

Improving SME access to equity finance

The UK economy is emerging from a severe downturn, into a credit-constrained world in which what were once its key industries may no longer be able to drive growth.¹ It is expected to rely heavily on innovative start-ups and small businesses, many of them financed by equity, to build new world-beating industries.² As bank lending recedes to more appropriate levels and uses, a great deal of equity investment that may have previously been crowded out by risk-loving banks could now resurface. The Rowlands Growth Capital Review, recently announced by the Department for Business, Innovation and Skills (BIS), is a timely response to this new environment and appropriately encompasses equity finance. Yet it may still be too narrow in scope to address the SME sector's real needs.³

In 2007, only about 2% of small and medium-sized enterprises (SMEs) were using equity finance – down from 7% in 2004.⁴ Four in five (80%) would not even consider it as an option. A minority (20%) were aware of local Venture Capital Funds (VCFs) and even fewer (13%) were aware of support programmes to help them attract equity investment.⁵ Worse still, the UK is one of a handful of EU countries where the number of business angel networks is in decline.⁶

ACCOUNTING FOR EQUITY

Accountants have an important role to play in improving access to equity finance by providing a service on both the supply and demand side. As the most trusted financial advisers to SMEs⁷, accountants are uniquely placed to provide insights into the financial situation and prospects of small businesses. Accountants are also in an excellent position to develop the investment-readiness of such businesses, making them more attractive to equity investors.

Survey evidence suggests that SMEs taking advice from accountants are more likely to be aware of local Venture Capital Funds (VCFs) and that SMEs with financially qualified managers have higher overall awareness of sources of equity finance and support programmes for those seeking equity finance.⁸ However, the number of referrals equity investors receive from accountants is still low, as

¹ ACCA Global Economic Conditions Survey, Q2 2009

² See for instance the Government's view in BIS, "New Industry, New Jobs" April 2009.

³ A simple estimate, based on the BIS 2007 Survey of SME Finances, suggests that the current terms of reference of the Rowlands Review will be relevant to between 1% and 12% of the stock of SMEs. This estimate includes established (>3 yrs old), cash-positive and consistently profitable businesses with expectations of moderate or substantial growth (these correspond to 12% and 1% coverage of the stock of SMEs respectively).

⁴ A. Cosh, A. Hughes, A. Bullock and I. Milner, "Financing UK Small and Medium Sized Enterprises – the 2007 Survey" Centre for Business Research, August 2008.

⁵ BIS 2007 Survey of SME Finances, reported in Cosh et. al., op. cit.

⁶ C. Mason (2009) "Public policy support for the informal venture capital market in Europe: A critical review" *International Small Business Journal* v. 27

⁷ BIS, op. cit.

⁸ Cosh et al, op. cit.

are conversion rates.⁹ Developing these professionals from providers of information to active intermediaries would go a long way towards establishing equity as a viable option for financing SMEs. Facilitating the due diligence process in particular is a crucial opportunity for accountants to add value. There is evidence that careful due diligence increases investor returns¹⁰ and that information in financial statements is relevant to potential investors, varying in its usefulness depending on the nature and maturity of the business.¹¹

TARGETING GOVERNMENT SUPPORT

As with all government support, interventions in the market for equity finance need to be focused on areas of market failure. A substantial gap in equity funding exists around the £50,000 - £2,000,000 band. The government aims to address part of this through regional Enterprise Capital Funds (ECFs).¹² However, the lower end of this range is more properly the domain of individual and ad-hoc business angels;¹³ for the rest, investment has to come from organised angel groups that can also partner with larger private or public funds in order to identify bigger investment opportunities under co-investment schemes.¹⁴ In both cases, government policy should focus on encouraging and leveraging angel investment where possible.

Although it is important to restrict government intervention to areas of market failure, it is equally important that the government avoid self-defeating, narrow definitions of the investors, the users and the objectives involved in equity finance.

- **Investors.** Because most of the supply of equity finance rarely registers formally or goes by a convenient catch-all term, well-designed policies should aim to acknowledge and encourage a wide range of investors. For instance, small business owners and serial entrepreneurs, certain corporations and even some business recovery specialists are all potential sources of equity finance.
- **Users.** The government should be decisive in targeting a wider range of potential users of equity finance than the 2% of SMEs currently financed in this way. The difference between latent and active demand for equity finance among SMEs is substantial. Over ten times more SMEs admit that they would consider equity finance than actually use it; even more might find it to be well suited to their needs with appropriate advice, as the leading reasons for not seeking equity investment are unwillingness to lose control of the business (35%) and the conviction that the business does not need additional finance (31%).¹⁵ Owner-managers who appreciate

⁹ C. Mason, and R.T. Harrison, 'Developing Time Series Data on the Size and Scope of the UK Business Angel Market', BIS, May 2008.

¹⁰ R.E. Wiltbank, 'Siding with the angels' NESTA Research Report, May 2009. Wiltbank found that doing 20 or more hours of due diligence reduced the chances of an angel investor making a loss by a third.

¹¹ E. L. Black, "Financial statement components in valuation" *Venture Capital*, 2003, Vol. 5, no. 1 pp. 47-69. Black shows that earnings do not offer incremental value over operating cash flow in valuing start-ups, whereas they do in the case of growth or mature businesses.

¹² BIS, "New Industry, New Jobs" April 2009. Technically, "New Industry, New Jobs" acknowledges a gap in the £250k–£2m band, and Prof. Mason's testimony suggested a gap at the "£50k to, at most £3m" level.

¹³ R.E. Wiltbank, *op.cit.* The clear majority (90%) of individual angel investments were for less than £100,000.

¹⁴ S. Sharpe, A. Cosh, D. Connell, H. Parnell, "Start-up finance: The role of Micro Funds in the financing of new technology-based firms" NESTA, May 2009

¹⁵ BIS 2007 Survey of SME Finances, reported in Cosh et. al., *op. cit.*

the expertise and shared responsibility that equity investors bring, and who are able to plan medium-term equity investments into the life-cycle of their business, are much more likely to benefit from such sources of finance.

- **Objectives.** Much of the assistance already available from governments, both in the UK and abroad, is focused on narrow definitions of business growth, skewed towards employment and/or turnover growth. These are important criteria, but whether and how they relate to value creation is best left to investors themselves, not government, to decide.

ENCOURAGING ANGEL INVESTMENT

Angel investment suffered in the aftermath of the dotcom crash at the start of the decade. It could do so again in the current environment, which has increased the need for multiple rounds of funding and promises few exit opportunities.¹⁶ This is an environment that not all angel investors have the skills or the appetite for, and one in which the supportive function of angel networks becomes paramount. Research suggests that the following measures could help reverse the observed decline:

- **Tax Incentives:** The best estimates available suggest that, despite substantial average returns, around one quarter of all angel investment deals may not have taken place in the absence of Government incentives such as the Enterprise Investment Scheme (EIS).¹⁷ Even EIS is restricted to individual, standalone investments in ordinary shares, which severely limits its potential.¹⁸ The French experience shows that it is possible to offer extensive tax incentives without contravening EU State Aid rules.¹⁹ Encouraging higher levels of investment per individual could in fact allow investors to diversify further, thus reducing the overall risk involved.
- **Support for Networks:** Networks offer invaluable services to business angels in identifying investment-ready businesses and performing due diligence, which in turn increases expected returns.²⁰ It will be important to further examine support for networks in the form of capacity building for would-be investors and “gate-keepers” as well as subsidised administration. Unlike previous support schemes for equity investment, the resources made available will need to be sustained and consistent despite any changes in the machinery of government.
- **Developing investment-readiness:** Angel investors are constrained primarily by the lack of opportunities rather than by the lack of funds.²¹ Helping SMEs understand the benefits of equity and how to better signal their value to potential investors is therefore a crucial area of need. Investment readiness is about much more than preparing a business plan and can encompass

¹⁶ C. Mason, “Business Angels and the Financing of the Entrepreneurial Economy in the Financial Crisis” Presentation to the ACCA SME Committee, June 2009.

¹⁷ R.E. Wiltbank, op.cit.

¹⁸ See e.g. the BBAA response to HM Treasury consultation on the Enterprise Investment Scheme, June 2008.

¹⁹ EC State Aid Register no. N596a/2007, “Investissement dans les PME” March 2008. France has overcome the State Aid hurdle by offering relief from the French solidarity wealth tax to investors injecting equity into SMEs anywhere in the EU. Because such investment is rarely conducted across borders, this effectively remains a nationally focused scheme.

²⁰ R.E. Wiltbank, op.cit.

²¹ C. Mason (2009) “Public policy support for the informal venture capital market in Europe: A critical review” *International Small Business Journal* v. 27

management team skills and governance arrangements, the definition of business opportunities, the business model and routes to market, as well as presentation skills. Training for trusted intermediaries such as accountants could further enhance the investment-readiness of SMEs.²²

- **Developing exit routes:** Crucial to increasing the supply of equity finance is the availability of exit routes – whether by trade sale or public offering.²³ While improving the attractiveness of public listings is to some extent a matter of cost²⁴ and market infrastructure, both these and trade sales should also be facilitated by improving the ability of businesses to achieve a fair valuation. A number of interventions, such as better accounting for intangibles²⁵ or VC and business angel co-investment²⁶, could contribute to this. The incentives provided by the 18% rate of capital gains tax should also be closely considered.

IMPROVING POLICY THROUGH RESEARCH

The demand for, and flows of, SME equity finance are very hard to monitor. Top-down surveys of SMEs are frustrated by the very small number of equity-financed businesses.²⁷ High net worth individuals involved in angel finance tend to guard their anonymity, or at least prefer the privacy afforded to them by angel networks.²⁸ Friend and family finance is even harder to trace. Consequently, we are concerned that government simply does not have enough reliable information to inform policy in this area. In the case of angel investment, mapping and monitoring the geographical spread of business angels should be a priority, given their tendency to invest close to home.²⁹ Although the Rowlands Review has been given insufficient time to conduct primary research or even a thorough review of existing data, we hope that the need for further research on this matter will be highlighted among its recommendations.

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²² Ibid.

²³ T. McKaskill, K. M. Weaver and P. Dickson, "Developing an exit readiness index: a research note" *Venture Capital*, April-September 2004, Vol. 6, No. 2/3 pp. 173–179.

²⁴ B. Burton, C. Helliard and D. Power, "A behavioural finance perspective on IPOs and SEOs" ACCA, 2003.

²⁵ C. Martin and J. Hartley, "SME intangible assets" ACCA, 2006.

²⁶ S. Chahine, I. Filatotchev and M. Right, "Venture Capitalists, Business Angels, and Performance of Entrepreneurial IPOs in the UK and France" Working Paper, Centre for Management Buy-Out Research, May 2006. The interaction of VC and business angel investment was found to substantially reduce the level of under-valuation of IPOs.

²⁷ For instance, the sample for the authoritative BIS 2007 Survey of SME Finances contains so few SMEs using equity finance that no further breakdown of this category was statistically possible.

²⁸ C. Mason and R.T. Harrison, 'Developing Time Series Data on the Size and Scope of the UK Business Angel Market', BIS, May 2008.

²⁹ R.E. Wiltbank, op.cit.

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