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Creating New Capital Markets for Emerging Ventures

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CREATING NEW CAPITAL MARKETS FOR EMERGING VENTURES

I. BACKGROUND DISCUSSION

A. OBJECTIVE

Access to "patient capital" emerged from the White House Conference on Small Business as the most critical obstacle to the vitality of early-stage, innovative, high growth ventures. The need was defined more precisely as seed and start-up capital on the order of $250,000 to $1,000,000, well below the interest thresholds of most venture capital funds, but well within the range of typical private equity investor financing.

The Office of Advocacy of the U.S. Small Business Administration, as the entity charged with implementing the recommendations of the White Conference on Small Business, is undertaking a substantive effort to develop a national capital market designed to:

1) Provide entrepreneurs with expanded access to private equity investors.

2) Increase opportunities for qualified private equity investors to participate in the rewards and risks of financing emerging growth companies.

3) Reduce the cost of raising private equity capital through legislative and regulatory provisions that limit the liability of professional service providers.

4) Reduce the cost of raising private equity capital through the use of standard interstate disclosure documents and policies.

5) Employ controlled access through the Internet as the vehicle for exchanging investor and investment opportunity information, but not conducting securities transactions.

6) Lower transaction costs through the identification of a

suggested set of commonly accepted terms and conditions for equity deals.

7) Accomplish the above while maintaining an appropriate balance between venture promotion and investor protection.

II. UNDERLYING PREMISE

The U.S. economy passed a milestone in 1979 - the transition from a declining industrial/manufacturing economy to an emerging entrepreneurial/innovation-driven economy. Evidence supporting this conclusion includes the following:

- The payrolls of the Fortune 500 Largest U.S. Industrial Corporations peaked in 1979 at 16 million jobs. Since 1979, Fortune 500 payrolls have fallen by over 4 million jobs. From 1979 to 1995, the invisible entrepreneurial economy generated over 24 million new jobs.[1]

- The most successful entrepreneurial ventures find their way into the visible public equity markets primarily through initial public offerings in the over-the-counter market. In 1979, the volume of shares traded on the NASDAQ market was less than half the trading volume on the NYSE. In 1994, NASDAQ share volume exceeded NYSE volume for the first time.[2]

- Technology-related industries generate more than one ninth of U.S. gross domestic product, up from one twentieth a decade ago.

- In 1995, for the second consecutive year, the Geneva-based World Economic Forum and the International Institute for Management and Development in Lausanne, Switzerland ranked the U.S. as the world's most competitive economy. The report cited the aggressiveness of U.S. industry as particularly noticeable in new technologies ranging from computers to telecommunications.[3]

The "atomization" of America that began in the seventies is now an economic fact of life. American business "birthrates" are currently as much as three times higher than in other industrial nations. Our country's uniqueness is our ability to spawn innovative, high growth entrepreneurial ventures. The transition

to an entrepreneurial economy has profound implications for investors, the equity capital markets and for public policy designed to promote job growth, deficit reduction and global competitiveness.

III. THE CAPITAL FORMATION CHALLENGE

Most of the new jobs attributed to small firms are created by entrepreneurial ventures that start small and grow fast. For entrepreneurs, raising patient, high risk equity financing is the critical capital formation challenge. Two types of financing obstacles confront entrepreneurs: raising equity capital at the seed and start-up stage and raising equity capital for established ventures growing faster than internal cash flows can support.

- Since 1975 over 75% of net new jobs were created by entrepreneurial ventures. Along with job creation, innovation, risk, growth and the creation of wealth for entrepreneurs and investors characterize entrepreneurial ventures.[4]

- Despite the record $4.2 billion raised by venture capitalists in 1994, "few venture funds specialize in seed investments" (John Mumford, Crosspoint Venture Partners). "It's the gap between $100,000 and $1 million that's still unfilled." (Richard Meyer, National Census of Early-Stage Capital Financing).

- Two segments make up the venture capital market - one visible and one invisible. The visible segment is represented by about 500 venture capital funds that manage about $35 billion, less than the total assets of the Bank of Boston. The invisible segment is made up of about two million primarily self-made, high net worth individuals - often referred to as "business angels." The size of the private equity portfolios of business angels is unknown.[5]

- Venture capital funds invest about $4 billion annually in about three thousand ventures.[6] Every business day more than $4 billion changes hands before noon on the floor of the New York Stock Exchange. Venture fund financings typically are

later stage deals in excess of $2-3 million. Conservative estimates suggest that annually about 250,000 business angels invest $10-20 billion in over thirty thousand ventures. Angel financings typically are seed and start-up deals in the $100,000 to $1 million range. The number of potential angels is estimated to exceed the number of active angels by a factor of five to ten.[7]

• The allocation of scarce resources to their most productive uses requires "efficient markets." Efficient markets are characterized by fully informed buyers and sellers and by minimal transactions costs. In the farm system were new ventures are spawned and where equity financing is provided primarily by self-made private investors, the capital markets are anything but efficient.

• The number of entrepreneurial ventures that need equity financing is estimated to include about 50,000 start-ups per year (5%-10% of total start-ups) and 300,000 ventures growing faster than 20% per year (including about 80,000 growing faster than 50% per year).[8]

At the critical early stage of the venture, private equity investors provide the largest source of equity financing for emerging high growth ventures.[9] Angels are value-added investors in the sense that in addition to capital, the investor brings expertise and experience to the venture. Most important is that angels have a higher propensity than venture capital funds to provide the crucial smaller rounds of seed and start-up financing required by early-stage ventures and angels have longer exit horizons than their venture fund counterparts - thus they provide patient capital. Yet despite these differences between angels and venture capital funds, their roles are complementary. By focusing on early stage innovative ventures, angels are providing the start-up funds for those high growth ventures that will require later and larger rounds of financing from the formal venture capital industry. Thus, angels are spawning the innovative high growth

ventures that will become attractive to the venture capital industry.

In addition to this complementary role of angels, private investors are also providing equity capital for innovative middle market ventures. Middle market ventures, characterized by substantial growth that cannot be sustained by retained earnings, will never reach the formal venture capital market. These ventures can, if properly structured, offer capital gains and cash-out opportunities for investors. These ventures make up the backbone of the entrepreneurial economy, most will remain privately owned or will be sold, and they rely heavily on bootstrap financing and financing from private investors.

Angels are investing in precisely the area where credit financing alone cannot sustain the appetite for capital. While access to credit is critical for many small business owners, early stage and middle market innovative high growth ventures cannot be capitalized with additional debt. For the early stage innovative venture, the major asset of the firm is the entrepreneur. These firms are short on hard assets and cannot offer the collateral required by most lenders. By focusing only on the credit side of the balance sheet and its high fixed cost interest payment burden, a substantial debt to equity imbalance will persist, further restricting the firms access to the capital that is critical for the long term growth and survival of the venture.

Informed estimates suggest that our country's entrepreneurs need on a yearly basis about $60 billion of patient, high-risk

value-added equity capital - about fifteen times the annual investment of the institutional venture capital pool.[10] Raising additional patient, high-risk equity financing in the range of $20-$30 billion per year is our country's real capital formation challenge.

IV. PRIVATE EQUITY INVESTORS - "BUSINESS ANGELS"

One of the cornerstones underlying the work of the Center for Venture Research at the University of New Hampshire is the proposition that the know-how and the capital of self-made, high net worth individuals are two of this country's most potent, but least understood and largely untapped economic resources.

A Center for Venture Research analysis of the financial histories of 284 technology-based firms founded in New England revealed that more firms raised equity capital from private investors than from any other outside source, that private investors were the primary source of capital when the size of a round of financing was under $1 million and that seed and start-up financing accounted for 60% of angel deals compared to 28% of venture fund deals.[11]

The economy of the 1970's, 80's and early 90's spawned a growing choir of angels. Indicators that there is more than enough know-how and capital in the heads and the pocketbooks of self-made, high net worth individuals to meet the equity financing needs of current and future generations of entrepreneurial ventures include the following:

• In 1984, 40% of the Forbes Four Hundred Richest People in America were entirely self-made. By 1994, 80% of the Forbes Four Hundred were self-made, i.e. first generation money. A net worth of $310 million was required to make the cut. Aggregate net worth of the Four Hundred was estimated by Forbes to be $349 billion, ten times the capital managed by venture capital funds.[12]

• Bill Gates, number one on the Forbes Four Hundred list, is Exhibit A on the angel list. For reasons he describes as intellectual as well as financial, Gates has bankrolled several start-up ventures in the biotech field.

• Nine years ago (1986) a U.S. News and World Report cover story reported that the typical millionaire is a self-made entrepreneur. Two years later (1988) a TIME magazine story reported that an estimated two million U.S. men and women are millionaires, and nearly 90% of them earned their fortune by starting their own firm.

• Responses to a survey of the investment behavior of 150 of the country's richest families - each of whom has at least $100 million in assets - led Graystone Partners (a Chicago-based matchmaker for wealthy families and investment managers) to conclude that capital preservation is no longer the overarching consideration it used to be- "this generation has to be more aggressive than the last."[13] Over the next five years, wealthy families expect to move more of their wealth into relatively speculative investments. The fraction of wealthy families investing in private equity is forecast to grow from 20.7% currently to 30.7% in five years. The forecasted rate of growth in private equity investing is the highest among twenty-four investment categories.

• From 1974 to 1994, the number of households with income over $100,000 grew from 2.0 million (2.7% of all households) to 5.6 million (5.8% of all households).[14]

V. ANGEL TRAITS

Private investors in entrepreneurial ventures (business angels) are a diverse and dispersed population of high net worth individuals. Their wealth originates from a variety of sources. For purposes of developing a vibrant, informed capital market for early-stage ventures, it is appropriate to focus upon self-made,

high net worth investors, particularly successful entrepreneurs. These individuals, and their associates, are equipped to evaluate the merits and the risks of prospective investments and to provide the value of their entrepreneurial know-how to the ventures they bankroll.[15] Despite their diversity, self-made private investors exhibit many common characteristics:

- They typically invest in ventures involved in markets and technologies with which they are familiar.

- They invest relatively close to home, typically within one days' drive.

- They are "active" investors, serving on a working Board of Directors or providing guidance through an informal consulting/mentoring role.

- As a group, private investors prefer to invest at the seed and start-up stages in the life of a venture.

- They are patient investors. Exit horizons tend to be five to ten years or more.

- A round of angel financing is typically less than $1 million and, in most cases, less than $500 thousand.

- Angels tend to coinvest with trusted friends and business associates. The size of one investor's participation in a round of financing is usually in the $25-$100 thousand range.

- Required investment returns are no higher, and often lower, than the returns required by venture capital funds.

- Angels often take bigger risks or accept lower rewards when they are attracted by the nonfinancial characteristics of an entrepreneur's proposal. They are, quite literally, "adventure" investors.

- Their investment terms and conditions tend to be briefer and more informal than those of venture capital funds.

The informal investor market tends to be in the form of self-contained regional local networks of investors, who obtain information about investment opportunities from a variety of mostly

local sources. Most notable of these active angel markets is the Silicon Valley area of California and the Route 128 corridor around Boston. While the conditions that led to the development of these markets are not found to the same extent in other areas of the nation, other areas do have many of the building blocks from which a more vibrant angel capital market could be developed. Through modern networking many of the lessons learned in Silicon Valley and along Route 128 can be applied to other areas of the country. Through a combination of education and electronic communication, innovative entrepreneurial ventures in all parts of the nation would gain access to early stage capital.

VI. ANGEL MARKETS

In a free enterprise economy, the allocation of scarce resources to their most productive uses requires "efficient" markets. Efficient markets are characterized by fully informed buyers and sellers and by low transactions costs. Private investing in early-stage ventures occurs in an inefficient market. There are no directories of private investors, no public records of their investment transactions, few vehicles exist for bringing together potential investors and ventures seeking funds and transactions costs are high. The private equity market displays the following characteristics:

- Despite its relative invisibility, the angel market is the oldest and the largest venture capital market.[16]
- The private equity market tends to be regional in scope, rather than local or national.

• The angel market is more vibrant in some regions than in others. The Silicon Valley area of California and the Route 128 corridor around Boston are examples of active private equity markets.

• Raising private equity capital involves a costly and time-consuming personal networking process. Successful outcomes are often random events.

• The majority of active private investors report that they have additional capital available to invest. Limited deal flow is the primary constraint.

• The number of successful, high net worth entrepreneurs has grown dramatically over the past twenty years. Informed estimates suggest that the number of latent or potential self-made, private investors exceeds the number of active investors by a factor of five to ten.

• Much remains to be learned about the attitudes, behavior and characteristics of both active and latent private investors. Greater understanding of the "ABC's" of angels would significantly enhance efforts to create a more vibrant and informed national angel capital market.

• Entrepreneurs and latent private investors typically have little or no experience with pricing and structuring a venture investment. They depend heavily upon professional advisors, often for basic information.

• Raising the level of confidence and competence of both entrepreneurs and latent investors in their ability to intelligently price and structure a venture investment would make a major contribution to a robust private equity market.

VII. THE INTERNET

Beyond the "information superhighway" and other overworked metaphors, there lies a larger truth - the move to conducting business on-line is becoming an economic reality - an unrelenting and unforgiving reality with far-reaching implications for change in all aspects of business, including the capital markets. Through the Internet a substantial amount of information can be made available and an increase in this information flow will lead to a

more effective early stage equity market. In the absence of appropriate rules for the market, the new reality is fraught with the potential for abuse and fraud.

- More than two dozen experts in information technology and public policy, meeting recently in Aspen, Colorado, predicted a revolution in the infrastructure of the marketplace in which computer networks will act to speed up all markets, enabling producers and consumers to communicate directly. The Internet will enable regional and even global markets to be more efficient than ever before. The risks of the electronic frontier were likened to the American frontier of the late 19th century: rough, mostly lawless, but rich with possibility and ultimately united by a common set of values.[17]

- About half a dozen venture capitalists now promote themselves electronically by offering information through the Internet and a large group of others say they plan to do so soon. Being on the Internet is "a way to address a new constituency" (James Swartz - Accel Partners). He notes that most Internet users are "engineering, scientific, technology types - classic entrepreneurial types trying to find their way out into the world."[18]

- An electronic prospectus may soon find its way onto the World Wide Web. Dubbed the "hyper-prospectus", it would have hyperlinks embedded in the text, allowing potential investors to jump to other related Web sites, for example, video comments by industry analysts. Investors could attach to the hyperprospectus questions or comments that would be available for other investors to view. Currently, SEC rules present some obstacles. For example, all investors must have access to the same information in the same place. Because of its hyperlink capabilities, the hyperprospectus is not standardized. According to one investment banker: "The hyperprospectus is going to happen anyway. So at some point the SEC is going to have to reconcile customer demand for customized information with its requirements for fairness."[19]

- Investment scams are hitting the Internet at the same time legitimate financial firms, such as Fidelity Investments and Charles Schwab & Co. are going on line to reach customers. Last March the SEC charged that Pleasure Time, Inc. persuaded 20,000 investors to mail in $3.3 million to finance a fraudulent telephone lottery operated by a Native American tribe.[20]

VIII. PUBLIC POLICY PROPOSAL

Two testable propositions underlie the project described in Part II of this report. First, given the right market conditions, the know-how and the capital of private equity investors are more than adequate to meet the needs of entrepreneurial ventures. Second, policymakers can earn the biggest return on their policy investment by undertaking initiatives that significantly enhance the scale and efficiency of the private equity markets that serve entrepreneurs.

The project proposed is multidimensional. At least seven interactive tasks are embedded within it.

- Create a vehicle for providing investors with convenient access to information about entrepreneurial ventures seeking equity financing, i.e. enhanced deal flow. The not-for-profit Technology Capital Network at MIT is the leading example of current efforts to "make a market" for early-stage equity financing.

- Provide the growing population of entrepreneurs and private investors with convenient access to the know-how required to intelligently price, structure, monitor and exit a venture investment - the "central mysteries" of venture capital.

- Alert potential angels to the rewards and risks of investing their know-how and a prudent fraction of their investment portfolios in entrepreneurial ventures. Increasing the number of active angels from 250,000 to 1 million (about half the two million or more self-made millionaires in the U.S.) by the year 2000 should be a policy objective for dealing with our capital formation challenge.

- Reduce the costs of raising capital by establishing reasonable limits on the liability of public accounting firms, attorneys and other providers of professional services. The current spate of securities litigation has led to extraordinary efforts to guard against shareholder suits and to increased liability insurance premiums.

- Promote coherent, friction-free capital markets through elimination of the artificial policy and regulatory barriers to capital flows created by lack of uniformity and reciprocity

across state lines.

• Balance the public responsibility for investor protection (e.g. full disclosure, merit review and rigorous fraud prosecution) with an economic policy promoting capital formation for entrepreneurs.

• Acquire a significantly greater understanding of the attitudes, behavior and characteristics of business angels. The better the characteristics of angels are understood, the better public policy can support the market's needs.

IX. CONCLUSION

The history of business growth in the U.S. is the history of equity financing. In today's entrepreneurial economy, creating quality jobs in globally competitive ventures is a chaotic, untidy process. However, corporate America endures precisely because it innovates, adapts and evolves. Equity capital for entrepreneurs is the fuel for the innovation process.

1) "The Fortune 500," Fortune, 1979-1995.

2) National Association of Securities Dealers, Washington, DC.

3) "U.S. is Ranked Mosts Competitive Economy in the World," The New York Times, 9/6/95.

4) CORPORATE ALMANAC 1994, Cognetics, Inc., Cambridge, MA.

5) Venture Capital Journal, Securities Data Publishing Co., N.Y, NY.

6) Ibid.

7) See for example - "Holdings of Privately-Held Business Assets by American Families: Findings from the 1989 Consumer Finance Survey," Charles Ou, Office of Economic Research, Office of Advocacy, U.S. Small Business Administration, April, 1993, Washington, DC.

8) See for example - "The Hidden Economy: While Big Companies Languish, Little Ones are Creating Jobs and Fueling Demand," David L. Birch, The Wall Street Journal, 6/10/88.

9) See for example - "Who Bankrolls High Tech Entrepreneurs," J. Freear and W. Wetzel, Journal of Business Venturing, March, 1990.

10) See for Example - "The Hidden Economy...," op. cit.

11) See For Example - "Who Bankrolls High Tech Entrepreneurs," op. cit.

12) "The 400 Richest People in America," Forbes, Special Edition, 1984-1994.

13) "Really Rich," Barron's, 5/1/95.

14) "How We Have Changed in 20 Years," Wall Street Journal, 3/29/95.

15) See Appendix A.

16) See Appendix A.

17) "Technology," Peter H. Lewis, The New York Times, 8/28/95.

18) "Looking for Venture Capital? Try Checking the Internet," The Wall Street Journal, 7/26/95.

19) "IPO = Internet Public Offering:," Inc. Technology, 1995, No. 3.

20) "SEC Targets Investment Claim in On-line Probe," The Boston Globe, 8/8/95.