it, rather than be given it all at once, thus catering for contingencies while avoiding paying for unnecessary finance.

Second, the processing of applications for large amounts of money takes time: not because the institutions are necessarily bureaucratic, but because they need time to investigate your plan and to go through the same thought process as you have to. Long-term financial needs have to be planned well in advance. Institutions will not be happy with urgent requests for funds.

NOTES

- (1) **Smaller Companies :** Capital Employed less than £250,000
- Medium Small : Capital Employed £250,000 and over up to about £4M
- (2) **Capital Employed is:** Total capital and reserves and minority shareholders interests plus deferred tax plus bank loans and overdrafts, long term and short term loans plus net amount due to other group members
- (3) **Large Companies used for comparison purposes here are:** 'Large listed and unlisted companies in manufacturing distribution and certain other services'. Their data were taken from Business Monitor, Company Finance, for the same year.

REFERENCES

1. M. Tamari, 'The Financial Structure of the Small Firm - An International Comparison of Corporate Accounting in the USA, France, the UK, Israel and Japan', American Journal of Small Businesses, Vol. IV, No.4, Spring 1980

Appendix 1 Over The Counter (OTC) Floatations

Rough estimate of minimum capital and cost are as follows:

	<u>Offer for Sale</u>	<u>Placing</u>
Minimum capital offer	£300,000	£200,000
Cost	£180,000	£40,000