LEARNING OBJECTIVES

This chapter considers the financial management of small and medium enterprises (SMEs). When compared with large companies SMEs have different financial goals and characteristics resulting in the need for different financial techniques and sources of funds. Unlike large listed companies SMEs tend to suffer from capital rationing of long-term debt and equity.

How to identify SMEs is discussed first. Then the financial characteristics of SMEs are examined, followed by their evaluation of projects and estimation of cost of capital. The financing of SMEs in Australia is explored including equity and the need for investment-readiness. The chapter concludes with the management of the SME finance function.

When you have completed this chapter you will be able to:

- identify small and medium businesses in contrast to large firms
- understand some of the key differences between large companies and SMEs
- appreciate the financial goals of the owner-managers of SMEs
- use capital budgeting and cost-of-capital techniques for SMEs
- appreciate the financing requirements at various stages of the business life cycle of SMEs
- understand the role of venture capital
- appreciate the need for investment-readiness by SMEs seeking external funds
- appreciate the importance of the role of the SME finance function.
IDENTIFYING SMEs

Mozell and Midgley conducted a national survey in 1993 and asked 1,200 respondents: “What type of business do you think of when I say small business?” The image of a small retail shop predominated with 78% giving one or more examples of a small retail shop.¹ But the Australian sector of small and medium businesses is much more diverse than this.

From the financial year 1998/99 the Australian Bureau of Statistics (ABS) has collected data for “small firms” which it classified as having less than 20 fulltime employees, and “medium size firms” as having 20 to 199 employees. “Large firms” had 200 or more employees.²,³

Qualitatively SMEs have at least two common characteristics. They are managed by one person or a small team, in contrast to the professional management team of the large listed company. They are independently owned by the managers who contribute most, if not all, the equity capital.

The most comprehensive report to government about small business in Australia was made by the House of Representatives Standing Committee on Industry, Science and Technology. Called the Beddall Report (1990), it provided a definition of small business that has become generally accepted:

a. being independently owned and managed,

b. being closely controlled by owner-managers who also contribute most, if not all, of the operating capital, and

c. having the principal decision-making functions resting with the owner-managers.

Although the sense and practicability of quantitative and qualitative definitions are reasonable, analysts and researchers can use an operational or “grounded” definition.⁴ They can select an approach that is appropriate to their aims and this may be a mix of the two basic approaches. If financial analysis or research is required for SMEs in Australia it could be reasonable to focus on business enterprises that are not listed on the main stock exchange. Generally these will not be “large”, that is, they will tend to have less than 200 employees. This definition highlights the difference between the degree of riskiness in being an owner of a business and in owning a proportion of the ordinary shares in a listed company. Ordinary shareholders only risk the value of their shares, whereas SME owner-managers risk the total value of their net assets. Also, the sources of new funds, both debt and equity, for SMEs is severely limited compared to the financing available to listed companies.

There are currently more than 1.1 million non-agricultural businesses in Australia. Proportionately they comprise 96% small firms and 4% medium and large firms. Since less than 1% of businesses are large, about
99% of non-agricultural firms are SMEs. However, of the small-firm component of SMEs, about 85% are micro-enterprises having less than 5 employees.\(^5\)

For more information regarding small firms and their contribution to the economy and society refer to *understanding small business* <www.sbeducation.info/>.

The emphasis in this chapter will be on SMEs which are unlisted firms, but which are not very small “Mum and Dad” type businesses. Although these firms have problems of a financial nature, their needs and problems are highly personal. Emphasis will be placed on firms which are growth-oriented, that is, they intend to grow and ultimately become large firms—of course a proportion of very small firms may be growth-oriented from inception, but they will not remain small for long if they are successful.

▲ SMALL VERSUS LARGE: IS THERE A DIFFERENCE IN FINANCIAL MANAGEMENT?

We might reasonably question the rationale for studying SMEs separately from large businesses. That is, is the financial management of an SME different from that of a large firm?

There are financial differences between large firms and SMEs, and these have been measured by studies around the world of various financial ratios.\(^6\) We are not concerned here with the very small section of the SME spectrum, the corner store with no intention to grow.

It has been found that there are two differences in financial characteristics between large firms and small firms.\(^7\)

1. Variability in profitability is greater for small businesses than for large enterprises. Business risk, as measured by the variability of earnings before interest and tax, is greater for small firms. The inability to diversify across investments, as well as geographically, increases small-firm volatility of profits.

2. Small businesses have lower levels of long-term debt to total assets than large businesses have. It seems that small firms find it easier to access short-term debt such as trade credit, bank overdraft and bank bills than long-term debt.

There are four other differences found in a number of studies; however, they are disputed by other researchers.

1. Small businesses were found to be less profitable than large firms in American studies, although not in studies from the United Kingdom.

2. Small firms may have lower dividend-payout ratios. This tends to indicate
that, when it comes to equity, small firms rely more on retaining net profits as a source of funds than new share issues.

3. Large firms may have more liquidity, as reflected by the current ratio. One reason may be that SMEs rely more heavily on current liabilities as a source of debt. They may also hold smaller levels of accounts receivable and inventory, as reflected by higher turnover ratios of these assets.

4. The small business capital structure may be more debt-oriented, with a greater tendency for using short-term credit. Their heavy use of debt is usually perceived as one of the basic characteristics of managing SMEs.

Studies of the comparisons between the financial characteristics and performance of SMEs and large enterprises have been difficult and therefore limited, especially in Australia. SMEs that have a corporate structure are generally proprietary limited companies whose shares are not traded on a stock exchange. Although financial-statement data for listed companies is widely available, SMEs are subject to few disclosure requirements and reduced audit vigilance. There can, therefore, be doubts about the reliability of SME accounting data. Also, SMEs are not a homogenous group, varying from home-based enterprises and franchises to the more traditional small businesses. An additional problem is that the financial profile of a small enterprise is related to its stage of development (see later). The profile changes as the enterprise grows from start-up to take-off and then towards maturity.

Although there have been no significant general studies of the financial differences between SMEs and large firms in Australia, P.J. Hutchinson completed a relevant study of 33 newly listed SMEs (total assets less than $5 million).\(^8\) The assets of the selected small companies grew in a period of 10 years after public flotation at an average rate of at least twice the rate of inflation. Thirty-three listed mature large companies were matched with the growth SMEs from their flotation dates. The growth SMEs proved to be very different from the mature companies. They were *more profitable, less liquid, and more highly geared but had a lower proportion of long-term debt*.\(^9\) In the 10 years after flotation of the SMEs the financial differences normalised, i.e. became similar to the mature firms (which is what the SMEs were becoming). It was noted in particular that the proportion of long-term debt held by the SMEs increased to become similar to the mature firms. This suggests that at and prior to flotation a *finance gap* for long-term debt (see later) existed for SMEs as compared to large listed companies.

Although more research is needed, there are clearly some differences between the large and small firm in terms of their financial data. There are
some underlying reasons for these differences. It has been said that *a small business is not a little big business*—the issue is more than a matter of the number of zeroes. In other words, there are reasons why traditional financial analysis may not tell the whole story at times. Here are a few of these reasons.

- The owner may not always be a value maximiser. There may be some personal goals that are of equal if not greater importance. Personal lifestyles realised through the business may distort the economic content of the financial statements, such as ownership by the firm of a holiday house. Also, because the SME, in a way, is an extension of the owner, it becomes difficult to separate the firm from the owner in a financial context without causing distortions. For example, in making an investment decision, the need to develop autonomy outside the firm may be as important as the investment's net present value.

- For the SME, the goal of survival may supercede ideal financial practices, owing largely to the small firm’s limited access to the capital markets, and to the insistence of bankers on looking to the owner’s collateral security and/or personal guarantees in addition to the firm’s financial position.

- SME owner-managers may have a strong preference for the financing options that minimise intrusion into their businesses. Ownership and control dictate funding preferences.

- Traditional definitions of debt and equity may not apply. For instance, loans to the owners may in reality be a form of equity, because there is no intent for the firm to repay the loan. Also, the owner’s personal preference for financial risk, rather than the goal of minimising the firm’s cost of capital, is more important in determining the desired level of debt.

- For the small firm, because of its high degree of riskiness and the need for liquidity ahead of profit, “cash is king”. The owner must absolutely understand and manage the firm’s cash flows, especially for small high-growth firms or companies experiencing rapid change.

The implications of these differences are truly significant to the small owner. In making financial decisions, the owner should seek to maximise the total value of both business and individual wealth, subject to personal lifestyle preferences. Second, SME owners should make every effort to maintain flexibility when dealing with bankers and other providers of capital. Finally, the owner should always prepare a cash budget along with the income statement, and contingency planning should be a constant.
Robert Soldofsky (1964) studied a large number of small firms in the US, where, among other things, he asked the owners how they went about analysing capital-budgeting projects. Fifty per cent of the respondents said that they used the payback period (PBP) technique and 40% of the firms used no formal analysis at all.\textsuperscript{11}

L. R. Runyon (1983) studied more than 200 small American companies with net worths between $500,000 and $1 million. In probing into their approaches for evaluating the merits of proposed capital investments, he learned that only 14% of the firms used any form of a discounted-cash-flow (DCF) technique; 70% indicated they used no DCF approach at all; and 9% used no formal analysis of any form. Little use was ever made of any market-value rules afforded by present-value analysis.\textsuperscript{12}

In an examination in 1986 of surveys and the finance literature Bhandari said that ‘. . . in small firms, payback is not simply the major, but often the only, technique used’.\textsuperscript{13}

The PBP method is used to estimate the time taken for the investment outlay of a project to be “recouped” from the cash flows it generates for the firm. Essentially, the emphasis is liquidity—‘how quickly will we get the money back?’ The user tends to compare the estimate to a desired target period. In its bare form PBP shows no concern for changing the value of a firm. It overlooks the time value of money and cash flows received after any target period may be ignored.

Northcott and Karl (1990) surveyed 43 New Zealand SMEs and found that PBP was the leading technique in terms of both usage and importance to owners.\textsuperscript{14}

Vos and Vos (2000) surveyed the capital budgeting criteria and techniques used by 238 small firms in New Zealand in May 1999. Fifty-eight per cent of the firms had nil to four employees, 27% had five to 19 employees, 11% had 20 to 99 employees, and the balance of 4% had 100 to 500 employees. According to the researchers, ‘. . . firm value maximisation is not, on the whole, at the forefront of these manager’s minds when evaluating their investment decisions’.

Respondents were asked for details of the evaluation methods for their investment projects. A resounding 49% and 51% of companies never used net present value (NPV) or internal rate of return (IRR) techniques respectively. Sixty-seven per cent of firms always or usually used “intuition/gut feel”:

*The intuition part of the decision making process refers to the market knowledge, experience, gut feel or managerial knowledge that the*
decisionmaker uses to influence the determination. The high level of non-financial reliance in the decisionmaking process indicates the low level of quantitative sophistication in small New Zealand businesses.

The leading technique was PBP, used by 49% of respondents always or usually.

The firms were asked Do you differentiate between projects on the basis of risk? and 74% said always or usually. Thirty-three per cent used ‘intuition, market knowledge and experience’, and the most frequently used technique (by 31% of firms) was to adjust the PBP according to risk.

The few companies (10% of respondents) which claimed to use DCF techniques were asked what was used as a discount rate. The leading rate was a ‘judgment-based target return’ used by 42% of firms. The very few companies which made estimates of the cost of equity based this upon a historical accounting return on equity or historical risk premium. Only 10% of the users of DCF estimated a weighted average cost of capital (WACC).

Sixty-nine per cent of firms responded that they either always (22%) or usually (27%) or sometimes (20%) were constrained by capital rationing. According to Vos and Vos

Although small businesses feel restrained by capital constraints when they have an investment opportunity, they rarely prepare the adequate financial plans, with detailed quantitative analysis, to present to the capital markets . . . and simply “feel” or “know” that the project is profitable over time.15

Clearly, despite an awareness of capital rationing, the surveyed small business owner-managers rely heavily on what they would argue is informed intuition in assessing the viability of investment opportunities. Value maximisation techniques using DCF are generally not adopted. The leading quantitative technique used, despite its practical limitations for large listed companies, is PBP and its adjustment for perceived project risk.

Rationale for SME practices
The cause for such limited use of DCF tools over such a long time period probably rests with the nature of the small firm itself. Several important reasons exist, among them the following:

1. As previously stated, for many owners of small firms the business is an extension of their lives. As a consequence, non-financial variables may play a significant part in their decisions. For instance, the desire to be viewed as a respected part of the community may be more important to the owner than the present value of a decision.
2. The frequent capital rationing and liquidity problems of the SME impact directly on the decision-making process within the firm, where survival becomes the top priority.

3. The greater uncertainty of cash flows within the SME makes long-term forecasts and planning unappealing, and even viewed as a waste of time. The owner simply has no confidence in his or her ability to reasonably predict cash flows beyond two or three years. Thus, calculating the cash flows for the entire life of a project is viewed as an effort in futility.

4. Because the value of a closely held firm is not as observable as a publicly held firm, where the market value of the firm’s securities are actively traded in the marketplace, the owner of the SME may consider the market-value rule of maximising NPVs irrelevant. In this environment, estimating the firm’s WACC is also difficult. If computing the large firm’s WACC is difficult at best, the measurement for the SME becomes virtually impossible.

5. The smaller size of projects of an SME may make NPV computations not feasible in a practical sense. Much of the time and costs required to analyse a capital investment are fixed; thus, the firm incurs a diseconomy of scale in evaluation costs.

6. Management talent within an SME is a scarce resource. Also, the training of the owner-managers is frequently of a technical nature, as opposed to a business or finance orientation. The perspective of these owners is influenced greatly by their backgrounds. On the other hand, it would be hoped that the advice of an accountant-adviser would be sought when making important financial decisions.

The foregoing characteristics of the SME, and equally important the owners, have a significant impact on the decision-making process within the small firm, whether or not we agree with the logic. The result is a short-term mind set, prompted somewhat by necessity and partly by choice. Nevertheless, given the nature of the environment, what could we recommend to the owner-managers of the SME? That is, could there be a better process for making investment decisions for the SME?

A marginal approach
DCF techniques based upon WACC discount rates are the conventional wisdom for project evaluation by large listed companies. The PBP and accounting rate of return (ARR) tend to be criticised because they ignore the time value of money involving the use of a discount rate. But apart from this, the DCF approaches have a rationale underlying their usage.

Large companies have a pool of funds available to them. Debt
continuously matures and is replaced or rolled over, retained profits flow in from revenue less expenses, and new equity or hybrid finance issues are made in the market as needed. Financing decisions appear to be made continuously, quite independently of individual project (investment) decisions. It is possible to determine a steady cost for the fund, called its WACC.

There is also a separate pool of projects (the capital budget) and projects are accepted or rejected, ideally by using DCF techniques.

Although it may appear that the two pools are separate and independent, the WACC provides the link between them by forming the basis for the discount rate used for project evaluation. ‘The only constraint financing poses is that projects should minimally earn the average cost of the pool of funds.’

This conventional wisdom (the “traditional approach” to business finance) does not apply to the small unlisted company for some important reasons.

1. There is no pool of available finance. Instead, funds are arranged only when needed for specific purposes.

2. There is no steady average cost of capital:

   The cost is as varied as the types of financing . . . because financing is inevitably arranged only when needed . . . It would be risky to the firm’s liquidity if investment decisions were made independent of financing considerations.

3. Each project is vital to the SME, impacting on its operations, liquidity, profits, capital structure and future. Unlike the large company there is no diversification afforded by a portfolio of projects and different types of operations.

4. The SME needs to maintain a liquidity priority rather than the traditional profit or value maximisation. It is ‘characterised by infrequent dealings in the money market, limited access to external funds . . . the lack of predictable continuous resources and backup finance.”

These considerations provide an apparent rationale for a marginal approach to SME capital budgeting. Rather than a separation of investment and financing decisions, the basis of decisions needs to be a marginal analysis of individual project returns and financing costs. Short-run solvency calls for investments to finance themselves, and the major constraint on project acceptance may be the specific form of available finance, rather than project profitability.

Langdon and Francis (1975) illustrate the approach with an example similar to the following.
An SME is faced with two alternative projects requiring an initial outlay of $20,000.

<table>
<thead>
<tr>
<th>IRR</th>
<th>Operating Cash Inflows</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Project A</td>
<td>20%</td>
<td>$3,000</td>
<td>11,000</td>
<td>17,000</td>
</tr>
<tr>
<td>Project B</td>
<td>16%</td>
<td>8,900</td>
<td>8,900</td>
<td>8,900</td>
</tr>
</tbody>
</table>

Conventional wisdom would suggest that Project A should be accepted with the higher IRR. However, the company must raise the finance specifically for the project. A financial institution can provide lease-type propositions “Debt 1” and “Debt 2” as follows:

<table>
<thead>
<tr>
<th>Financing Cash Outflows</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt 1</td>
<td>$8,000</td>
<td>8,000</td>
<td>8,000</td>
</tr>
<tr>
<td>Debt 2</td>
<td>12,000</td>
<td>5,000</td>
<td>5,000</td>
</tr>
</tbody>
</table>

Should the PBP method be used, neither project, irrespective of the financing package, would return its outlay in 3 years. After 3 years the following amounts would remain unrecouped, and Project B Debt 1 would have the largest amount “due”:

- Project A Debt 1 $13,000
- Project A Debt 2 11,000
- Project B Debt 1 17,300
- Project B Debt 2 15,300

A marginal analysis of matching inflows to outflows for each project and package indicates that Project B Debt 1 should be accepted because it is the only possibility under which inflows exceed outflows in Year 1 (inflow $8,900 less outflow $8,000).

A conscious trade-off between profitability (IRR) and long-term liquidity and short-term liquidity would result.

Langdon and Francis stress the dangers inherent in the marginal analysis and argue for a forward-looking attitude to prevent a series of ad hoc expedient marginal decisions.

*It must be conscious of where it is heading and evaluate each marginal decision as a step along a planned path. It must be appreciated that objective financial planning should be an integral part of overall company strategy... Financial strategy is something to be worked out in advance so you are adaptable and flexible because of finance, not constrained by the lack of it.*
A better way of capital budgeting for the SME

An agency problem can develop in large firms where management is more concerned with its own priorities than serving the owners’ best interests—thus becoming wealth satisfiers, rather than wealth maximisers. If potential conflicts of interest develop, they cannot and should not be ignored. However, the SME has a different situation. If the owner-managers are one and the same, the decision to be wealth satisfiers rather than wealth maximisers cannot be criticised. If the owners are maximising their utility, which includes more than financial considerations, who is to say they are wrong? What can be done, however, is to address the potential need of the SME to consider liquidity on an equal footing with value maximisation, as well as the problem of estimating cash flows in the long-term future. Also, at least partially, the difficulty in measuring the firm’s WACC may be removed.

The need for liquidity

While not an ideal answer, a case may be developed for the SME to use a discounted payback period (DPBP) in evaluating a proposed investment. The payback method provides an indication of how long funds are tied up in an investment. As such, it gives some measure of liquidity, which in turn may be vitally important for the small firm. Also, although we may fault the payback approach for ignoring cash flows beyond the payback period, such a limitation may have less significance for the SME, because the cash flows are more uncertain over the long run. Example 22.1 illustrates the calculation of the DPBP.

EXAMPLE 22.1

The cash flows for a small firm’s project have been estimated for the first five years of its life. The project is expected to cost $50,000, and the owners have a required rate of return of 15%. The expected cash flows for the first five years are as follows:

<table>
<thead>
<tr>
<th>Years</th>
<th>Expected cash flows</th>
<th>Cumulative cash flows</th>
<th>Present value of expected cash flows</th>
<th>Cumulative present values</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$12,000</td>
<td>$12,000</td>
<td>$10,435</td>
<td>$10,435</td>
</tr>
<tr>
<td>2</td>
<td>14,000</td>
<td>26,000</td>
<td>10,586</td>
<td>21,021</td>
</tr>
<tr>
<td>3</td>
<td>17,000</td>
<td>43,000</td>
<td>11,178</td>
<td>32,199</td>
</tr>
<tr>
<td>4</td>
<td>20,000</td>
<td>63,000</td>
<td>11,435</td>
<td>43,634</td>
</tr>
<tr>
<td>5</td>
<td>20,000</td>
<td>83,000</td>
<td>9,944</td>
<td>53,578</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Total present value</td>
<td>$53,578</td>
</tr>
</tbody>
</table>

The PBP for the investment would be 3.35 years ($43,000 received in three years and the remaining $7,000 recouped in .35 years, i.e.
$7,000/$20,000). However, using the owner’s required rate of return of 15%, the present value of the first five years’ expected cash flows is $53,578. Using these present values, the owners recoup their investment on a present-value basis in 4.64 years ($43,634 of the investment received in four years and the remaining $6,366 in .64 year, i.e. $6,366/$9,944). By comparing projects in this manner, consideration can be given both to the present-value criterion and the liquidity of the project.

**Direct approach to measuring the cost of capital**

The methodology for measuring the cost of capital is not totally applicable for the SME. There is no access to market data for the small firm as for the large company whose shares are traded on the ASX. Thus, an alternative method should be sought.

The cost of capital is an opportunity-cost concept. Shareholders should receive from their investment in the firm an amount at least equal to the rate of return available in the capital markets, given the level of risk. The market data of the firm’s securities is traditionally used to estimate these opportunity costs, but no such information is available for most SMEs. The conventional approach therefore needs to be modified.

An SME is either family owned or owned by a small group of investors who are relatively close to the situation. Therefore these owners can be asked directly about their desired rates of return on their equity, which can be set after informing them about competitive rates in the marketplace. The residual **NPV approach** can then be used, which compares the cash flows going to the owners (who would be the shareholders for the company form of SME) to their required rate of return, rather than using a WACC for all investors.

**Residual net present value**

The **residual NPV** is a slight modification of the conventional WACC approach. Rather than computing the present value of the expected cash flows going to all investors discounted at the WACC, the cash is estimated that will flow to the owners after all debt-holders and preference shareholders have been paid their returns. These flows are then discounted at the owners’ required rate of return. Thus the following method can be adopted:

1. Compute the residual cash flows available to the owners of the SME, net of interest expense, debt principal repayment, and preference dividend payments.
2. Have the owners of the SME decide what is a fair rate of return for the project, given its level of business risk. This rate may be somewhat subjective; however, an appropriate rate can be determined by allowing for any alternative uses of the funds and by considering personal factors that affect the owners’ total utility from operating the business.
3. Calculate the present value of the residual cash flows going to the owners and determine the project’s DPBP. Use these results to evaluate the proposed project against other projects under consideration or that have been recently accepted.

**EXAMPLE 22.2**

Assume the Exemplar Company is contemplating an investment that costs $55,000. The project would have an expected life of about 15 years; however, the uncertainty of these cash flows makes management uncomfortable about projecting the flows beyond six years. The firm has a 40% target debt ratio; the interest rate on the debt is expected to be 10%; and the principal on the debt is to be repaid over 10 years by reducing the balance by 10% at the end of each year. The company has a policy of paying fully franked dividends to the shareholder owners. The resulting before-tax cash flows going to the owners in each year are computed in Table 22.1.

Beginning with the expected cashflows from operations for each of the six years, subtract the interest expense, which is 12% of the remaining debt balance each year. A $2,200 payment on the debt principal is made at the end of each year, which is subtracted from the cash flows from operations and after interest expense. The remaining amount is the before-tax cash flow accruing to the owners of the SME. Using a 15% before-tax required rate of return, the present value of these residual cash flows is calculated and shown in the last row in Table 22.1.

From the present values of the annual cash flows in Table 22.1, calculate the DPBP as follows:

\[ \text{DPBP} = (5 \text{ years of before-tax cash flows with present value of $54,214}) + (.097 \text{ years to receive remaining cash flow of $786 or } \frac{786}{8,145}) \]

\[ = 5.097 \text{ years} \]

**TABLE 22.1**

**EXEMPLAR COMPANY PROJECT ANALYSIS**

<table>
<thead>
<tr>
<th></th>
<th>YR 1</th>
<th>YR 2</th>
<th>YR 3</th>
<th>YR 4</th>
<th>YR 5</th>
<th>YR 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating cash flows</td>
<td>$18,556</td>
<td>$20,250</td>
<td>$21,345</td>
<td>$21,116</td>
<td>$22,228</td>
<td>$22,140</td>
</tr>
<tr>
<td>Interest</td>
<td>(2,640)</td>
<td>(2,376)</td>
<td>(2,112)</td>
<td>(1,540)</td>
<td>(1,320)</td>
<td>(1,100)</td>
</tr>
<tr>
<td>Debt payment</td>
<td>(2,200)</td>
<td>(2,200)</td>
<td>(2,200)</td>
<td>(2,200)</td>
<td>(2,200)</td>
<td>(2,200)</td>
</tr>
<tr>
<td>Cash flow to owners</td>
<td>$13,716</td>
<td>$15,674</td>
<td>$17,033</td>
<td>$17,376</td>
<td>$18,708</td>
<td>$18,840</td>
</tr>
<tr>
<td>Present value</td>
<td>$11,927</td>
<td>$11,852</td>
<td>$11,199</td>
<td>$9,935</td>
<td>$9,301</td>
<td>$8,145</td>
</tr>
<tr>
<td>Cumulative present value</td>
<td>$11,927</td>
<td>$23,779</td>
<td>$34,978</td>
<td>$44,913</td>
<td>$54,214</td>
<td>$62,359</td>
</tr>
</tbody>
</table>
Thus, in 5.097 years, the owners may expect to recoup their original investment, while earning their required rate of return of 15% before-tax. The decision to accept or reject the project would come only after comparing it with other alternative uses of the funds and the impact on the project of key non-financial variables that only the owners can know.

### FINANCING THE SME

The SME sector ranges from the one-person sole trader to the manufacturing company with 199 employees. A large proportion of SMEs are, however, very small, having less than 5 employees.

When it comes to financing, the very small firms, and many of the remaining small firms which do not intend to grow, tend to rely heavily on the equity and debt supplied by the founders, friends, relatives, private backers, and trade credit, and debt from the capital market (especially from banks). Although financial problems figure largely in the reasons for the failure of such firms, these are probably due more to lack of information and incompetence on the part of owner-managers than the unavailability of finance.

#### Business life cycle

There is an important, although small, proportion of SME operators who are growth-motivated and have an enterprise that can grow. Such firms tend to have a *business life cycle* with commensurate financing needs.20 See Figure 22.1, which has one axis indicating time and the other axis with a measure of SME growth (such as sales).

![FIGURE 22.1
BUSINESS LIFE CYCLE](image-url)
**Stage 1: Start-up**

At the start-up stage the major source of finance is likely to be the private resources of the starter. These will tend to be limited, even when supplemented in some cases by loans from friends, relatives and the occasional private backer. Under-capitalisation is a common cause of a crisis in Stage 1 with subsequent failure. Trade credit will often become available, and debt from financial institutions such as banks will only be available if the owner has collateral security, such as a home or other property.

**Stage 2: Early growth**

Early growth occurs as production, sales or services and a market develop. Staff, often part-time or casual, will be added. Premises may be rented and equipment leased. Only limited funds come from retained earnings. Although future prospects may be bright (but uncertain), the track record of the business is limited and collateral security and personal guarantees have been fully utilised to obtain short-term and medium-term debt, mainly from trading banks.

In these stages (and Stage 3) owners often resort to “bootstrapping”, that is, alternative means of securing resources that do not require traditional funding. They acquire resources from customers and suppliers as well as using their own resources. They buy used equipment, withhold staff salaries, accelerate invoicing, negotiate conditions with suppliers, delay payment to suppliers, and borrow equipment from other businesses.

Stages 1 and 2 comprise the establishment or infant stage of growth, perhaps three years of critical development before the firm goes through the “knothole” into Stage 3, or closes.

**Stage 3: Take-off**

Into the take-off stage a track record has been established for the ability of the owner and the success of the product or service. Turnover increases rapidly and projections for future growth are strong. Long-term funds become essential, especially for working capital, but here is the problem for the business. Retention is limited because although accounting profits may be growing, cash-flow is low and is needed to fund working capital. There is no proven junior share market for the flotation of growing SMEs, and few investors are willing to purchase minority equity positions in unlisted companies. Long-term debt is very hard to obtain from traditional sources, especially as the firm has fully utilised its collateral security and the personal guarantees of owners.

This is the growth stage in which good financial management is absolutely critical. Incompetence in financial management as well as the financing difficulties can create a liquidity crisis and likely failure, especially if the firm was under-capitalised at inception but managed to continue to Stage 3.
Stage 4: Maturity
With adequate financial management and the acquisition of long-term finance, the firm may continue to grow to a sufficient size to float on the ASX. Equity then becomes available as well as a variety of other funds, and if it has not already done so, it soon joins the Big Business class.

Our stage model is very generalised, but it is sufficiently helpful to indicate the three trouble spots in Australia for the financing of growth SMEs:

- There is a shortage of long-term debt, especially in Stage 3.
- There is a shortage of equity in Stages 1 and 3.
- There may be an insufficient proportion of SMEs which proceed to public flotation in Stage 4.

Finance gap
In looking more closely at these three financing aspects, there is a finance gap in Australia for SMEs.21

Long-term debt
Hutchinson—see earlier—found that newly listed growth SMEs had a significantly lower level of long-term debt than mature listed firms.

In a 1991 survey by the Bureau of Industrial Economics of the sources of finance for manufacturing small businesses, more than 80% of the firms received debt from banks, which provide little long-term debt. The predominant forms of debt were mainly at-call debt (bank overdraft), short-term bills and traditional medium-term debt (term loans and finance leases). There was limited use of other sources and forms of debt.22

The Wallis Inquiry into the Australian financial system found in 1997 that small business demand for suitable bank debt was not being met, and there is little evidence of major improvement since then.23

There are two aspects of the debt gap. The first is a lack of long-term debt. Apart from residential mortgages, commercial bank debt is limited to term loans or leases of three to five years or occasionally seven years. The second aspect is caused by the fact that not all small firms can provide collateral security required by banks for debt finance:

They may be viable ventures, have good track records, and have potential returns that are as high, or higher, as those of firms that have available collateral. Without collateral security to restrict their downside risk, banks seem unwilling to lend in such cases and are also unwilling to charge a higher interest rate to compensate for low collateral.24
**Equity**

Large listed companies obtain their equity from financial institutions, overseas investors, other companies and private individuals. Small companies seeking equity have a more restricted set of options. About 80% comes from owners or related family, only 2.5% from financial institutions and effectively nil from overseas investors. Individual investors and other businesses provide minimal equity.25

Closely held SMEs have difficulty in raising new equity. Finding new partners or investors is difficult even if the owner is willing to accept some dilution of ownership and control of his or her business. One reason is that it is difficult to sell such shares at a later date when there is no recognised market.

See later for more discussion of equity for SMEs and their investment-readiness.

**Flotation of small businesses**

There are stringent requirements and high costs for small companies, such as those in the take-off stage of growth, wishing to float and be listed on the ASX. Moreover, the costs of the flotation procedure are proportionately higher for small than large companies. See the Focus on finance, ‘To float or not to float that is the question,’ *Financial Management 3/e*, pp. 565–6.

To counter such problems, second boards were established by the stock exchanges in each state between 1984 and 1986. Activity peaked on the second boards in 1986–87—listed companies had a market value of $2,600 million, but following the sharemarket crash of October 1987 and the subsequent economic recession, the new boards collapsed. These second boards were discontinued from 30 June 1992. The Newcastle Stock Exchange (NSX) reactivated in 2000 and the Bendigo Stock Exchange (BSE) revived in 2001 to provide for small listings are yet to achieve general acceptance and a viable volume of activity. Australia now has no effective second share board and this has restricted the opportunity for small-growth firms in the take-off stage to become public listed companies.

Most commentators argue that there is a finance gap for growth small businesses in relation to long-term debt, equity and flotation in Australia. This has also been found in other Western countries.

The small business growth cycle did not include the development of the high-growth technology-based SME which undertakes research and development, develops prototypes and commercialises its innovations prior to Stage 1 (start-up). Although such enterprises may be able to reach Stage 1 by using personal funds and government assistance, actual start-up and early growth require equity beyond the owner’s resources. The Espie Committee was established in 1981 to examine the failure of new technology companies to
develop in Australia. A key finding was the unavailability of equity capital for Stages 1 and 2 of such companies, and this remains a challenge in Australia.

Although there is evidence of a finance gap for the three aspects discussed, there is no consensus regarding its causes. There can be supply-side considerations due to gaps in the capital market for unlisted companies.

There are also demand-side issues for SMEs that wish to grow but are unwilling to accept external long-term funds. Small business literature provides theoretical and empirical support for the pecking order approach by small business operators seeking funds. According to recent New Zealand SME research, “any apparent gap is in part a consequence rather than a cause of the financing preferences of small firm owners”. Because of a need to retain independence, ownership and control such owners may follow pecking order theory in choosing their funds.

Small firm owners will try to meet their finance needs from a pecking order of, first, their “own” money (personal savings, retained earnings); second, short-term borrowings; third, longer-term debt; and, least preferred of all, from the introduction of new equity investors, which represents the maximum intrusion.

Venture capital can provide one of the solutions to the small firm finance gap and is now discussed.

**VENTURE CAPITAL**

Venture capital may be defined as the provision to actual or possible high-growth projects, or firms with risky but potentially high-reward activities, of public or private funds from sources other than the official share market. It may have one of the following forms:

- equity, usually of a minority position
- debt which is convertible to equity
- debt of a risk-capital nature, i.e. of medium- to long-term and granted more on the basis of the profit prospects of a project or firm than its security

Venture capital differs from other forms of finance because it involves a package deal. The venture capitalist (investor) often provides management and commercial expertise along with the funds. As discussed in the final section, the owner-manager of the SME has many “hats” in managing the enterprise. In the growth enterprise in particular, assistance can be needed in management, and particularly in financial management.

Venture capital has been called “adventure capital” because it is provided for high-risk ventures, but it has the potential for higher returns than from
other forms of investment. It is also called “patient capital”. The investee company needs to be coaxed through its development with management assistance and often further injections of funds until maturity, when the investor anticipates a capital gain from the sale or flotation of the investee company. This may take 5 to 7 years depending on where the venture capitalist enters the SMEs growth cycle.

In practice, venture capital forms a spectrum. It may be provided for Stages 1 to 3 and just prior to sale or flotation in Stage 4. It can be called seed capital if provided for the high-tech enterprise prior to and in Stage 1, and start-up capital for other SMEs for Stage 1. Development capital is the venture capital provided in Stage 3 (take-off) and afterwards.

The precise nature of the venture-capital package depends on where the venture capitalist enters into the SME’s development. The greatest risk is in the early stages, therefore equity is most appropriate at this time. As the SME’s cash flow will be low in the early periods, payments of debt interest and dividends can be avoided. But the investor can be rewarded later with very high capital gains from the increase in the value of the equity. The extent of required managerial assistance from the venture capitalist is likely to be greatest in the early phase. In the SME’s later stages its riskiness will reduce and its cash flow will improve. Debt becomes a more suitable form of finance, and less management assistance may be needed from the venture capitalist because the SME becomes large enough to recruit specialist staff. The most popular form of venture capital from the investor’s viewpoint is development capital provided in the later stages.

There are various sources of venture capital in Australia.

Sources of venture capital
The supply of venture capital is best considered by studying some specific investment groups and institutions.

Corporate investors
There is little available data regarding the extent of direct venture capital support for small firms from large companies, but there seems to be little incentive for companies to become equity-involved unless there is an obvious synergy with their existing business. Some corporate venturing emerged in the 1980s by firms such as Amcor, Telstra, BHP and CRA but with little success. The corporate trend is for outright purchase or to enter into joint venture arrangements with smaller companies. Also, according to the ABS, about 7% of funds for venture capital vehicles come from the investment of ‘private trading enterprises’.29

Bank equity
The charter of the Commonwealth Development Bank (CDB) was amended in 1986 to allow it to provide equity to small firms ‘which are able to
demonstrate prospects of strong sales and profit growth’. Because of its recognised skills and experience the CDB is ideally placed to assist the financing of small innovative businesses but the majority of its activities and funds are directed at debt finance.

In late 1995 the Federal Government made changes to Reserve Bank prudential requirements to allow banks to make equity investments in businesses up to an aggregate amount of 5% of a bank’s core capital. The conservatism of banks has been illustrated by a clear indication that they are interested only in established companies with strong trading records. About 7% of funds provided to venture capital vehicles come from the investment of banks.30

Superannuation funds
Since the mid-1980s the Commonwealth Government has supported savings via superannuation to encourage provision for retirement by the workforce. There has therefore been an ongoing shift in household savings from traditional banking/deposit institutions into superannuation funds, which now comprise the largest pool of long-term savings in Australia.

Since 1990 the Federal Government has unsuccessfully attempted to persuade the funds to place at least 1% of their investments in venture capital, as has happened in the US and some OECD countries. The funds’ involvement in the small business market is mainly made indirectly through investments in the formal venture capital industry; where direct investments are made it is generally in mature firms which are listed or close to listing. About 35% of funds provided to venture capital vehicles in Australia come from resident superannuation funds, and 21% from overseas pension funds.31

Formal venture capital market
Before 1980, venture capital (especially equity) provided by financial institutions in Australia was almost non-existent. There is no available data but a limited amount of equity would have been provided by a few large companies and informal venture capital by “business angels” (private investors such as accountants, doctors, sharebrokers and solicitors).

From 1983 a formal venture capital market developed with the establishment of management and investment companies (MICs) recommended by the Espie Committee to provide equity capital and management expertise. A flaw in the scheme was the restriction that only investments in early-stage technology companies were permitted. Many MICs developed extremely high-risk portfolios because a maximum investment for most MICs was only about $1m in any one investee. Little capacity was left for follow-on support investing.

The MICs were subject to Federal Government regulation and licensing, and investors were granted tax concessions. At the same time, second boards
opened in all states for the listing of small companies. The MICs provided a

catalyst or multiplier effect—venture capital (non-MIC funds) was generated by
private enterprises, many with corporate or institutional investors. It also began
the process of training people to manage venture capital investments and the
resulting pool of experience grew. A number of successful investees emerged
such as Vision Systems, AMRAD and Cochlear. Unfortunately, the share market

crash of October 1987 intervened, followed by high interest rates and economic
recession. The MIC scheme was closed in 1991 by the Federal Government.

The experience of the MIC scheme highlighted the risky nature of early-
stage investments and a shortage of “winners”. Associated with the loss of
second boards needed for exiting their investments, formal venture capitalists
accordingly focused on development capital for much of the 1990s. But
overall, the formal venture capital industry is now the major provider of equity
to SMEs in Australia.

By the mid-1990s private equity had become a growth industry in the US,
UK and across Europe, courted by governments as a vital driver of economic
growth. The amount invested in the international private equity market
increased five times from 1995 to 2000. Capital raisings in Australia by private
equity fund managers were between $100m and $150m each financial year in
the early 1990s. The market took off in 1996–97 when $409m was raised,
there was a dip in 1997–98 to $266m, an increase to $812m in 1998–99, and a
record peak of $1.2b in 1999–2000. Because of the world-wide effect of the
March 2000 dot com share price collapse, the peak may take time to be
exceeded. In 1996–97 only 7% of formal venture capital funds went to early-
stage companies, but increased to 14% for 1999-2000.

The Australian venture capital market is still immature and at an early
stage of development. It lags behind the US and the UK. The proportion of
venture capital funds raised to GNP increased from 0.6% for 1996–97 to
0.9% by June 2000. But this compares unfavourably with proportions of 2.7%
in the US and 4.8% in the UK. There are a number of reason for this including
the poor small business and entrepreneurial image in Australia, lack of tertiary
enterprise studies, small local markets, a short venture capital history, and poor
government strategy:

. . . Australia’s venture capital market . . . lacks the long pedigree of the
US venture capital market, the luxury of a huge market on its doorstep,
and a broad seasoned pool of talent that has weathered several
generations at technology’s coalface.33

. . . Federal Government has failed to provide an enticing, easily
understood investment environment for local and overseas investors . . .
there is no comprehensive approach that addresses investment, CGT and
important elements such as employee share options. Australia lacks an
overarching plan to direct capital into promising young businesses . . .
Government has stopped short of following all its good intentions.
Unlike the US, they just haven’t got the whole package right . . .

Pooled Development Funds (PDFs)
In 1992 PDFs were established by the Federal Government to replace the MIC
scheme, and to remove some of the MIC problems such as lack of flexibility
for operators and an absence of incentives for institutional investors. Private
investment companies established under the PDF Act 1992 are registered with
a licensing board and are expected to provide new equity for SMEs (not
involved in property or retail sectors) with assets of less than $50m.

Early in 2000 changes were made by government following a 1998
review which indicated that the program had been less than successful. PDFs
can now make loans to equity investees, and, importantly, Australian
superannuation funds and similar overseas pension funds (and limited
partnerships) can now wholly own a PDF. A number of PDFs have an emphasis
on biotechnology industries.

PDFs have various taxation benefits and pay only 15% tax on the
component of their taxable income derived from investments in SMEs.
Dividends and capital gains on sale received by shareholders are tax exempt.
For the financial year 1999/2000 $158m was raised by PDFs, with total capital
at the end of the year at $476m. During the year $310m was invested in 280
investee companies.

By mid-2001 about 100 PDFs had been established, and 30 had listed on
the ASX providing an avenue for retail investors to hold actively traded shares
in the venture capital industry. Time only will indicate the success or otherwise
of the PDF program in meeting the need for venture capital by small
enterprises.

Innovation Investment Fund (IIF)
A recent venture capital initiative by the Federal Government is modelled on
the Small Business Investment Company (SBIC) program which has existed in
the US since 1958 supervised by the Small Business Administration (SBA).
Established as a joint private/public initiative SBICs have invested more than
US$16b in 110,000 financings. Despite ups and downs the program has
successfully survived and helped to develop corporations such as Apple
Computers and Intel.

By June 1998 government complemented the PDF scheme by allocating
$130m to a Small Business Innovation Fund, now called the Innovation
Investment Fund (IIF), aimed at filling the early-stage finance gap in the range
of $.5m to $2m investments for new technologically based firms. The IIF is intended to compensate for the emphasis by venture capitalists on supplying development capital rather than seed capital or start-up capital.

The fund licensed five venture capitalist firms, to be administered by private sector managers. Each firm is expected to have a 10-year life span and must invest at least 50% of funds into early-stage activities, providing seed capital, start-up capital or first-round capital. Fund managers were required to find $1 of private institutional funds for each $2 contributed by government. Profitable firms will repay government capital plus interest, based on the long-term bond rate, and only 10% of their profits.

By November 2000, LookSmart was by far the most successful investment, initially funded by AMWIN Management P/L, one of the five venture capitalists. LookSmart returned $51m for the government.

A second round of $90.7m from the IIF was awarded to four new venture capitalists in late 2000. The largest of these was Nanyang Ventures, funded $25m from the IIF and $25m from institutional investors, St Georges Bank and Queensland Investment Corporation. Less generous government contributions were made in the second round. Nanyang received a 1:1 ratio (government to institutions), and the other three firms received 1.28:1, 1.38:1 and 1.49:1.

The IIF model may provide a winner for the government-sponsored attempt to bring together public and private funds and initiatives to provide start-up and early-stage funds in the formal venture capital industry.

**Informal venture capital (IVC)**

The term “business angel” was first applied to private investors “descending from on high” to provide finances for Broadway stage productions. Business angels are generally people with a professional or business background willing to make equity (or venture capital type debt) investments in enterprises which tend to be disregarded by formal venture capitalists. See the Focus on finance, ‘Business Angels to the rescue,’ Financial Management 3/e, pp. 571–2.

A detailed discussion of business angels in Australia and matching services which aim to bring together SME investors and business angels can be found at understanding small business, <www.sbeducation.info/>, Informal venture capital in Australia.

It appears that the finance gap may still be present in Australia, particularly for long-term debt, the seed capital and start-up requirements of technologically based high-growth small businesses, and the early-capital stages of other growth small firms. However, improvements have taken place from the late 1990s due to a world-wide interest in private equity and a more active stance by government. Because of the importance of these enterprises to job creation, innovation and economic growth, governments should continue to be
concerned with the finance gap and the supply of venture capital. An
appreciation of the concept of the small business finance function may assist
with these challenges—see later.

Two important studies and an emphasis on the demand side for equity
and venture capital are discussed in the next section.

## SMEs AND INVESTMENT-READINESS

Two major research studies were commissioned by the Commonwealth
Government, *Financing Growth* (1995) and *Investment Readiness Study*
(1997) to quantify the equity gaps for SMEs. 35

**Financing growth (1995)**

The National Investment Council was asked to investigate the ‘capital needs of
SMEs aspiring to significant growth and whose equity is not listed on the main
board of the Australian Stock Exchange (ASX)’.

From interviews with more than 60 industry participants, it was found
that:

1. The ‘vast majority of SMEs (had) no aspirations for significant growth’.
   Probably only about 10% of small firms ‘aspire, plan and achieve growth
   (to) provide the essential dynamism of the SME sector’.

2. Most growth firms seeking equity were not “investment-ready”, that is, they
   failed to meet fundamental requirements to be attractive to external
   investors.

3. Despite the difficulties small firms have in obtaining investment capital,
   there was no shortage of capital in Australia. However, there were major
difficulties in the efficiency of the market’s allocation processes and the
ability to deal with the risk, uncertainty, high cost and regulatory
impediments incurred when investing in small business.

4. High search, information and transaction costs, and risks and uncertainty,
   were inherent characteristics of the small firm capital market that
   constrained the flow of capital to small firms.

5. Corporation Act prospectus requirements and other regulations acted as
   major constraints and impediments in the already difficult search process
   that emerging growth firms must undertake in order to obtain equity.

6. There was virtually no information on the current and potential role of
   Australian private investors in small business.

7. A gap existed in the supply of equity finance in Australia for amounts
   between approximately $0.5 and $2m. This was above the typical upper
   threshold of most potential business angels (BAs) and below the typical
minimum investment threshold of many venture capital firms. Little was known about the magnitude and significance of this gap and the extent to which amounts of less than $0.5 million were actually serviced by BAs.

In view of the importance of small firms, particularly the “gazelles” (growth firms), the Financing Growth study investigated factors critical to gazelle growth, including the following:

- Small firms must be willing to share equity with external investors.
- Small firms must be willing to delegate decision making to non-owner-managers. Many owner-managers who lack the management skills growing businesses require can then focus on their areas of expertise, which are often the key to the firm’s growth.

In addition, gazelles needed to meet other minimum criteria to be attractive to investors, including the following:

- Governance arrangements must be in place to separate the personal affairs of the owner from those of the business. At a minimum, this requires audited accounts and a clear demonstration that business accounts are not tax driven.
- The firm must be sustainable in the absence of the owner.
- The owner-manager and other key personnel must possess adequate management skills.

The recommendations of the Financing Growth inquiry included:

1. That assistance be provided to assist gazelles to become investment-ready.
2. That the Corporation Act be urgently reviewed, to remove unnecessary impediments.
3. That there be further research on how to “lift the blindfolds in the search for/by business angels”, such as the development of viable matching schemes.
4. That ways to narrow and reduce the impact of the financing gap be investigated.

The National Investment Council reported that even among the Australian gazelles that were seeking external equity, not many understood what was needed to attract external equity investment. From the interviews and research undertaken, it was found that SME owners were either not willing to, or did not know how to, meet the requirements of external investors. Therefore, it suggested that the “concept of investment-ready needs to be clarified and tailored to reflect the requirements of different stages of growth and different classes of investors”.

The Commonwealth Government
took up the recommendation and commissioned the *Investment Readiness Study* (1997).

**Investment Readiness Study (1997)**

The Centre for Innovation and Enterprise and Ernst & Young were commissioned by the Federal Government to ‘evaluate and establish a set of “investment-ready” criteria for different equity investor types, as they apply to SMEs at different stages of their life cycle and to different types of SMEs’.

The *Investment Readiness Study* (IRS) involved a survey of a cross-section of equity investor groups, based on a generic set of investment criteria involving investor parameters, market, personal, organisational and financial factors. Some important issues were confirmed:

1. That SME owner-managers lack an understanding of external equity as an alternative financing source;
2. that investment-readiness was a complex issue involving subjective evaluation by the equity investor and a “mind set” change process by the owner-manager; and
3. that most SMEs do not possess the attributes to meet the requirements of venture capital investors and BAs.

Following consultation with investor groups the IRS confirmed an equity gap of between $0.5m and $2.5m for SMEs.

Equity investments for amounts of less than $0.5m were seen as the province of BAs who are limited by their available funds and exposure to a few investments. The formal venture capital market tended to limit SME injections to amounts of $2m to $2.5m because smaller investments were generally not cost effective given the high risks involved and the high costs of evaluating and monitoring small investments. The gap between $0.5m and $2.5m equated to early-stage investments where risk levels were perceived to be particularly high, but little was known about the size and significance of this gap.

A return on equity of 25–30% p.a. over 3–5 years was required by a venture capitalist or BA who invests in a minority position in the ordinary shares of an unlisted later-stage SME. At that time about 8% p.a. could be returned from treasury bonds, and 15% p.a. from blue chip listed shares, so that a further risk premium of 10–15% p.a. was needed to compensate for the high risk, lack of marketability and minority position of investing in a small company. For early-stage ventures a return of 40–50% p.a. may be required. Therefore, “SMEs who are between the debt parameters and have not yet reached the equity investor parameters of return on investment, present a problem for the SME sector”.

As part of its investment-readiness, the SME has to ensure that it can
professionally present a proposal that can satisfy financial and non-financial considerations of a venture capitalist or BA. It needs to possess the necessary qualities to develop a relationship with the investor, including a sufficient level of trust and comfort to enable an amicable partnership.

Getting ready for investment
The purpose of the IRS was to provide SMEs with the information they need to become “investment-ready” by identifying what venture capital investors would be looking for in an equity investment opportunity. The investment decision of the venture capitalist incorporates three major components:

1. Investment parameters. These represent the established investment guidelines and focus of the investor, which may include, for example, a focus on large manufacturers or management buyouts over $5m.

2. Growth opportunity. This represents the evaluation of the external factors impacting on the investment potential such as market opportunity, product innovativeness and competitiveness, external influences and the capital growth return potential.

3. Internal capabilities. This represents the capabilities of management and the internal operations and controls present in the business to achieve the identified growth potential.

The third factor relates to the investment-readiness of the equity applicant, and reflects the ability of the SME owner-manager to develop the growth opportunity.

Venture capital investors (venture capital funds, superannuation funds, BAs, PDFs, banks and companies) were surveyed and their investment-ready criteria summarised. These criteria apply to SMEs at different stages of their life cycle and to different types of firms. Three matrices were prepared regarding:

1. SME stages of development
2. SME equity providers
3. Investment decision criteria by the investor group

The matrices were intended to be used as practical guidelines for SMEs and their advisers to understand the requirements of equity providers and to contrast these with the situation of their business. An inability to match the guidelines at a particular stage of growth indicates a lack of investment-readiness and calls for constructive changes in the business and owner-manager.

The study and the working matrices fill an important information gap between investors and SMEs and are a first step in the need for an increased market awareness and desire for change by SME proprietors in becoming
willing and ready for equity investment. There is also a need for the formal venture capital industry to become more proactive in reducing the investment-readiness barrier.

Ernst & Young et al. indicated that government had an important role in the education process that is needed for both businesses and investors. Equally important were business and industry bodies, and advisers such as accountants and angel-matching service managers in constant contact with the SME sector.

The Victorian Government was the first to initiate and subsidise an Investor Readiness Program which steered SMEs to BAs or formal venture capitalists. In September 1997 it opened an Investment Readiness web site, although it has since closed.

There is no doubt that the two studies have raised the issue in Australia of the necessity for small firms to change their “mind set” towards becoming investor-ready, and then to subsequently pursue BAs or formal venture capital bodies for larger sums.

The final section explains the importance of every SME to maintain an active finance function.

SME FINANCE FUNCTION

All financial management textbooks assume that the objective of the financial decision making of the large company is to maximise the shareholders’ wealth. This has been the basis for a company’s finance function and it directs investment, financing and dividend decisions. Administratively, the finance function in many companies is separated into a treasury division and an accounting division. A financial executive may have overall responsibility for the function, with a financial manager and a chief accountant (or controller) being responsible for the two respective divisions.

For the SME there is also the need for a finance function, in the same manner that a marketing function and a human-resources function are required. However, the decisions of the function should maximise the total value of both the business and the individual owner’s wealth, subject to personal lifestyle preferences. Flexibility and the need for liquidity also become an essential basis for decisions.

There is considerable evidence that the inability of SME owner-managers to appreciate the significance of the finance function and to competently manage it has led to problems and failures. Time and time again poor financial management has been a key cause of the legal failure of SMEs. In a 1991 study of 2,353 small workplaces the most frequently mentioned problem was that of finance, mentioned by 28% of the sample. A 1993 study of 1,374 small service companies concluded that financial aspects were the number one constraint facing service businesses.
As with the finance function of the large business, the SME finance function needs to cover the accounting information system and the investment, financing and dividend decisions. An accounting system that provides information for making decisions needs to be designed specifically for the SME and needs to be linked to a cash budget and a long-term planning system. As we have seen, different techniques may be needed for investment decisions. The acquisition of finance will be a key aspect and will include the preparation of adequate applications for funds based on a business plan, as well as networking to bankers and other sources of funds. The requirements of the function will vary with the size of the SME and its stage of growth.

The question arises as to who can actually operate the SME finance function. The owner-manager will remain responsible for the function, but has to have as many “hats” as there are functions in the business, and is unlikely to have expertise in more than one or two specific areas. When an SME is large enough it should appoint a person with financial expertise to undertake the function, but this may take quite a time, perhaps into Stage 3 of growth. In the meantime, who can service the finance function? The logical person is the external accountant, who is the chief outside professional adviser to SMEs in Australia. The accountant is the best equipped professional to assist because of his or her financial background, and because the vast majority of SME owner-managers already use accountancy services for taxation and compliance with annual reports.

It is important that both SME operators and accountants be aware of the importance of the finance function and its need to be serviced competently.

**SUMMARY**

There is no doubt that SME owners’ perspectives on financial management differ from that of a large company and reasons have been discussed for this. It was observed that SMEs characteristically (1) have greater variability of profits, (2) have less liquidity, and (3) use greater amounts of short-term debt. Also, compared to listed companies, there is a finance gap for long-term debt and equity. These differences lead to different capital budgeting techniques and to different financing choices. The importance to SMEs of the concept of investment-readiness has been discussed and the proper management of the finance function of the SME cannot be too highly stressed.

**STUDY QUESTIONS**

22.1 Provide three definitions of “small business”. Illustrate these with examples of SMEs known to you.
22.2 “A small business is not a little big business.” Explain what this means, with examples.

22.3 Explain differences in financial characteristics between SMEs and listed companies. Use the Australian study by P.J. Hutchinson.

22.4 Evaluate the proposition that “all SME owner-managers should concentrate on the maximisation of wealth in operating their firms”. Support your views with reference to the owner-manager of an SME known to you.

22.5 Provide a rationale for SMEs not using the discounted cashflow approach to capital budgeting with the traditional weighted average cost of capital as the discount rate.

22.6 Explain the “marginal approach” to SME capital budgeting suggested by Langdon and Francis. Evaluate the pros and cons of this procedure.

22.7 Explain the discounted payback period, the direct approach to measuring a “cost of capital”, and the residual net present value. Why may these procedures be more suitable for SMEs than for listed companies?

22.8 Adopt the business life cycle approach to explain the finance requirements of SMEs and the availability of finance, at each stage.

22.9 What is financial “bootstrapping”? Why might SMEs resort to this?

22.10 Explain the SME finance gap in Australia. What suggestions can you make to help close the gap?

22.11 What is venture capital? How does it differ from traditional types of finance?

22.12 Explain the following terms: second boards; management and investment companies (MICs); pooled development funds (PDFs); Innovation Investment Fund (IIF).

22.13 You need to find information about business angels that may provide finance to a growing SME for which you are an adviser. Obtain your information from the Internet: understanding small business <www.sbeducation.info>, Browse the web . . . SB financing.

22.14 With regard to growing SMEs what is meant by “investment-readiness”? What characteristics of the owner-manager and the business would you look for to decide whether an SME is investment-ready?

22.15 Evaluate the proposition that the finance function of a small firm should be operated from the date of its start-up by a public accountant.

NOTES


3. Prior to 1998–99 the ABS defined small businesses as manufacturing firms with less than 100 employees, and non-manufacturing firms with less than 20 employees.

4. For a discussion of small business definitions, see R. Peacock, chapter 1,

5. ABS Cat. 1321.0 Small Business in Australia 2001 (Commonwealth of Australia, 2002).


9. These characteristics were similar to those of growth SMEs in the United Kingdom.


17. ibid.

18. ibid.

19. ibid.


21. Johns et al. found a finance gap in Australia in the mid-1970s: “... The evidence suggests that firms particularly requiring funds, that is, the fast growing or newly established firms... were not generally the firms which were successful in obtaining funds...” B. Johns, W. Dunlop and K. Lamb, Finance for Small Business in Australia—An Assessment of Adequacy (Australian Small Business Bureau, 1976).


25. BIE Submission, op cit.


28. See note 20.


30. ibid.

31. ibid.


