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Informal Equity Capital for SMEs: A Review of Literature

Prepared for Industry Canada
by
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March 2000

Research Paper prepared for the Small Business Policy Branch as part of the Small and Medium-Sized Enterprise (SME) Financing Data Initiative

Canada

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Cat. No. Iu188-27/2006E-PDF
ISBN 0-662-43188-X
53228E

Aussi offert en français sous le titre *Capitaux propres informels et PME : Analyse documentaire*.

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OBJECTIVE

This report reviews the public literature regarding the supply of, and demand for, early stage equity from private (informal) investors. This work is intended to help inform the development of Industry Canada's plans for its Canadian field research on risk capital financing of SMEs in Canada. The particular study objectives are to review existing literature with a view to:

(a) informing the development of Canadian public policy as it relates to enhancing access to risk capital by SMEs;

(b) determining the role played by informal and corporate angel investors during the start-up and growth stages of SMEs and to identify barriers informal investors face when investing; and,

(c) mapping SME owners' usage and perceptions of equity financing.

SCOPE OF THE WORK

The contribution of small and medium scale enterprises (SMEs) to a nation's economy has been well documented. SMEs have been described as efficient and prolific job creators[1], the seeds of big businesses, the fuel of national economic engines[2], etc. However, an important problem that SMEs often face is access to capital. This challenge is particularly acute for firms with prospects of high growth. Such firms are especially important from a policy perspective: high growth firms, the so-called "gazelles", comprise a small proportion of new businesses, yet they account for most new job creation.

To enable growth firms to achieve their full potential, a variety of public and private sector initiatives have been undertaken to facilitate access to capital. Recently, attention is increasingly focused on the informal venture capital market. Informal investors (also known as private investors or business angels) are individuals who invest personal funds at arm's length in businesses owned by third parties. At the early stages of business formation, private investment is the single most important source of external risk capital for small businesses. Such investment also tends to be accompanied by the talents, interest, experience, and contacts of the investor(s). This paper reviews the research literature on this subject with a particular interest in the Canadian context. It also considers policy implications and identifies areas where further research would be needed.

This literature review includes, to the (limited!) extent the available literature permits, available published and un-published documents (including reports of studies where the studies

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[1] White, M. (then Governor of Texas) Small Business Administration Program Review, Pt. 3: hearings, 99th Congress, 1st session, 1985. United States Congress. House Committee on Small Business. Washington, D.C., USGPO. 1986 p. 404.

[2] Lader (1996).

themselves may not be available) about SMEs' usage and perception of equity financing in Canada. The findings of the literature review are presented in a framework organized according to the following key themes:

(a) The impact of informal investments on SMEs performance;

(b) The factors that encourage (or discourage) SMEs to secure informal investments;

(c) The perception of informal investments among the SME community;

(d) The state of readiness of SMEs to secure informal investments;

(e) The opportunities that government might have to improve the access to informal investments by SMEs

(f) recent empirical and theoretical analysis on SMEs' usage and perception of equity financing as defined above.

In addition, the report includes an analysis of the perceived gaps in the existing literature.

FINDINGS OF THE LITERATURE REVIEW

To set the context for informal investment, it is useful to situate it within the scheme of alternative sources of equity capital.

EXTERNAL SOURCES OF EQUITY

The three (3) sources of external equity typically available to small firms are:

- the public equity market - through an initial public offering (IPO);
- the professional venture capital market; and,
- the informal risk capital market .

The Public Equity Market

The first ever entry of a firm unto the public equity market is through an initial public offering (IPO). IPOs present firms the opportunity to raise risk capital, typically in amounts in excess of $10 million.[3] For most small firms, however, this is not a realistic option and the amount of capital necessary to justify an IPO far exceeds immediate needs. In addition, few SMEs satisfy the listing requirements of most stock exchanges. Moreover, the high costs involved in the process - complying with securities regulations, hiring professionals, etc - render this option unreasonable for most small firms. Even if they could afford it, the high costs would not be justified by the relatively small amounts businesses often seek at the early stages of their life cycles.

Professional Venture Capital Market

Venture capital, considered as "the early-stage financing of relatively small, rapidly growing companies"[4] presents a more realistic option for growth-oriented firms. The venture capital market has been experiencing rapid growth in recent years in both the US and Canada.

According to the US Small Business Administration ("The Process and Analysis Behind ACE-NET" (www.sba.gov)), the amount of capital under management by US venture capital funds increased from US$4.5b in 1980 to US$44b in 1995. Average venture capital fund size also increased from US$46m in 1987 to US$80m in 1995. Ordinarily, growth of the pool of venture capital would have been viewed as good news for the US SME sector. However, the SBA has suggested that the organized venture capital industry may have become a victim of its own

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[3] Noteworthy exceptions to this situation are the SCOR (Small Corporate Offering Registration) program in the US and, in Canada, the JCP (Junior Capital Pools, once available through the former Alberta Stock Exchange and now available as CPCs, Capital Pool Companies, on the new Canadian Venture Exchange, CDNX). These programs provide, at least notionally, the ability to raise relatively small quantities of equity capital directly from a public solicitation.

[4] Pratt, Stanley (1982) in Sahu (1987).

success. With the rapid growth in the amount of available funds, the average value of individual investments has also experienced a rapid growth. According to the SBA, large funds now prefer to invest not less than US$10m in any given venture capital partnership and prefer to represent less than 10% of that partnership capital. The 10/10 rule tends to drive venture capital funds to the US$100m+ range, beyond the needs of most SMEs. The SBA report indicates that venture capitalists rarely fund deals of less than US$3m to US$4m.

The funds argue that it costs them virtually as much to perform due diligence analysis on a small investment opportunity as it does on a large one. They therefore find it more cost efficient to concentrate on the larger opportunities. Hence, in the US context, and in spite of the appreciable increase in the total value of investments, the volume has not experienced significant growth. Another reason why US venture capital funds are shifting towards bigger and later-stage firms is that those firms have the collateral and the reputation (track record) to mitigate the negative effects of adverse selection and moral hazard. The cumulative effect is that for many US small firms, obtaining risk capital remains a problem in spite of the rapid growth of the venture capital industry.

In Canada, the amount of capital under management by Canadian venture capital firms has also grown substantially. In 1980, the industry managed a total of $400 million. By 1985, institutional venture capital companies managed $1.4 billion. This had grown to almost $3 billion by 1990, $6 billion by 1995, and now exceeds $10 billion (Macdonald and Associates, 1996; Amit et al., 1998; various annual reports of the Canadian Venture Capital Association, www.cvca.ca). Virtually all of this growth in capital has derived from the expansion and proliferation of Labour Sponsored Venture Capital Companies. This has been a mixed blessing. On the one hand, the expansion of the industry has increased the availability of risk capital. On the other hand, concerns have been expressed that labour sponsored funds have been crowding out private independent suppliers of capital and that the supply of tax-incented capital has driven down returns in the industry, limiting the further involvement of pension funds, mutual funds, and other institutional sources.

The Canadian industry still tends to invest in smaller amounts than in the US (CVCA, various years); however, most firms prefer investments of at least $1 million. Moreover, the majority of Canadian venture capital is invested in expansion-stage deals (or beyond) and in technology-based firms. A minority of investments is directed to seed and start-up stage investments (CVCA, various years).[5] Anecdotal reports place the turndown rate of applications for venture capital at more than 97 percent.

Typically, private investors provide smaller amounts of capital for seed and early stage firms. This marketplace for informal capital is the central topic of this report.

[5] Recent anecdotal evidence suggests that several new funds are being established that will seek to invest at earlier stages.

THE INFORMAL VENTURE CAPITAL MARKETPLACE

Due to the challenges many SMEs face in obtaining risk capital from the public equity market and the formal venture capital market, attention is increasingly being focused on the informal venture capital market. Business angels (also known as angel investors, informal investors, and private investors) are increasingly making a strong impact both in terms of value and volume of investment. Typically, these investments are in sectors and stages that are complimentary to those in which institutional venture capital firms focus and are particularly important for start-ups and early-stage firms (Freear and Wetzel, 1988).

The informal venture capital market comprises individuals who provide risk capital directly to new and growing businesses with which they had no previous relationship. In the US, this market has been identified as the single most important source of risk capital for SMEs.[6] Data for the importance of the informal market in the Canadian context are scarce. In a pilot study conducted within the Ottawa-Carleton Region, Riding & Short (1987a) confirm that the informal venture capital market plays an important role in Canada and estimate that active informal investors comprise approximately 0.05 percent of the population of the Ottawa-Carleton Region. Extrapolation of these nationally suggests an investment rate of informal capital of the order of $1 to 2 billion annually.

More recently, Farrell (1999) estimated that one in five owners of new businesses in the Atlantic Region had also made arm's-length private investments in other businesses. Farrell also found that almost 15 percent of the 310 business owners she surveyed reported receiving some form of informal investment, capital contributed at arm's length by someone other than the original owner.[7] She estimates the rate of private investment in the Atlantic provinces at $85 million annually. Extrapolation of Farrell's results to the 952,000 Canadian employer businesses suggests an annual rate of investment of approximately $20 billion annually.

Suret and his colleagues (1995), in their study of private investment in Quebec, confirm the importance of private investment stating:

> *"Based on the most realistic hypotheses and an inferential method, we can estimate that there are approximately 2,175 angels in Quebec. Their collective portfolio is on the order of $1.36 billion. Annually they apparently invest $232.5 million and could draw on an additional $277 million if a sufficient number of profitable projects were submitted to them. If the average amount invested is consistent, it can be estimated that Quebec angels finance an average of 840 projects each year. ... On an annual basis, angels apparently finance six to seven times more business firms than institutional investors, providing total amounts representing one and a half to two times the amounts actually invested by that industry, which is, however, extensively subsidized."*

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[6] The Center for Venture Economics (1995), in a report for the Office of Advocacy of the US Small Business Administration, estimated that approximately 250,000 angel investors were investing about US$20b in 30,000 small companies each year. That is approximately twice the value of annual investment by US institutional venture capital funds and about fifteen (15) times the number of companies receiving investment (Freer, Sohl and Wetzel, 1996 in Acs and Tarpley, 1998).

[7] This frequency is substantially higher than estimates based on surveys conducted by the Canadian Labour Market and Productivity Centre (1995) and the Canadian Bankers Association (1998) and may reflect a regional aspect of the market.

Recent surveys of SMEs conducted by the Canadian Labour Market and Productivity Centre (1995) and the Canadian Bankers Association (1998) also confirm the important role of private investment, a role that is particularly focussed on growth-oriented firms.

The importance of business angels lies not only in their value and volume of investment but also in the *nature* of their investment. They distinguish themselves in, at least, three (3) important ways (Harrison & Mason, 1992).

1) First, they mostly concentrate on the provision of the relatively small investments needed in the critical start-up and early stages where institutional venture capitalists are increasingly feeling reluctant to invest and, therefore, where the equity gap is most significant. For instance, in the sample of 179 Canadian private investors reported by Feeney, Haines and Riding (1999), over 60% of investments were in the seed or start-up stages and the typical (median) investment sizes were between \$100,000 and \$200,000[8].

2) Compared with the formal venture capital market, they are more accommodating to the needs of SME owners by having lower rejection rates, longer exit horizons (patient capital), and target rates of return that are similar to those of institutional venture capitalists even though they assume more risk.

3) Third, unlike the formal venture capitalists who usually concentrate in a few core areas (both in terms of geographical area and investment sectors), informal investors usually invest in their local economies, thus helping to reduce regional and sectoral disparities.

ATTRIBUTES OF PRIVATE INVESTORS

The supply side of the informal market has been widely studied and a consistent picture of informal investors emerges.

- Informal investors are self-made, high income, well educated (normally hold a minimum of a college degree), and middle-aged.
- They are predominantly male (98.1% in Haar, Star and MacMillan, 1988) and have substantial business experience. Most angels have entrepreneurial experience as owners or managers – that is, they do not tend to be wealthy professionals such as physicians, dentists, etc.
- They usually prefer investing within their localities. In Riding and Short (1987a), over 85% of the investments by the respondents had been limited to within 50 miles of home or office.
- Angels differ in the degree to which they participate in the management of their investments: whilst most would take on roles such as board membership, consulting duties, or part-time employment, others prefer to play a passive role. Passive investors hardly exist independently; the usually act in concert with an informal network headed by an active angel(s) who performs the due diligence and who also

[8] The average investment size was \$225,000 but this was skewed by a few large deals in the real estate, construction, and financial services sectors.

manage(s) the investments.

- Business angels are generally experienced investors confident about their ability to appraise investment opportunities and therefore do not typically rely on professionals.
- Their investment decisions are usually opportunistic (based on commercial intuition) rather than scientific (Mason and Harrison, 1996). A KPMG (1992) report, for instance, indicated that they do not perform traditional financial analysis like Internal Rate of Return (IRR), Net Present Value (NPV) and payback period.

Canadian studies (Riding and Short; 1987a; Feeney et al, 1999) confirm that the characteristics of Canadian angel investors are generally consistent with the wider literature. Riding and Short (1987a) however, find a few differences. Canadian investors display higher rates of activity (investment), lower rates of participation in the management of the investee firm, and higher rejection rates of possible investment opportunities than their counterparts in the US. They also commit higher amounts of capital to individual investments than their US counterparts[9], though the usually assume minority roles in the investee firms.

MOTIVATIONS OF ANGEL INVESTORS

The literature suggests that economic motives (particularly the opportunity for high capital appreciation) are a primary reasons for informal investments. In addition to that, however, there are some significant non-economic motives. Many investors derive 'psychic income' from the opportunity to play active roles in the entrepreneurial process (Sullivan and Miller, 1996 refer to this as a “hedonistic motive”). Others invest on 'moral' grounds. Most investors are former business owners who have succeeded through their own efforts or with the help of others. Many feel an obligation to give back to society, through investments in up and coming entrepreneurs, job creation in areas of high unemployment, ventures developing socially useful technology (e.g. medical or energy saving) and ventures created by minorities (Wetzel, 1983). Sullivan and Miller (1996) refer to these as altruistic motives. Many investors are willing to trade-off economic returns to obtain these hedonistic and altruistic returns.

Sullivan and Miller (1996) advise that entrepreneurs should adopt a marketing perspective in raising finance for their business ventures. They argue that adopting a marketing perspective would enable entrepreneurs see potential investors as a market of 'customers' with a broad range of needs, wants and values. By limiting their view of investors to the *homo economicus*[10], as often happens, entrepreneurs may be missing significant segments of the market. The 'customers' should, therefore, be segmented according to their different desired benefits. Table 1 shows the distinguishing characteristics of the various investor clusters described by Sullivan and Miller.

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[9] Feeney et al (1999) attribute this to Canadian Securities laws that limit smaller deals.

[10] The rational economic man only interested in economic returns.

Table 1

CLUSTER 1: Economic Investor

- ·Only financial motivations are important
- ·Seeks highest return of the investor clusters
- ·Perceives highest level of risk among investors
- ·Prefers straight equity participation
- ·Has shortest holding period
- ·Tends to make larger investments
- ·Least satisfied with investments
- ·Most likely to rely on recommendation of a knowledgeable investor

CLUSTER 2: Hedonistic Investor

- ·Perceives lowest level of risk
- ·More likely to invest with a group than are other clusters
- ·More likely to hold a combination of debt and equity
- ·Considers both financial and non-financial motives important
- ·Enjoys the opportunity to play a part in entrepreneurial process
- ·Most satisfied with investments
- ·Least likely to be middle aged (45-54); most likely over 55

CLUSTER 3: Altruistic Investor

- ·Considers socially beneficial motivations important
- ·Less interested in financial return than others
- ·Most likely to make smaller investments
- ·Most patient in expectations for cashing out the investment
- ·Tends to be self-reliant instead of relying on others
- ·More likely to be middle-aged

Adopted from Sullivan and Miller (1996)

In a recent study of angels in Britain, Coveney and his associates (1998) identify four categories of angels.

1. **Entrepreneur Angels** were the most active and experienced, with high levels of wealth that were "self-made". They tended to take large stakes in their ventures and two-thirds of their investments were in start-ups. They invested in ventures "for fun and satisfaction as well as for financial returns" and they tended to be satisfied with their investments.

2. **Income-Seeking Angels** were less active than Entrepreneur Angels, making one or two low-level deals over three years. They tended to be less wealthy than Entrepreneur Angels, make more cautious commitments, and prefer majority holdings. They prefer more local deals because they tend to be actively involved with their ventures.

3. **Wealth Maximising Angels**, like Entrepreneur Angels, have high levels of wealth but in a higher proportion of cases, their wealth tended to be inherited. They are more likely to take on a formal, often a day-to-day, role with the investee firms. Most believed that their level of investment activity was restivted by a lack of suitable business proposals. They tended to invest in 2-3 deals over a three-year period.

In addition, Coveney and his colleagues also identified **latent angels, virgin angels**, and **corporate angels** among the 359 participants in their study. The following matrix illustrates the relationship among the four types of active investors.

Highly Entrepreneurial	***Wealth Maximising Angels***	***Entrepreneurial Angels***
Finance & Business Background	***Income Seeking Angels***	***Corporate Angels***
Not Entrepreneurial	**Low Levels of Investment Activity**	**High Levels of Investment Activity**

Based on Coveney et al. (1998).

Operation Of The Informal Capital Market

Business angels normally operate through informal networks of trusted friends and business associates. 'Archangels', individuals who are knowledgeable about and experienced with the operations of the informal investment market, may organize such networks. Information sharing within the networks has at least three advantages. First, it generates co-investments and risk sharing opportunities (particularly important as most angels prefer not to invest alone). Second, other network members usually return the favor when they also find good investment opportunities. Third, it acts as a screening device.

Most business angels are value-added investors. They do not only provide capital. They often assist their investees to obtain additional financing, recruit top management and board members, develop the companies' long term strategy, etc. (Prowse, 1998). This is particularly important to entrepreneurs who are less experienced and less confident. Exit opportunities available to informal investors include IPOs, mergers and acquisitions, and share buy-backs.

In most countries, the operation of the informal venture capital market is usually characterized as inefficient and the market has even been described as inchoate. As one venture capitalist stated, "if stock markets are an extremely efficient capital market, angel investing is at the other end of the spectrum"[11]. The inefficiency has been attributed to three (3) main factors:

1) *invisibility of informal investors:* for fear of being pestered by unwanted calls from desperate entrepreneurs, most angels prefer to remain anonymous. In fact the market has been described as a giant hide and seek game in which each of the players is blindfolded.

2) *the fragmented nature of the market:* the reliance of informal investors on 'primitive' (Prowse, 1998) informal networks of trusted friends and business associates in the referral/search process has led to the proliferation of several (highly invisible) networks.

3) *poor communication channels:* there are no clearly defined channels of communication between entrepreneurs and business angels. This leads to high search costs and frustrations for both investors and entrepreneurs.

In the Canadian context, these problems are being addressed by a variety of public sector and private sector initiatives. All three levels of government have established mechanisms to address the fragmented nature of the market.[12] However, attempts to improve the informal marketplace in Canada must still contend with securities regulations. As MacIntosh (1995) notes, compliance

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[11] Sherid, P. (1997) *Angels of capitalism: technology millionaires funnel money into start-ups* U.S. News & World Report Oct. 13 v123 n14 pp. 43-45.

[12] For example, Industry Canada has implemented the Canadian Community Investment Program (CCIP), a program that assists smaller municipalities to establish intermediaries to help businesses become ready for investment, to assist with locating suitable investors, and to provide post-investment counsel. Provincial and municipal governments have also established mechanisms to help address the issues listed by Mason and Harrison.

with securities acts generally entails a high cost and that it is likely than many deals are not in full compliance. MacIntosh argues that securities regulations are particularly troublesome for knowledge-based firms.

The cumulative effect of the above factors is that the number and quality of investment opportunities that informal investors come across are highly dependent on random events (Harrison and Mason, 1992). In addition to the fact that most angels might actually prefer to invest within their localities where they will be able to 'oversee' their investments, it is plausible to suggest that it is partially a result of the limitations imposed by the reach of their (usually regionally based) networks. Riding and Short (1987a) find that even though about 36% of investors in their sample stated that they had no geographical constraints on the location of their investments, in reality more than 85% of investments were located within 50 miles of their office or home. It is conceivable, then, that if the reach of their networks is extended, some would be willing to invest wherever opportunities are.

On Angels' Perspective of The Market

The major sources of complaint by informal investors are the difficulties and frustrations involved in finding sufficient 'good quality' investment opportunities.[13] In fact, many angels would have invested more if they had come across more opportunities. This seems ironic considering the fact that there are many entrepreneurs with bright ideas in search of capital. This situation, perhaps, is what drives Navarre and Janoff (1986) to conclude that the difficulties in raising capital faced by small Canadian businesses might be better attributed to a lack of awareness than to an actual shortage of capital.

Business owners often lament that there is a shortage of risk capital: they contend that a "gap" exists. However, another perspective of the informal market, one rooted in the supply side, is that the marketplace is one in which investors are looking to invest in potentially profitable business opportunities. They, too, perceive a "gap", one characterized by a shortage of well-managed high potential businesses. The primary reason that informal investors reject opportunities is their perception of a shortage – of the managerial talent necessary to commercialize innovation.

[13] Angels in Ottawa-Carleton do not appear to face this problem (Riding & Short, 1987a). It is not clear, however, to what extent that would be representative of Canada as a whole.

On Business Owners' Perspectives of the Informal Market

Empirical research on the informal venture capital market has so far largely concentrated on the supply side (the business angels) with relatively little done on the demand side (entrepreneurs). The purpose of this study is to evaluate, on the basis of the published professional and academic literature, the perspective of the demand side on angel financing.

The impact of informal investments on SMs performance

In one of the few empirical studies that have examined the demand side, Riding and Short (1987a) find that a major problem entrepreneurs face is the high cost of searching for capital. The entrepreneurs they interviewed estimated that the search process consumes an average of 16% of their time – the equivalent of one day in six. This was primarily attributed to the lack of well-established channels of communication between them and potential investors. The diversion of their time arguably reduces the human resources available for development of the business itself.

Lumme and her colleagues (1998) investigated the value-added contribution of business angels in Finland. They noted that angels contribute skills, expertise, knowledge and contacts that can enhance the performance of investee businesses and that "the economic importance of informal venture capital activitiy arises as much from this hands-on involvement as from the finance they provide" (p. 69). Moreover, Timmons (1990, p. 40) noted that most business angels had founded and developed businesses and were therefore able to "add a lot more to [a] business than just money". Other studies that confirm this result include the works of Wetzel (1994), Mason and Harrison (1996), and Cressy and Oloffson (1997).

The Lumme study revealed that most investors were actively involved in their firms and that the most common form of involvement (initiating contacts with new sources of funding and strategic management and control) are undertaken by more than 80 percent of investors. The effectiveness of these contributions does not appear to have been studied. No references to empirical examinations of the effect of private investment on success or survival rates were identified by Lumme and her associates.

Farrell (1998), however, did attempt to document the role of private investments on the success of businesses. She found that the incidence of business failure among 264 firms that had not received private investment was 20.5 percent while the failure rate among 46 enterprises that had received private investment was lower, 17.4 percent. This finding must be regarded as highly tentative, for several reasons. First, it is not clear that Farrell was comparing "apples with apples". For example, it is reasonable to expect that the firms that received angel financing in the first place were better quality investments. Second, Farrell did not control for sectoral or other potential determinants of success. Third, the time frame over which Farrell conducted her work was too short to provide definitive data even if she had controlled for other factors.

Factors that encourage (or discourage) SMEs to secure informal investments

Two streams of literature address this question. One stream of literature follows from the theoretical literatures of finance and economics. The second stream derives from empirical studies of the preferences of business owners.

That part of the theoretical literature that stems from modern finance usually takes the perspective of large firms that operate in the setting of efficient capital markets. A part of this literature addresses the choices that face shareholder owners of large firms (and their agents, the Boards of Directors) with respect to financing alternatives. While this literature does not pertain directly to angels, it provides a conceptual setting for understanding financing choices.

A second segment of the theoretical literature stems from the economics of capital rationing. During the last twenty years, economic theorists have addressed the question of capital market gaps by conceptually modelling the interface between providers of capital (particularly lenders) and businesses seeking financing in the context of perfect markets. Again, a short review of that literature provides a second conceptual framework for considering SME owners' financing choices.

The Theoretical Literature of Finance and Economics

The theoretical literature speaks to factors that encourage (or discourage) SME owners to secure equity capital such as informal investments and institutional venture capital.. Two streams of this literature are relevant: the theory of financing choices and the theory of credit rationing.

The Theory of Financing Choices

In general, three categories of financing are available to all businesses: internal equity, external equity and debt. For large firms that are listed on major stock exchanges an ordering of financing preferences known as the "pecking order theory" has been argued on theoretical grounds by Myers (1984) and Myers and Majluf (1984). According to this theory, firms prefer internal sources of finance (i.e. internal equity) to external sources. In resorting to external sources, firms prefer debt to external equity The order of the preference is from the one which is least sensitive (and least risky) to the one which is most sensitive (and most risky) to asymmetric information between corporate insiders and less well-informed market participants.

For smaller firms, entrepreneurs' initial sources of capital are typically raised from personal sources (savings, mortgages, retirement funds, life insurance, friends, family). Beyond these sources, debt is the most common source of external finance used by small businesses (Binks, Ennew & Reed, 1992) and is particularly important to Canadian firms (Petersen and Shulman, 1988). While this ordering of preferences is the same as that predicted by the "pecking order theory, it reflects owners' tradeoffs between control and growth. The Canadian Bankers Association (1998) finds that 85 percent of business owners would eschew growth if it compromised control.

Credit Rationing

What is Credit Rationing?

In economics, the price of a good is established when the quantity supplied equals the quantity demanded. When there is too much of a good available, the price drops, enticing more consumers to demand the good and discouraging suppliers from providing more of it. When consumers demand larger quantities of a product than the market is supplying, prices rise. This discourages consumers from purchasing more of that product (and may abandon their decision to purchase a product in the first place), and additional suppliers are lured into the market. If a market is functioning properly, the demand for a product will always be satisfied because price will balance the needs of the consumers and suppliers.

When the good in question is capital, some small business owners complain that they cannot find the funds they need to satisfy their financing needs. If applicants who are denied capital are willing to pay higher economic costs for financing but cannot get it, credit then appears to be 'rationed' from an apparently finite supply of capital. This is a phenomenon known as credit rationing.

Theorists have offered a variety of theories about situations that might lead to credit rationing, whether it happens, if it is a significant economic occurrence, and its effects on businesses. On a conceptual level, credit rationing could have the following consequences:

- If present, credit rationing could imply that small or new businesses do not have access to financing and, therefore face obstacles to their development, growth, and survival.

- Credit rationing might also disadvantage financially businesses that compete with firms that are part of industrial groups or that are owned by larger businesses.

- Credit rationing can result in levels of investment that differ from optimal levels, thereby affecting economic growth, inflation, employment, and a variety of other factors.

In short, credit rationing might arguably oblige risky businesses to seek equity financing because they are unable to obtain debt capital - quite possibly angel investments. Thus work on credit rationing is important in this context because, according to some studies, firms that are denied bank credit may be obliged to seek financing in the equity markets. This would be particularly true for smaller, riskier businesses and suggests that equity financing sought from private investors may not be a matter of choice – that credit rationing may be a factor that encourages SMEs to secure informal investments.

The Basis of Credit Rationing

Theories about capital rationing are based on informational asymmetries between lenders and borrowers. Informational asymmetries refer to the disparity between the information available to businesses seeking capital and suppliers of capital who are typically assumed to be at an informational disadvantage with respect to insiders of the business. Two direct aspects of informational asymmetry are usually identified: adverse selection and moral hazard.

> *Adverse selection.* Theoretical models often assume that an entrepreneur has private knowledge about the success probability of a project or expected profits that is not shared with the financier. Consequently, suppliers of capital cannot differentiate between a 'high-quality' business and a 'low-quality' business and adverse selection can result.
>
> *Moral hazard* refers to the inability of the external-to-the-firm supplier of capital to control fully how the entrepreneur uses funds provided. Owners can conceivably benefit economically by, for example, redirecting borrowed funds to invest in higher risk projects than those approved by the lender. To avoid this situation, financiers can implement contract provisions that discourage borrowers from acting against the interests of investor or lender, and these precautionary actions can lead to credit rationing.

Finally, the economic costs incurred by finance provider to verify the performance or 'financial states' of entrepreneurs, can lead to credit rationing. Certain types of moral hazard play a role in the costly monitoring problem, but these moral hazard problems do not affect the outcome of the entrepreneurs' projects. Instead, moral hazard affects costly monitoring problems by adding the risk that entrepreneurs will lie about their returns and profit at the expense of the bank. Even in models without adverse selection or certain types of moral hazard problems, banks might find it beneficial to ration credit.

Credit Rationing in the Context of SMEs

The concept of credit rationing is important for SMEs because the most common source of external financing for small firms is bank debt[14]. Small firms, however, find it more difficult to obtain bank loans than do large firms (Orser, Riding and Swift, 1994). And when they do obtain the loans, it is usually at higher interest rates and on more stringent terms than large firms. In Canada, this situation is even worsened by the perception among the small business community that, in comparison with other countries, they find it even more difficult to obtain bank loans (Peterson & Schulman, 1987).
Binks et al (1992) caution that restricted access to bank debt by small business may not be directly attributable to their size but, rather, to problems associated with the availability of information from which projects are evaluated (information asymmetry

[14] For most small businesses the high costs involved in floating debt instruments like bonds and debentures put that option beyond their means; the relatively small amounts they usually desire to raise are not enough to justify those costs. Moreover, they do not possess the requisite collateral or reputation to back such instruments up.

noted previously). They argue that such information problems are not peculiar to the small business sector alone, but are predominant there because of the anticipated (proportionately) higher costs of information-gathering associated with that sector. Binks et al suggest that the provision of finance by a bank to a firm could be considered as a simple contract between the two (2) parties in which the bank is the principal and the small firm is the agent. This relationship potentially leads to the problem of information asymmetry.

Information asymmetry can occur in two main ways for SMEs. The first, 'hidden information' results when one party to a transaction has relevant information that is not available to the other party. The party with the relevant information may have the incentive to misrepresent the information in its favor. In the bank-firm context, the business owner may overstate the likelihood of success. The possibility of benefiting from the 'hidden information' could lead to the proliferation of 'low quality' projects on the market. Since banks may lack the information to distinguish between 'low quality' and 'high quality' projects, they are faced with the option of raising interest rates on all loans. But as interest rates rise, low risk (high quality) projects finding the rates too high will exit the market, leaving only high risk (low quality) projects - adverse selection. The second, 'hidden action' results from the possibility that after signing the contract (obtaining the loan), the informed party (firm) will not act in conformity with the contract. The firm may act out of self-interest, even if that has adverse effects on the bank - moral hazard. It is important to note that information asymmetry may be even more acute in the case of small firms as, having discovered good investment opportunities, they are usually reluctant to disclose relevant confidential information to outsiders who have the capability to of stealing their ideas (Peterson and Schulman, 1987).

Availability of collateral and reputation (track record) can alleviate the problem of adverse selection and moral hazard. Low risk borrowers (who would otherwise leave the market due to high interest rates) can signal their status through the provision of adequate collateral and good reputation. With their assets at stake as collateral, firms will be motivated to perform to the best of their abilities. In this context lack of collateral and reputation may lead to a firm being denied credit: To the extent that small firms possess less collateral and reputation than large firms, they may face yet greater difficulty raising capital than do large firms. Worse still, since there is considerable uncertainty surrounding the survival and growth of SMEs, their asset-backed collateral are usually valued at 'carcass value' to ensure that the loan is realistically covered in case of default and immediate realization (Binks et al, 1992). This implies that the already disadvantaged small firm may even need proportionately more collateral than do large firms.

In addition, small firms are frequently under-capitalized (Blanton and Dorman, 1994). That is, the term structure of loans granted to SMEs does not suit their needs. Whilst many SMEs need long term capital, banks are usually only willing to grant them short-term loans. SMEs have, therefore, had to rely on short-term sources such as lines of credit to finance long-term needs like new equipment purchases (Riding and Short, 1987a).

PREFERENCES AND PERCEPTION OF BUSINESS OWNERS ON INFORMAL INVESTMENTS

There is very little study of SME owners' perception of informal investments. To enable angels to monitor the performance of their investments and/or to satisfy their 'emotional' needs (discussed earlier), most of them participate, to different degrees, in the operation and decision-making of their investments. The forms of participation include representation on the Boards of Directors and the performance of some consulting duties. Some angels even obtain majority-voting rights over key management decisions. This is often problematic for entrepreneurs who value autonomy and control over their businesses (Canadian Bankers Association, 1998). Indeed, Oesch and his colleagues (1996) find that autonomy is an important reason that individuals undertake entrepreneurship and business ownership.

The one study that investigated owners' attitudes to informal investment was that conducted for the Canadian Bankers Association (1998) based on a sample of Ontario business owners. They found that the majority of business owners were unaware of private investments as a potential source of capital. Of the minority of owners who were aware of equity financing, few would relinquish control in order to obtain the ownership capital needed for substantive growth. It follows that:

(a) the proportion of business willing to accept external equity capital to finance growth is small (approximately 15% of business owners); however, from previous sections of this study, recall that

(b) the proportion of businesses in which private investors are willing to invest is also very small.

Consequently, the intersection of these sets (businesses willing to accept external ownership capital and those in which investors might be interested) is very small in relative terms. Moreover, not all businesses that are seeking external growth capital are prepared for the investment process. In absolute terms, however, there remains a large number of businesses that require early-stage risk capital. The problem is exacerbated because the small "willing and able" portion of the demand side needs to be brought into contact with the "interested and able" portion of the supply side.

THE READINESS OF SMES TO SECURE INFORMAL INVESTMENTS

One way of measuring the state of SMEs' readiness to receive informal capital is by seeing them through the eyes of informal investors. The two most important investment evaluation criteria used by informal investors are quality of management and market potential of the product or service (Haar *et al,* 1988; Riding and Short, 1987a). As Haar *et al* point out, this is not surprising. Whereas formal venture capitalists play an active role in managing down the risk and assessing due diligence on the part of the venture team, angel investors usually do not. They therefore feel more dependent on the capabilities of the management team. Feeney *et al* (1999) go a step further to distinguish between the primary reason why an investor would reject a deal (primary 'deal killer') and the primary reason why they would accept a deal (primary 'deal maker')[15]. They find that whilst the primary 'deal killer' is management ability, the primary 'deal maker' is the growth potential of the opportunity and the entrepreneur(s)' capability to realize those potentials.

The research literature indicates that the turndown rate of informal investors is very high. DalCin *et al* (1993) estimate that angel investors in Canada turn down as much as 97% of investment proposals they receive. Riding and Short also conclude that angels in Ottawa-Carleton have higher rejection rates than their US counterparts[16]. Considering the fact that informal investors have more funds to invest than they actually do, it appears that they do not find most of the opportunities they come across 'ready' for investment when measured against their investment criteria. Blatt and Riding (1993) and Blatt (1993) sum it up when they say, "while there is no shortage of entrepreneurs seeking capital, most investors are less than impressed with the quality of deals".

Another frequent source of contention is the disparity in valuations of businesses between investors and owners during investment negotiations. This is particularly important when (as is normally the case), angels obtain common shares (or convertible securities) in exchange for their investments. Since these firms are not listed, they have no market-determined values or other arms-length methods of valuation. In the process, investors frequently identify entrepreneurs' "inflated" valuation of their businesses as an impediment to investing (Haines et al., 1998).

THE ROLE OF GOVERNMENT

The literature reviewed thus far indicates that Canadian small businesses (and indeed small businesses all over the world) feel the presence of a financing gap. On the other hand, Riding and Short (1987a) report that informal investors do not perceive capital market gaps (as already noted elsewhere, they usually have extra funds to invest). It therefore appears that that the gap, at least the size of it, may be more attributable to inefficiencies in the informal capital market rather than an actual shortage of capital. In recognition of this, researchers and others have advanced a variety of recommendations regarding the role of government.

Coveney and colleagues (1998) recommended a "four-pronged approach" to the UK government:

1. move away from local programs to national programs;
2. focus on angels who make larger and more frequent investments;
3. encourage private sector business introduction services;
4. support tax benefits for private investors.

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[15] They found that the reasons for investing were not simply the opposite of the reasons for rejecting.

[16] It is not clear to what extent this might be representative of Canada as a whole.

In spite of their excellent analysis of UK angels, these suggestions are, for the most part, not consistent with the Canadian setting. In the UK, with its high population density, fewer levels of government, unified tax and regulatory system, and small land mass, there is less difference between "local" and "national" initiatives than in Canada. In the Canadian context, local programs remain the most effective means of marshalling private capital. Coveney et al.'s second recommendation is both difficult to implement and inconsistent with the goal of assisting earlier stage firms to raise relatively small amounts of capital. Likewise, the recommendation to encourage sector introduction services is at odds with Mason and Harrison's argument that such services would gravitate to larger deals that are more profitable to broker in absolute terms, again defeating the purpose of facilitating investments in smaller firms.

In recognition of the importance of the informal market, governments have undertaken a variety of initiatives to address these problems. The most frequently used are reviewed presently.

Matchmaking Services

In an attempt to help solve the inefficiencies in the informal investment market, primarily the invisibility and fragmented nature of the market as well as the poor communication channels, a variety of matchmaking services have emerged through the efforts of both the private and public sectors. These services aim at bringing entrepreneurs and potential investors together.

Three major approaches to matchmaking have been identified in the literature (Harrison and Mason, 1993). The first is the production and distribution of investment bulletins with brief descriptions of companies seeking capital for distribution among potential investors (e.g. The Market Place Bulletin published by the Ontario Ministry of Industry, Trade and Technology). The second method involves the hosting of investors meetings at which finance-seeking entrepreneurs make short presentations to an audience of potential investors (e.g. the Angel Introduction Forum by the Business Development Bank of Canada). The third approach, which has received the most attention in the academic literature, is computerized matching based on a database of investor interests and business characteristics.

The most successful of these computer matchmaking services appears to be the US based ACE-Net. In Canada, the first ambitious attempt was the (now-defunct) Canadian Opportunities Investment Network (COIN). More recently, Industry Canada has established the Canada Community Investment Plan (CCIP). This program assists municipalities to develop growth-oriented firms by, among other things, introducing up potential investors and entrepreneurs and providing an element of mentoring in the investment process.

Attempts to address the inefficiencies in the informal capital market through the formation of formal matchmaking or referral services have achieved limited results. In the case of COIN, a Canadian initiative undertaken during the late 1980's, Blatt and Riding (1993) estimated that 52% of Canadian investors were not familiar with COIN. According to their estimates, an additional 39% were aware of its existence but had elected not to use COIN. Two major factors account for this situation: the desire of informal entrepreneurs to maintain their anonymity and the high premium they place on previous knowledge of the entrepreneurs. In spite of these problems, the inefficiencies in the traditional mode of operation are so glaring whilst the potential benefits of referral services are so great that organizational efforts are likely to continue. Harrison and Mason (1993) suggest three (3) factors critical to the success of such matchmaking services.

First, there is the need to build critical masses of investors and entrepreneur clients. A large database would help promote the visibility and credibility of the network in the business community. Moreover, informal investors' individual preferences are diverse and therefore the probability that an individual investor would be interested in a specific venture is small; a large database would help increase the chances (Landstrom, 1998). Building such a database, however, may not be easy. Informal investors in particular have expressed less interest in systematic referral services than entrepreneurs have (Riding and Short, 1987a). It therefore appears that to be able to build the needed critical mass, investors might have to be offered some incentives (lower registration fees, for instance). Passwords are currently being used by computer matchmaking services to help preserve the anonymity of investors. Another point of contention is the geographical coverage of the network. Informal investors favor a regional service, whilst entrepreneurs prefer a nationwide format (Riding and Short, 1987a). This is not surprising. Whilst entrepreneurs are interested in having access to as many investors as possible (hence the nationwide preference), informal investors normally invest within their localities for such reasons as trust and the ability to oversee and participate in the running of their investments. A comprise might be a nationwide network of regionally based networks.

Second, the service should be well resourced. It is not likely that such services would be self-sustaining. They therefore need public sector support and/or sponsorship. A US study suggests that there is a direct correlation between funding and the number of investors and entrepreneurs recruited into the service (Harrison and Mason, 1993). Blatt and Riding (1993) found that lack of effective marketing (needed to maintain a high profile campaign) was one of the reasons for the failure of COIN.

Third it is desirable to undertake some prior vetting of investment opportunities. There has been some debate over this. Some researchers suggest that referral services should not attempt to evaluate the merits of investment proposals (Wetzel, 1983). Investors are capable of doing that themselves. It is important to note, however, that investors' problem is not coming into contact with investment opportunities. Rather, the problem is coming into contact with *good quality* opportunities. It would be necessary, therefore, to ensure the credibility of the service by maintaining certain minimum standards for information disclosure. Proliferation of low quality projects may simply drive investors away. The attempt to maintain minimum standards should, however, be balanced with the fact that informal investors are usually sophisticated investors capable of making their own judgments (Riding and Short, 1987a). Perhaps the standards ought to relate to requirements for information disclosure. In this context, the SCOR form used in most US jurisdictions has been approved by the North American Association of Securities Administrators. It is sufficiently extensive that investors would find the information useful yet business owners who are not serious would be discouraged from completing it.

In attempting to set-up a new referral service or improving on an existing one, lessons from the problems faced by COIN could be the starting point. Blatt and Riding (1993) present an analysis of the problems with suggested solutions. It is also important to note that both investors and entrepreneurs prefer such a body to be run by a non-profit, non-government body.

Preparing Entrepreneurs

Probably the first thing that needs to be done is to help SMEs get 'ready' for investment by assisting them to address the investment criteria used by informal investors. Addressing the two most important of these criteria - quality of management (the 'deal killer) and the market potential of the opportunity (the 'deal maker') - could significantly reduce the high rejection rates by angels.

Entrepreneurs need to appreciate the fact that the only 'collateral' informal investors have is management's ability to achieve results. It is therefore of utmost importance that they put together good management teams before approaching investors. One way of attracting high caliber professionals without the immediate need for substantial amounts of cash is through the use of stock options. This has become a more attractive option in light of recent tax changes. A referral service[17] could examine the possibility of assisting entrepreneurs to come up with such packages.

Entrepreneurs might consider emphasizing financial returns for the benefit of economic investors whilst emphasizing on hedonistic and/or altruistic returns for the benefit of the other two (2) investor groups. Opportunities for socialization (with other investors or through company visits) might appeal to the hedonistic investor whilst stressing on the positive benefits of the venture to the community (e.g. employment opportunities) might interest the altruistic investor. Similarly, different investment structures could be used to appeal to the different groups. Considerations here include the size of investment, expected duration of the investment, and the type of investment vehicle (debt, common stocks, preferred shares or convertibles). Entrepreneurs who do not have the required skills in their management teams should endeavor to seek outside professional help in preparing their investment documents.

Attracting Virgin Angels

One of the benefits that have come out of the extensive studies on the demographics of informal investors is that, it has made it possible to identify people with similar characteristics but who are not yet participating in the informal capital market. These people have been referred to as 'virgin angels'. 'Virgin angels' far outnumber 'practicing' angels. The good news is that given the necessary incentives, over 71% of 'virgin angels' are willing to invest some amount of their portfolio (between 1% and 14%) in the informal venture capital market (Freer et al, 1994). This implies that the potential size of the informal venture capital market is far bigger than its present size. Short and Riding (1987a) estimate that the potential size of the informal market in Canada may be ten (10) to twenty (20) times the size of the institutional venture capital market. The question is, what are the incentives that would attract virgin angels?

[17] Discussed below.

Nearly 50% of virgin angels in Mason and Harrison (1993) cited the inability to identify firms requiring finance as the major reason why they have never invested in entrepreneurial companies. Other considerations included the high risks involved, concerns about exit routes and lack of expertise in investment appraisal. Asked about what incentives might encourage them to enter the informal market, the three most cited factors were personal knowledge about the management team, provision of information on companies seeking finance by a trustworthy source (these two factors essentially relate to concerns about risk) and tax incentives[18]. Efforts geared at enticing the virgin angels should seek to address these concerns. In this context, a referral service would greatly assist in the identification of investment opportunities; workshops could help equip them with the necessary skills and information; and, mentors ('archangels') could assist new angels until they gain roots. Prior screening of enlisted projects by referral services will also give such investors a certain level of comfort. However, screening implies that market facilitators would be "advising" prospective investors. Unless facilitators have been qualified by securities commissions, advising is not permitted. In this way, securities regulations constitute a further barrier to private investment.

A Caveat

Lerner (1998) raises an issue that gives some food for thought. SMEs, particularly start-ups, are inherently more risky than large firms. There is considerable uncertainty regarding their survival and growth. Why then, Lerner asks, would any one want to encourage amateur individual investors, rather than specialized financial intermediaries such as venture capitalists, to invest in this sector?[19] Care should therefore be taken to ensure that in the attempt to solve one problem, another one is not created. Questions that need to be addressed include the following. What type of investors are we encouraging? What type of funds are we attracting?

The prime targets should be value-adding investors. These are mostly entrepreneurs or people with similar experience. In fact, that is an important characteristic of angel investors. Riding and Short (1987a) find that of 25 investors interviewed, 21 had previously been involved at the top management level in the start-up of a new venture[20]. In addition to funds, such investors are able to use their contacts and experience to assist the investee firms. The targeted investor should, on average, be able to withstand the loss of their investment in the informal capital market. In recognition of the importance of this factor, the concept paper by the OSC staff[21] states that even though education and experience should count towards the definition of a sophisticated or accredited investor[22], ability to withstand financial loss of the investment in the informal market

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[18] Tax incentives are discussed in detail below.

[19] Brav and Gompers (1997) find that IPOs that had previously received equity financing from venture capital funds perform better than other offerings (including those funded by individual investors).

[20] Das and Lerner (1995) in Lerner (1998) suggest that, in some cases, the involvement of unsophisticated individual investors can make it more difficult for an entrepreneurial firm to raise external capital.

[21] "*Revamping the Regulation of the Exempt Market*" (www.osc.gov.on.ca).

[22] The paper proposes that, as in the US, this class of investors should be exempted from the requirement for a prospectus.

should be the overriding criteria.

Consciously targeting funds that should, by the very nature of their objectives, be invested in relatively safe securities does not appear to be prudent. Riding and Short (1987, 1988) and Short and Riding (1989) find that investors were reluctant to invest their Registered Retired Savings Plan (RRSP) funds in the informal capital market. That should not be surprising. Retirement savings (a security objective) and informal investment (a risky investment) are not a good match.

Tax Incentives

Informal investors have a high propensity to reinvest in the informal market. Haar, Starr and MacMillan (1988) found that about 90% of their respondents would reinvest in an informal risk capital investment. About 86% of those who had found other investment types more profitable would still invest in angel type projects. Even amongst those whose angel investments had failed, as much as 68% would invest in angel type projects again. This important re-circulation of innovative capital is slowed down by high capital gains tax in, at least, two (2) significant ways. First, it reduces the enthusiasm of investors to realize their capital gains. Second, it decreases the amount of the realized gain that eventually goes to the investor. *Reductions in the capital gains tax in the US is one of the primary factors that have spurred the rapid growth of the formal venture capital market (Wetzel, 1983; Gompers, 1998).* It is not unreasonable to believe that similar reductions geared towards the informal private sector would achieve comparable results. Also, many studies suggest that lowering capital gains would be one of the most influential factors in attracting virgin angels to become active angels (KPMG, 1992; Freear et al, 1994). According to Ernst and Young (2000, as reported by Hill), "there is a disparity in worldwide taxation practices that we feel put early stage technology companies in Canada at a disadvantage".

Given this background, it appears that the following changes made to the capital gains tax in the 2000 federal budget could have a positive impact on the informal capital market.

1) The reduction of the taxable proportion of capital gains on investments from 75% to 66%

2) The reduction of overall capital gains tax for individuals from 37.5% to 33.3%

3) The introduction of a roll over relief that allows investors to defer taxes on capital gains from eligible small business investments provided they are reinvested in another small business within 120 days of the disposition or 60 days after the end of the calendar year. The tax-deferred rollover is limited to a maximum of $500,000 a year and must be invested in qualified businesses with assets of less than $2.5m

Though these changes are positive steps, they fall short of the provisions that obtain in the US[23], and they represent an improvement over past periods. With the increasingly global nature of financial marketplaces and the ease with which information may now be disseminated, investment capital will inevitably flow to regimes in which the after-tax rates of return are highest. Therefore, *parity with the US of capital gains taxation should remain an objective.* The impact of these changes on the informal investment market needs to be studied as this could lay the foundation for future policy changes.

Concerns have been expressed that such tax incentives may entice the 'wrong' type of investors - particularly those who may lack the financial sophistication possessed by the average informal investor and who may therefore be better off in relatively low risk ventures. This is where attempts by referral services to ensure that registered entrepreneurial projects meet certain minimum standards as well as holding workshops to educate interested investors would serve a useful purpose.

Regulatory Changes

Securities regulation falls under provincial jurisdiction and therefore differs among provinces. The most influential of the provincial securities regulators is the Ontario Securities Commission (OSC) which oversees the largest Stock Exchange in Canada, the Toronto Stock Exchange. The Ontario Securities Act specifies that before any firm can raise capital through the distribution of securities, it must file a prospectus with the OSC. The Act grants some exemptions to this rule.

1. The 'Private Company Exemption'. A private company is prohibited by its corporate charter from inviting the public to subscribe for its shares. Under the exemption, the maximum number of shareholders (excluding employees) a private company can have is 50. The most important issue is determining if a firm can avoid issuing a prospectus under this exemption is whether or not a potential investor is 'a member of the public'.

2. The 'Private Placement Exemption'. Under this exemption if an investor invests a minimum of $150,000 (not to be syndicated), he/she is deemed sophisticated and a prospectus is not needed. The OSC must however be notified of such trades and the firm may be required to provide an offering memorandum.

3. The 'Seed Capital' exemption. Under this, a company can raise funds in smaller amounts from a maximum of 25 investors, having invited no more than 50 people. This exemption can only be used once.

The above regulations are restrictive. They limit the ability of small firms to raise funds as well as the ability of matchmaking services operate. The regulatory environment appears more favorable in the US where a prospectus is not required if a potential investor qualifies

[23] For instance, overall individual capital gains tax in the US is 20%; rollover relief is virtually limitless (Ottawa Citizen, Feb. 29, 2000).

as an accredited investor. In general, accredited investors are defined as natural persons whose networth (with or without spouse) is more than US$1 million and whose individual income exceeds US$200,000 for the most recent two years (US$300,000 including spouse's income). Such persons are assumed to be sophisticated[24] and therefore more flexibility is permitted in the communication between them and entrepreneurs than is permitted with the general public.

Following recommendations by The McCallum Task Force on Small Business Financing (Ontario Securities Commission, 1996), the OSC is currently considering amendments to the (Ontario) regulations to adopt a net worth rule similar to that which prevails in the US. There remains the need to facilitate the process in order to alleviate the current unfavorable environment under which small businesses and matchmaking services operate.

The plurality of securities regulations across provinces makes it difficult and costly for firms (small ones especially) to raise funds across provinces. There is therefore the need for a body (along the lines of the US Securities and Exchange Commission) that would coordinate regulations across provinces in order to reduce the inter-provincial differences.

[24] A sophisticated investor is "one who has the knowledge and experience to obtain and analyse the information needed to assess a particular investment opportunity without the assistance provided by the prospectus format and who has the financial ability to withstand the loss of the investment" (*Revamping the Regulation of the Exempt Market* www.osc.gov.on.ca).

Suggested Areas for Future Research

This section identifies apparent gaps existing in the literature and, therefore, where further research would be useful.

Corporate Angels

Corporate angels may be defined as businesses - other than venture capital firms - that act as business angels. Though these corporate angels play a role in financing SMEs, particularly in the technology sector, they have received no attention in the research literature. Research on this issue would yet better inform policy makers on the extent of this segment of the angel market as well as what could be done to encourage it.[25]

Entrepreneurs Perceptions on the Angel Market

Empirical research on angel investment has almost exclusively concentrated on the supply side (i.e. investors). It appears that the only studies in Canada that have empirically examined the demand side (i.e. SMEs) are Short (1987), Short and Riding (1987a), and the CBA (1998). A study based on a larger and more representative sample needs to be conducted to better inform policy makers on demand side issues.

The Size of the Informal Capital Market

It appears that no nationwide study has so far been conducted to estimate the actual and potential size of the informal market in Canada. Knowing these figures could give a relatively more objective basis to the efforts aimed at promoting the market.

The Impact of Private Investment on Success and Failure Rates

Arguably, private investors provide value-added to investee firms by means of their involvement. However, no data exist on the long-term impact of their involvement. To the extent that the viability and growth of businesses is promoted by the involvement of private investors, job creation and goals of economic prosperity will be furthered. To date, no study of the extent to which informal investors benefit society in these ways have been conducted. To do so requires a longitudinal study using a panel of businesses.

Attracting Virgin Angels

It would be useful to conduct a study on why virgin angels in Canada are not yet

[25] The only analysis of corporate angels uncovered in this study was a small section of the work of Coveney and his colleagues (1998) in the UK context. They report that corporate angels in the UK typically invest relatively large amounts (more than £200,000), usually take majority positions, support an average of three ventures each, and feel it important that prospective ventures are situated in an industry sector allied to that of the corporate angel.

participating in the market and what factors might entice them.

Angels' Investment Preferences

The issue of whether or not angel investors prefer certain sectors of the economy to others is debated in the literature, particularly between technology-based and non-technology-based sectors (Wetzel, 1983; Aram, 1989). Riding and Short (1989), for instance, find that the angels in their sample had invested mostly in the high-technology sector, but this is probably due to the size of that sector in the Ottawa-Carleton region from where the sample is taken. Knowing the investment preferences of Canadian angels would enable policy makers coordinate efforts aimed at improving the angel investment market and other programs[26] also aimed at assisting SMEs to obtain finance.

[26] Such as the loan guarantee program.

SUMMARY AND CONCLUSION

The growth of many Canadian small businesses has been impeded by lack of access to credit. Venture capital funds, which have been providing seed and early stage capital for small firms, are now increasingly moving towards bigger and later stage firms. In response, small firms have turned to the informal capital market. This market comprises of individuals (business angels) who provide risk capital directly to previously unrelated businesses. Business angels are now the single most significant source of external equity capital to SMEs. They provide the relatively small amounts needed by SMEs at the critical start-up and early stages and are more accommodative of the needs of SMEs.

The operation of the informal market has, however, been inefficient. This is largely attributable to the invisibility of informal investors, the fragmented nature of the market and poor communication channels between entrepreneurs and potential investors. The result is that whilst investors have extra funds to invest, SMEs are suffering from an acute credit gap. This situation leads one to believe that the credit gap may be due to the inefficiencies in the market rather than an actual shortage of capital. Some of the measures that can be put in place to address the inefficiencies have been discussed. These include helping entrepreneurs to be investor ready, establishing (or improving on existing) referral services, attracting virgin angels (potential investor who are not yet on the market), giving tax incentives and revising the current unfavorable securities regulations.

In conclusion, a booming economy, a surging capital market, and an aging population have helped create wealthy people who are willing to invest in the informal capital market. Inefficiencies in the market have, however, prevented the attainment of its full potential. Many SMEs are suffering from lack of capital. Entrepreneurs, particularly in the technology sector, are migrating to the US in search of capital to develop their ideas. Reducing the inefficiencies the market could significantly reduce these problems. This paper has offered some suggestions on how this could be done. It has also identified areas where further research would be useful.

Perhaps the most important type of future research recommended here is for longitudinal research. Longitudinal research in this context means following panels of businesses and investors on an ongoing basis over several years. Such research has both immediate and long-term benefits. Immediate benefits result from the gathering of baseline data about investment preferences, amounts, and the types of enterprises. Long term data on firms present the opportunity to better learn about growth, survival and success rates. Long-term data on investors provides an opportunity to learn from panel data and to query panels on an ongoing basis about potential initiatives and interventions. To quote Farrell (1998):

> The causal effects and outcomes of investment decisions can only be determined with longitudinal analysis. The passage of time permits the resolution of the capital decisions made by the entrepreneur, the business success or failure, and the investment decisions

made by the investor. By following, over time, the investment habits of investors, their reinvestment propensity, and the effects of capital on companies and entrepreneurs we would have a far better understanding … this is expensive research, [justified by] the value of entrepreneurship [success] to society."

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