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Small business venture capital supply and demand analysis : a study. 1981

VC-004

Small Business Venture Capital [V.2]

Supply and Demand Analysis

A Study Prepared by
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for

The Small Business Financing Review
Department of Industry, Trade and Commerce
Ottawa

DRAFT FOR DISCUSSION PURPOSES ONLY

May 1, 1981

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1. INTRODUCTION

The availability of venture capital financing to small business owners has been the subject of considerable concern to the federal government.

It is a subject that has generated as many opinions as there are "players" in the whole arena of small business policy. Extremists at either end of the policy spectrum either argue that suppliers are rapacious, usurious, conservative or merely unreasonable, or that those seeking funds are naive, unprofessional, undeserving or incompetent.

Such views, although understandable, unfortunately generate more heat than light on the subject of equity financing for small business.

After receiving the background papers provided by the Department of Industry, Trade and Commerce and conducting our own search of the literature in this field, we developed a general frame of reference for our study.

A. The demand side must be analyzed if an understanding of both the economic and emotional factors of small business equity financing are to be properly understood. Profiles of venture capital seekers must be developed and refined if a more carefully defined set of government policies is to result from the Small Business Financing Review.

The owner of a business is not likely to view his company with the dispassion of a hired financial manager. For many entrepreneurs relinquishing even a minor degree of total control is anathema and all too often is considered when it may be too late in the game.

The attitudes of small business owners to equity financing opportunities will, therefore, be a key concern throughout the study.

This information will be integrated with our findings on the equity financing experiences of owners and their general perceptions of the equity marketplace.

B. Review the policies, practices and predispositions of venture capital suppliers. The experiences of equity financing concerns over the past five years have, by and large, not been as successful as companies would have liked.

Conventional, but undocumented wisdom, has it that venture capitalists do not really provide high risk capital, that they only lend to the already successful, that they are biased against certain regions and types of enterprise and that they "want more than their pound of flesh."

Although such views are the product of external assessment, they represent the general stereotype of venture capitalists.

The experiences, attitudes and practices of professional lenders of equity capital will be reviewed in depth to create a more substantial and verifiable data base on this key industry.

2. OBJECTIVES

The objectives of the qualitative research were three fold:

1) to provide insights into current attitudes toward and perceptions of financing alternatives within the small business community from both the supply and demand sides of venture capital;
2) to identify key issues, problems and opportunities;
3) to explore responses to suggested policy alternatives that could influence venture capital financing.

3. METHODOLOGY

Methodology of group formation and sampling characteristics.

The following criteria were followed in establishing focus groups.

Firms selected had to:

1) be owner-managed;
2) be in business at least 12 months;
3) carry at least one employee in terms of a direct labour expense;
4) be doing at least $500,000 per year in volume.

From these general criterias we further refined the list of industries by reviewing SIC categories currently in use.

We selected Dun & Bradstreet's listings of companies as the source for our focus group composition because:

1) SIC categories are used for all industries listed;
2) regional versions are available for the Atlantic region, Quebec, Ontario and the Western provinces;
3) companies are listed by cities, alphabetically as well as by industrial category;

4) the list also indicated principal owners and managers as well as numbers of employees in both plant and office positions and gave addresses and phone numbers.

We instructed Canadian Facts to concentrate on some fifty categories which we felt ran the gamut of manufacturing, processing, and service industries from resources through to high technology.

The field staff were instructed to talk only to owner-managers of firms with at least three employees who met other criteria already described.

The client was identified and those contacted were asked to participate on the basis that a major review of small business financing was being conducted by the Federal Government. They were asked to be part of this process since small business policies would inevitably affect their businesses. They were asked to join other owner-managers at a central location to discuss their experiences and views on equity financing for a maximum of two hours. They were given a financial incentive of $40 to attend.

In a similar way, we recruited venture capital representatives from major centres utilizing initially Yellow Pages of Listings of Business Financing Companies which list Banks, Venture Capital Companies and assorted private lenders. This group was most anxious to participate and, of course, understood quite quickly the general scope of our inquiries.

4. RESULTS - GENERAL

Focus group discussions were conducted in Toronto, Montreal, Vancouver, Calgary and Halifax. On the supply side, respondents represented some of the largest, most active and most influential venture capital companies or investors in the country.

On the demand side, respondents were all owner/operators of their own businesses. Those businesses represented had been in existence over a range of time, from just over one year to over forty years, with the majority in business over five years. All businesses had two or more salaried employees, and a minimal annual sales volume of $100,000. In fact, the majority had substantially greater sales volumes.

A good cross-section of small business operations was represented in the sample, although emphasis was concentrated on the manufacturing sector. A variety of products and manufacturing processes in wood, metal, plastics, chemicals and other materials was covered. Also represented were some wholesalers, retailers and service industries.

A total of 112 respondents participated in the qualitative investigation.

HIGHLIGHTS

* The fundamental psychological factor that influences attitudes, perceptions and behaviour is the illusion of independence that owning and operating a business provides.

* Many small businessmen lack business acumen, executive and management skills, marketing and sales know-how, etc. This lack of skills plus the inability to manoeuvre in the financial community frequently inhibits growth.

* For the large majority of small businessmen obtaining financing for growth is their most severe problem.

* Small businessmen know little about venture capital financing, and what they think they know is often inaccurate. Only two respondents in Toronto had had experience with venture capital.

* Small businessmen are often irrationally hostile toward venture capital financing because they believe it means giving up control of their enterprises.

* Small businessmen also believe that venture capitalists are remote and are only interested in large investment opportunities.

* There are two distinct categories of small businessmen: the proprietor, who is interested primarily in making a good living; and, the entrepreneur, who is determined to create a growth-oriented enterprise.

* Only a few respondents (entrepreneurial types) expressed interest in venture capital finacing. The rest don't want to give up any equity.

* There is little demand for venture capital, but there is demand for expertise in those areas in which the small businessman feels insecure.

* Banks are the most frequently used source of financing, for both real and psychological reasons, but it is an uneasy alliance. Banks are too conservative, too arbitrary, too expensive. All loans must be secured, often at double the value of the loan. It is almost impossible to get loans for intangibles such as working capital or marketing programmes, etc.

* Government functions much like the banks, demanding secured loans and high interest rates. Provincial plans are often more successful than federal plans. But, in fact, respondents were unfamiliar with or unaware of many government-sponsored financing plans.

5. RESULTS - DEMAND SIDE

A. The Fundamental Psychological Factor: Illusion of Independence

Respondents who participated in the qualitative research represented a wide range of small business activity and interest; and an equally wide range of experience, acumen, sophistication, ambition, and intelligence or articulateness. Nevertheless, one quality that was common to all respondents was a strong sense of commitment to their particular business enterprise.

The research reveals that the most prominent psychological factor operative in the small business community--one that greatly influences attitudes, perceptions and behaviour--is that certain sense of independence and autonomy that owning and operating one's business provides. Respondents derived great emotional satisfaction and gratification from the sense of being in control of their lives and fortunes, even though almost all their commentary belied and contradicted the fact of independence, autonomy and control.

Despite problems (financial and otherwise), dissatisfactions, and disappointments, the vast majority of respondents indicated little or no inclination to "work for somebody else", to surrender either their business operations or their dreams.

Commitment, perhaps more frequently than talent, is the cornerstone of their staying power. Their incentive comes from their drive to "create something out of nothing", or to "build something larger out of something smaller", to make a more than comfortable living if possible (which is perceived as just reward for their labours and their risks), and very importantly, to have a good time along the way.

But, everything considered, the research indicates that financial success and security, while an extremely critical motivating factor, is less important than the satisfaction gained from creating and building a viable entry in the commercial marketplace and maintaining an aura of psychological, social, career and economic independence.

For the most part, the independent businessman is the type who likes to do things his way, must do things his way--and that includes making mistakes and courting failures. Even potential disaster he finds preferable to being in someone else's employ. As a personality type he tends to be staunchly independent, somewhat ideosyncratic, egotistical, opinionated, adventurous, perhaps even reckless with gambling instincts. This explains why he is almost always willing to risk all his tangible assets, perhaps even alienate his family. The research clearly demonstrates that to the independent businessman his business is his baby, wife, mistress all rolled into one.

While respondents may be their own bosses and make the vital decisions regarding their companies' operations, the research again demonstrates that they are far from independent and autonomous. They are heir to the vagaries of the marketplace; and while they may be small enough to respond to shifting conditions, to problems or opportunities, they often lack the resources, financial, material, or human to do so. They are subject to several layers of government regulation and control. They often face employee and personnel problems, these sometimes exacerbated by government policies and programmes. And, of course, they are dependent on one or more institutions as sources of required capital. Respondents are independent in the context of being dissociated from other business enterprises and being their own bosses, but they are dependent in the context of being inter-related with complex and frequently awesome structures of institutions, practices, and regulations.

From the perspective of the "real" world, of pragmatics and practicalities, the small businessman is hardly independent, but from the perspective of the psychological and the emotional, the small businessman can savour the sense, the feel, the impression--in short, the illusion of independence and self-determination.

The illusory in this case is more important than the real because it is the illusory that propels the dynamics of behaviour and decision-making forward.

The research also indicates that the large majority of small businessmen lack business acumen. Basic executive and management skills; the financing, accounting, and bookkeeping abilities; marketing and sales know-how appeared to be missing from their repertoire. None of the respondents seemed to have had formal business education. None seemed to have had previous management or executive experience in a large company. The majority of respondents were former "hands-on" types, skilled tradesmen or labourers with a dream, ambition and some capital. Most of the remainder had had some previous work experience in other small companies much the same as those they currently operate. A few just went into business for themselves (based on a concept or idea) from the very beginning of their work careers. Lacking some very essential skills results in the creation of burdens and problems that need not exist, or in the inability to advance a company beyond a certain limited point of growth.

Most, but by no means all, respondents recognized their own shortcomings and inabilities, usually identified as being in the area of marketing and sales or in the general area of management techniques. Fewer respondents were able to identify financial matters, especially as they relate to the acquisition of capital, as an area in which they lack information, imagination, and know-how. The tendency in the area of financing was to place the blame for existing problems squarely in the lap of lending institutions.

For the overwhelming majority of respondents financing clearly represented the most troublesome arena of operations. It is here they felt most beleaguered, most beseiged, most helpless, least secure both psychologically and practically.

But, it is the fundamental psychological factor--their ability to believe in the illusion of independence--that creates their reluctance to take on "partners", their reluctance to give up control of their business operations. Thus, a severe conflict arises around the area of financing, whether it be at the start-up stage or the growth stage.

B. Venture Capital Financing: Attitudes and Perceptions

The research reveals that venture capital financing is an area characterized by an enormous lack of awareness, misinformation, misconception, and obviously little real experience. In fact, only in Toronto had a few respondents had any dealings (all unsuccessful, incidentally) with venture capital companies. Outside of Toronto a few respondents had made private deals with individuals, exchanging a small percentage of the business for the required capital, usually in the ten to twenty thousand dollar range. But, none of the respondents outside of Toronto had ever made a formal presentation to or even approached a venture capital company. What might be described as "top of mind" awareness, to borrow a phrase from advertising, of venture capital financing as an alternative to banks and government existed only in Toronto, and then only on the part of a few respondents.

The most telling evidence of the lack of awareness and understanding regarding venture capital is that the overwhelming majority of respondents were unable to provide an accurate definition of it. Most respondents demurred offering a definition. Others guessed that venture capital or "risk" capital referred to the money they themselves put into the business, money to start up with, money they were willing to risk, perhaps unsecured loans. Perhaps one respondent in each group, at best two, in Toronto, were able to state it was non-debt capital.

If the first barrier on the demand side to bringing supply and demand together is lack of awareness and understanding, the second, equally damaging barrier is the negative, almost hostile, perceptions and attitudes regarding venture capital that accompany awareness.

As one respondent in Toronto succinctly stated it "You're playing possibly with the devil". The general concensus is that venture capitalists are avaricious and power hungry. Respondents believed that venture capitalists always seek controlling interest in companies in which they invest, and that they keep their investments to an unfair minimum. With control, of course, they are in a position to be the final arbiter of decisions affecting the companies' operations and growth. A parallel feeling expressed by many respondents was that with few exceptions--if you are a very successful business--venture capital companies cannot be approached as an equal, but rather as a dominant force. The small businessman may not exactly be a "beggar", but he is almost always perceived to be in a disadvantageous bargaining position.

Such perceptions and attitudes as these may not only be erroneous and counter-productive, they are also in direct conflict with the small businessmen's real and psychological needs as the report has previously indicated.

Respondents articulated other negative impressions regarding venture capitalists: they anticipated that capital markets would be difficult to approach; that they would likely be conservative in their decisions regarding investments; that they might be unfamiliar with or otherwise incapable of assessing individual cases; that they would probably be interested only in large investment opportunities, fifty to one hundred thousand dollars or more; that they favour already successful companies; that they restrict their investments to manufacturing companies, and then to some self-defined limited area of interest; that they tend to be somewhat remote and insular.

Several respondents expressed the view that venture capital does not really exist in Canada; the banks don't offer it, the government doesn't offer it, and private capital is reserved for the privileged few. With the exception of Toronto where there was a bit more familiarity with venture capital, respondents were uncertain as to how to locate venture capital companies. However, respondents indicated that if they desired to investigate the matter, they would ask their accountants or perhaps their bank managers.

The research has delineated two distinct categories of small businessmen: the proprietor and the entrepreneur. The former runs his business with a limited vision and limited ambition. And, perhaps with limited skills and sophistication. This group represents the large majority of respondents. The remaining few, the entrepreneurs, tend to be not only growth oriented but acquisition oriented as well. In addition, they conceptualize growth not simply in terms of increased gross and profit, but also in terms of expansion--physically and geographically. They appear to be more knowledgeable, skillful and sophisticated than the majority of respondents.

Consequently, the entrepreneur tends to be more favourably inclined toward venture capital as a practical resource, as a means of realizing his vision, of obtaining his goals and objectives. Surrendering equity is not necessarily a threatening concept. At the very least he is open to the possibility. In addition, he appears to be more practiced at the art of preparing necessary documentation, and at selling himself, his vision, and his company.

To the majority of respondents, of course, the notion of surrendering equity in their companies is quite threatening. Proprietors by definition take a proprietary interest in their operations; that is, they dote on exclusivity and their horizons are relatively narrow. Even the idea of "selling away" less than half of their equity, considerably less than half, is unnerving. At the same time, on a rational level they can imagine certain advantages to a "partnership" under the right conditions. For example, a venture capital partner who would not "interfere" in the day-to-day operations of the company or attempt to initiate policy, but who might have the marketing or financial or administrative expertise they themselves lack could represent a distinct plus. What they envisaged was a kind of benevolent partner/advisor, a "silent" partner who nevertheless could be there when called upon. But, these "proprietor" businessmen are also suspicious of board representation for a venture capital partner. So, they were in conflict, and they tended to shy away from venture capital as a viable alternative.

In fact, the research reveals that from the demand perspective there is actually little demand for venture capital. For the vast majority of respondents the negatives associated with venture capital and the unknown quantities combine to reign supreme.

Since on the whole there is little interest in venture capital, there is correspondingly a paucity of ideas regarding incentives for capital markets and private investors to ensure an adequate supply of venture capital. However, respondents believed that tax credits, write-offs, rebates, or other government-sponsored incentives should apply directly to them (the primary risk-takers and day-to-day operators) and not just to venture capital investors. Furthermore, most of their ideas in this area related to government and the banks. They will be discussed further on in the report.

Clearly, venture capital enterprises or the venture capital "industry" must accomplish two primary tasks: one, create awareness and interest; and, two, create a positive image. Furthermore, the venture capital industry should consider offering a package of services as individual cases warrant: capital, either growth or start-up, plus marketing, sales, and management guidance.

C. Bank Financing: Attitudes and Perceptions

The research indicates that universally bank financing is the primary source for obtaining capital. There are many reasons for this, both real and psychological. They can be concisely enumerated: banks are ubiquitous; banks are traditional; banks are familiar and relatively non-threatening; bank loans are an accepted "way of life"; banks are commercially-oriented; banks are aggressive seekers of clients; banks are approachable and relatively egalitarian; respondents have established (if not always satisfactorily) interpersonal relationships with bank managers; respondents have a variety of accounts and loans with banks; and, banks take an "arms-length" position vis-a-vis the business enterprise which suits the temperament and needs of the small businessman.

The above, however, does not mean that banks meet all the respondents' expectations, fulfill all their requirements, or answer all their needs where working capital is concerned. Quite the contrary. Rather, of the available alternatives, banks are the most accessible, most immediate, and most convenient. But, banks have their policies, procedures and limitations which are frequently disadvantageous to the small businessman.

Almost always, working or growth capital, as opposed to funds for capital expenditures, is obtained through the personal assets of the small businessman, through company earnings and/or profits, or sometimes through loans against inventory, accounts receivable, and other tangible items. As a result, small businessmen are often under-capitalized when it comes to growth or working capital. And, almost all respondents reported being inhibited and constrained in their growth potential as a result of this situation.

Despite the fact that banks are perceived to be the small businessman's best ally, almost all respondents registered the same complaints. Most felt "under the thumb" of their bank managers, described as an uneasy alliance; that loan decisions are at best arbitrary; that most bank managers have little business sense or acumen, and are not truly sympathetic to the problems of small business; that banks are too conservative; that banks require too much collateral, including all the businessman's assets, the mortgage on his house, and his first born child--collateral that is often double the value of the loan; that bank officers and managers are unable to provide intelligent counsel; that banks don't provide information on cooperative government programmes; that banks only provide loans for tangible items such as buildings, machinery, and equipment--but not for working capital, or for marketing needs, or for personnel; and that the cost of money is far too high, almost usurious.

D. Government Financing: Attitudes and Perceptions

The large majority of respondents expressed the opinion that government, especially the federal government, functions much like the banks despite their claims to the contrary, and that the government exhibits many of the same vices as banks but few of their virtues.

About half the respondents had had experience with government departments, including the FBDB, in terms of receiving assistance with business financing problems. A few had applied for government assistance and been refused. But, attitudes and perceptions differed very little among respondents regardless of their experience with government or the lack of it.

Generally, provincial government programmes were considered to be more successful than federal government counterparts. They were generally easier to obtain, were more advantageous to the small businessman, and were more "community-oriented". In Montreal, several provincial financing plans were mentioned, including one expressly for innovative small business. In Toronto, the Ontario Development Corporation and Ontario Industry and Tourism were mentioned. Alberta Opportunity was mentioned in a positive way in Calgary. Provincial programmes in British Columbia were thought to be superior to federal programmes. And, in Halifax, a provincial programme, IEL, was mentioned. While not expressed openly, there was a covert feeling that the federal government's interests centred around Ontario small business--a view not shared by Toronto respondents.

In fact, generally, respondents were unaware of the variety of government financing plans available. Although FBDB, ITC, and DREE were mentioned specifically, and other financial plans alluded to, over-all confusion and misinformation seemed to abound. As some respondents in Montreal expressed it "There are too many programmes, it's confusing"; "There is a lack of communication between the government and small business"; and, "One government department doesn't know what the other departments are doing". These, and similar attitudes, were expressed by respondents in all groups. Clearly, small businessmen do not agree on what financing plans are available from government (federal or provincial) or the details of those plans.

Respondents do agree, however, that government is not involved in venture capital financing. The FBDB particularly was criticized for announcing that it is. According to respondents all government loans must be secured. Respondents believed that perhaps certain grant programmes did not require security, but they were far less aware of grant programmes than of loan programmes.

Indications from the research are that respondents tend to view government as an adversary rather than an ally. Those people who administer government financing programmes are thought to be ex-bankers who bring to their present responsibilities all their former prejudices and modus operandi, thereby compromising the small businessman a priori. Furthermore, FBDB and other government administrators were thought to be incapable of making intelligent, reasoned, or informed decisions regarding loan applications--frequently regardless of how well prepared the application was, or how justified the need. And, they were also thought to lack the skills to provide sound advice and guidance in financing.

Other complaints are these: government (FBDB and others) gives only secured loans, fully secured loans, they will not take capital risk and they are as conservative as banks; government does not offer advantageous interest rates, they are at approximately the same level as bank rates; government bureaucracy causes delays in decision-making and distribution of funds; government fails to communicate its various financing programmes successfully to the small business community; government only pays "lip service" to the needs and problems of the small business community in the hope of political gain, but in fact is disinterested in it; government provides loans only for tangibles and not for working capital, growth, brains, experience, ideas and concepts, marketing or other intangible needs; government often grants less than requested or required; government requires lengthy negotiations, immense paperwork, and all the risk-taking on the part of the businessman; government not interested in start-ups or turn-arounds, insists on a proven track record.

Most respondents felt that the government should provide more liberal tax and credit incentives for the small business community, and at the same time should reduce the burden of paper work presently required. In addition, respondents expressed the view that government should encourage young people just starting business ventures; should be constructive in their attitudes to all small businessmen; should create opportunities and environments for growth; and, finally, should be an ally and consultant to the small business community. How any of this could be accomplished specifically respondents were unable to articulate.

6. RESULTS: SUPPLY SIDE

Venture Capital Markets

Regarding venture capital financing, respondents identified three distinct problem areas: inadequacies of the small businessman; restrictive or inhibiting government policies; and, deficiencies in their own community.

Beyond that, however, there is Canada itself: its ethos, its self-image, its culture, its national character; its commercial history and traditions. Respondents felt that these factors mitigate against a truly vital and expansive venture capital market. Canada is too conservative (they themselves cannot avoid a conservative attitude); it is not prone to taking business risks; it lacks a history of merchant banking; it does not encourage, reward, or incorporate into mythology individual initiative or entrepreneurship; it does not provide a first-rate business education; it does not truly prize or protect Canadian achievement, it only pretends to; it is both envious and afraid of the commercial vitality and mass of the "giant to the south".

For these respondents, then, it was not just a question of government policies and programmes that could contribute to encouraging the venture capital market, or of patching the deficiencies of the small business community and their own--it was also a question of an inherent spirit and drive that will ultimately influence the venture capital dynamic.

A. Deficiencies in the Venture Capital Market

Most of the respondents characterized their investment philosophy as conservative and cautious. Though they perceived this as part of a national malaise, nevertheless they saw it as a fault in themselves, and detrimental to the viability and vitality of the venture capital market. For this and other reasons--the paucity of worthy candidates plus inhibiting government policies--respondents admitted making few investments over the course of a year, fewer than they would like to make.

Respondents said about themselves that they have narrow expertise which results in refusals that may not be justified for any sound business reason; few investments in start-ups or turn-arounds; lack of interest in many sectors of the small business community such as retail, service industry, and other non-manufacturing ventures.

There is a lack of interest in the hi-technology sector, for instance. This appears to be due in part to the fact that venture capitalists don't understand it, and due in part to the perceived nature of hi-tech enterprises. They are seen to require strong R&D support, highly developed manufacturing, marketing and management skills, and often small sums of money.

There was also recognition on the part of all respondents that the venture capital market was not prepared to make small investments for small business. Basically, they are not interested in investments under one hundred thousand dollars due to the cost of investigating and processing a single deal, and the time and effort required to monitor the business. Respondents recognized the existence of a "gap", but doubted they could fill it even with the added incentive of tax write-offs. Amounts under one hundred thousand dollars might be supplied by private investors.

Respondents were aware of their negative image in the small business community. They were also aware that relatively little is known about them, and that what is thought to be known is often mistaken. Respondents were quick to admit that they themselves contributed to this set of problems.

B. Inadequacies of the Small Businessman

According to respondents, one of the major difficulties the venture capital market has is identifying worthy investment candidates. Most small business operations were characterized as poorly managed and under-capitalized as well as being in the wrong place at the wrong time to allow for significant growth.

Respondents also felt that many small businessmen lack the very basic skills required not only to operate but to grow a company, and that general business acumen was at a low level. They found it difficult to have confidence in many of the businessmen who approached them. Small businessmen are also perceived to be poorly educated or trained in business management, most are unable to successfully put together a proposal or make an impressive presentation.

The decisive factor often is to distinguish between those small businessmen who are primarily interested in making a good living (the majority), and those who are determined to create a growth-oriented enterprise. Apparently, such small businessmen who have the ambition and the talent are to be found few and far between.

All respondents agreed that it is of primary importance to coax the real entrepreneurial talent out of the large corporations and into their own companies. Such men, it was felt, have both the skill and the experience, and thus the best chance at success. Coaxing this talent out of big business into small business would need to be a joint venture between government through tax and financial programmes and the venture capital market through capital infusion, encouragement and attentiveness.

C. Government Policies

The overriding feeling about the venture capital market and government tax policies can be summed up thus: if you win you lose, and if you lose you lose. In other words, tax policies are structured and designed to be detrimental to the venture capital community (or, at least inhibiting) whether its investments are profitable or not. Overall, venture capitalists are not friendly to government, nor do they trust the government's motives.

Respondents generally agreed that there should be many tax incentives, and liberal ones, in order to encourage both the small business community and the investment community. Those ideas articulated were sketchy and necessarily brief. They are enumerated below:

new pools of capital for the small business community should be encouraged through tax credits, write-offs, and other incentives--private investors and big business are potential sources;

the merchant banking concept with front-end write-offs should be put into practice;

investors should have the ability to file consolidated tax returns (in the U.S. investors must have 80% of common shares);

like corporations, individuals should be able to get tax write-offs for R&D expenditures, or there might be an R&D fund similar to that for oil drilling or the film industry;

as in the U.S. investors should be able to write-off flow through to individual investments;

have tax credits at two or three times investment;

tax write-offs for start-up losses, or perhaps shift write-offs from those without income to investors with capital.

From the venture capitalists perspective, government should limit its role to tax policies--those more favourable, of course, to venture capital investors--but government should definitely not attempt to become a "partner" in the business environment. It should not attempt to play broker or middleman, or any other role as an interpersonal force in the interplay between the demand side and the supply side of the small business sector.

7. Analysis and Recommendations

Without question, there is a need for a more in-depth testing of the recommendations presented below. However, the qualitative analysis did draw upon a large national sample that must be considered to have some validity and representativeness. Therefore, it is perceived that the recommendations presented are viable, pragmatic and generally indicative of the expressed needs and desires of the small business marketplace across Canada.

1. The primary area of government intervention at the federal level must be through the taxation mechanism. It is the one that is most generally acceptable to all parties actually in the market.

2. Both the supply and demand side of the venture capital sector recognize a gap does exist on the supply side for firms requiring $100,000 or less in equity investment. There is little likelihood, unless there are significant immediate tax changes, that this gap will be filled. Therefore, there is little option at least for the short term, but for this gap to be filled by the Federal Business Development Bank.

3. There is a dire need for greater education of small business owners and bankers in the area of business financing

and proper debt equity structures. Such education may take the form of small business start-up kits, public seminars, and staff training programmes staffed by experts conducted through the Canadian Bankers Association. The paucity of literature and structured approaches to this topic have been a prime contributor to the general ignorance in the marketplace.

4. Tax incentives and write-offs, similar to those generated for film, oil and gas and MURBs, should be created for the specific "sectors of opportunity" only to encourage the investment by Canadians into the sectors that will contribute most to job creation, technological advancement, the creation of exports and the replacement of imports. A clear and specific definition of these sectors must be developed.

5. The specific tax incentives could include the following:

a) Specific write-offs in the first year of an equity investment of 100 per cent of the amount invested against the personal income of the investors.

b) A tax free zone of three years for the earnings of new ventures in the "sector of opportunity".

c) A direct pass through of real losses during an initial three-year period for new firms to the equity investors proportionate to their investment and directly deductible from personal taxes payable.

d) Tax free status of dividends from the "sectors of opportunity" firms for a period of at least three years.

6. The establishment of a national advisory council on small business. The council would be drawn from small business, accounting, government and financial institutions and consist of a group of thirty. Special sub committees could act to advise the Federal Business Development Bank on venture capital investments and would act as a sounding board for all new federal government programme initiatives. The council would meet four times a year in various regions of the nation and would work to establish a national small business policy for Canada.

7. The proliferation of 300 programmes from 400 government departments has caused tremendous confusion in the marketplace. The federal and provincial governments have produced a number of programmes that operate in direct competition with each other. In total in 1980 nearly $6 billion was available in grants, subsidies, loan guarantees, consulting and insurance. However, only the more skilled and knowledgeable larger firms have been able to gain access to this pool of benefits.

We would recommend that this pool be recognized as a third financing option for small business and that the Federal Business Development Bank act as the central repository and clearing house for all of this information.

8. A further rationalization should take place of the above-mentioned programmes to consider what should be retained or eliminated and whether or not the administration of all of these programmes could best be handled by one central agency such as the Federal Business Development Bank.

9. There is no clear understanding as to whether or not small business in the "sectors of opportunity" require the venture capital financing to be provided at the introductory or growth stage of their business life cycle. However, it would seem reasonable that funding is needed at both stages. It is recommended, therefore, that once the "sectors" have been decided upon that a conscious effort be made to identify specific firms in each of the "sectors" and that these firms be informed of the options and opportunities available to them. This proactive role could best be performed by the Federal Business Development Bank. In addition, lists or catalogues of firms from these sectors should be submitted to the Association of Canadian Venture Capital Companies, bankers and accountants, to ensure that the supply side is aware of the opportunities for them.

A guide on venture capital sources should be supplied to all members of these "sectors".

10. Because of the success of the Japanese in this sector, special tax incentives should be prepared to encourage the banking community to invest up to the maximum of 10 per cent permitted by the Bank Act in "sectors of opportunity". This would reduce the risk aversion of the banking community and motivate a more Canadian specific equity oriented role on their part.

8. Areas for Further Research

It is without question that we would have only scratched the surface of the needs and opportunities of the venture capital market. However, we would like to make the following recommendations as to areas worthy of further research.

1. A specific empirical evaluation of the tax information and FBDB related proposals presented as recommendations. This study would evaluate the receptiveness of both the supply and demand side of the market to the proposals and establish a set of priorities for these options.

2. The construction of a sample small business start-up or financing kit.

3. The development of specific, or alternative financing and programme options for the retail and service sector.

4. The creation of listings of all available financing sources for small business by industry or sector.

5. The development of an educational programme for small business in financing options and for bankers in financing strategy.

We perceive the above programmes should be ones of maximum priority for the Department.

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25072 – BLU
25078 – RED
25075 – GRE
25074 – GRE
25073 – R. BLU
25079 – X. RED
25070 – YELLO
25077 – TAN

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