Closing the Regional Equity Capital Gap: The Role of Informal Venture Capital

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ABSTRACT. There is evidence from a number of countries that small firms encounter a shortage of long-term investment finance, particularly at start-up and initial growth. Expansion of the institutional venture capital industry has done little to fill this "equity gap" on account of its preference for making large investments in established companies and management/leveraged buyouts. Moreover, the supply of venture capital exhibits a high level of spatial concentration. Initiatives by state/provincial and local governments, most notably in economically lagging regions, to increase the supply of risk capital for start-ups and early stage businesses have at best provided a very partial, and often costly, solution. A more appropriate approach to increasing the supply of start-up and early stage finance is to facilitate the more efficient operation of the *informal* venture capital market. Informal investors, or "business angels", are private investors who provide risk capital directly to new and growing businesses in which they have no family connection. Most business angels are unable to find sufficient investment opportunities and so have substantial uncommitted funds available. There is also considerable scope for expanding the population of business angels. The most cost-effective means of closing the equity gap is therefore for the public sector to underwrite the operating costs of business introduction services whose objective is to overcome the two main sources of inefficiency in the informal venture capital market, namely the invisibility of business angels and the high search costs of angels seeking investment opportunities and entrepreneurs seeking investors, by the provision of a channel of communication between informal investors and entrepreneurs seeking finance.

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Introduction

Various studies show that the availability and cost of finance, especially long-term investment capital, is one of the most important constraints on the formation and development of small and medium-sized enterprises (SMEs) (Oakey, 1984; Monck *et al.*, 1988; Binks *et al.*, 1992; CBI, 1993; EVCA, 1993a). Obtaining finance is particularly difficult for new and recently established firms, fast-growing businesses and technology-based businesses. Access to public stock markets is precluded to the vast majority of smaller businesses because of the high fixed costs involved (Buckland and Davis, 1989) while reliance on debt finance leads to dangers of undercapitalisation, which is the most frequent cause of business failure (Binks and Vale, 1992).

The expansion of venture capital activity in most developed countries during the past 10 to 15 years has provided a new source of long-term investment capital which has contributed to the closing of this equity gap. Venture capital can be defined as an activity by which corporate investors provide long-term equity finance, supported by business skills, to unquoted companies with the potential to grow rapidly with the aim of making an eventual capital gain commensurate with the high risk and illiquidity involved in the investment rather than interest income or dividend yield. The venture capital industry is therefore characterised by a high rejection rate as very few businesses can demonstrate that they have the potential to provide annualised rates of return of 30 to 60 per cent which are typically sought. Venture capitalists devote considerable effort to evaluating potential investments and undertaking all possible 'due diligence' in order to filter out poor investments. Venture capital activity is also a "hands-on" activity: the venture capitalist will typically have an active involvement in the management of the business receiving the finance, both to contain potential down-side exposure and also to "add value" to the investment. Finally, venture capital investments require an identifiable exit route to enable the venture capitalist to realise their investment (Lorenz, 1989; Mason and Harrison, 1991; Murray, 1991a).

Venture capital activity originated in the USA immediately after World War Two but expanded enormously during the 1980s as a result of changes in tax and securities legislation. In 1979 there were about 225 venture capital firms which invested \$460 million in 375 companies. At its peak in 1987 over 700 venture capital firms invested \$3.94 billion in over 1700 companies. By the end of the decade this level of activity had fallen back a little with over \$3 billion invested in over 1300 companies (Bygrave and Timmons, 1992). A similar expansion in venture capital activity occurred during the 1980s in a number of other countries which had little or no prior experience of this form of financial activity. In Canada, the venture capital industry expanded between 1980 and 1990 from 20 firms with a pool of \$350 million to about 75 firms and a pool of \$3.3bn (MacDonald, 1991). In the UK prior to 1979 there were about 20 venture capital companies with a total investment of £20 million. By 1992 there were well over 100 venture capital firms which invested £1.25bn in 1147 companies (plus a further £183m in 149 companies in other countries) (BVCA, 1993). There has also been an increase in venture capital activity in other European countries (EVCA, 1993b). Indeed, Europe has overtaken the USA in terms of venture capital investments (EVCA, 1993a), with a total of ECU 4.7 billion (\$1 = 1.13 ECU) invested in 6197 companies in 1992 (EVCA, 1993b)

Venture capital and the equity gap

The venture capital industry has had a catalytic role in the entrepreneurial process by identifying, financially supporting and nurturing growth-minded businesses with entrepreneurial talent to start-up and grow. The evidence for this is most clear cut in the USA. Bygrave and Timmons (1992) note that venture capital-backed companies have added value through technological and market innovations, while their economic contributions have included significant job creation, new R&D expenditures, export sales and payment of taxes. World class technology companies such as Digital Equipment Corporation, Apple Computer, Sun Microsystems, Lotus, Compaq and Prime Computer as well as market innovators such as Federal Express and Staples Inc were backed by venture capitalists at their start-up. In Europe too, venture-capital backed companies have, in aggregate, experienced above average rates of employment growth, with the EVCA describing such companies as "engines for our economies" (EVCA, 1993a, p. 4). At a sub-national level an active local venture capital industry has played a critical role in the development of "high-tech" clusters such as Silicon Valley and Route 128 (Florida and Kenney, 1988a; Bygrave and Timmons, 1992).

However, the venture capital industry is in a process of change throughout the developed world. The industry has contracted in recent years in terms of the amounts of finance raised and invested, the investment focus of the industry has shifted and there are marked spatial variations in the availability of venture capital. These developments have raised the concern that developed economies "may be losing the unique company building skills that have been so vital to the entrepreneurial process" (Bygrave and Timmons, 1992, p. 66). Moreover, this has occurred during a period of recession when the need for such skills is at its greatest. We examine each of these issues in turn.

Size of the venture capital pool

The first aspect of concern is that the rapid growth of venture capital activity came to a halt in the late 1980s. Since then amounts raised and invested have both fallen and there has been a shake-out in the number of venture capital firms. For example, venture capital firms in the UK have experienced difficulties in raising additional funds since 1989 as a result of the increasing concern of institutional investors about the future returns from venture capital activity. Indeed, the longer term availability of funds is the single most important concern of venture capitalists. The immediate consequence has been greater competition for the scarce supply of institutional funds. Most venture capitalists believe that these conditions will result in a shakeout, with poor performing and marginal funds likely to exit the industry (Murray, 1991a; 1991b). Moreover, given the two or three year time-lag between creating a new fund and making investments, it is likely that this drop in new funds will be reflected in a reduced value of annual investments from the mid-1990s onwards (Murray, 1995). The UK experience is reflected elsewhere in Europe: new funds raised by the European venture capital industry peaked in 1989 at ECU 5.8m, falling to ECU 4.2m in 1992 (EVCA, 1993b). Similar trends are also apparent in the USA where venture capital activity has declined sharply since 1987 (Bygrave and Timmons, 1992). There was a recovery in 1992, although activity remains well below the peak levels of the 1980s. In Canada a number of seasoned venture capital firms with a proven track-record have also been unable to raise new funds (Doyle, 1993).

Investment focus

Significant shifts in the investment focus of the venture capital industry is the second issue for concern. In the late 1970s and early 1980s the emphasis of the venture capital industry was on early stage and technology-based businesses. However, the contemporary industry is now dominated by later stage deals, and especially management buyouts (MBOs)/leveraged buyouts (LBOs). In the UK the number of start-up and early stage investments has fallen from the 400–500 range in 1988 and 1989 to 222 in 1992. More significantly, start-ups and early stage investments have fallen as a proportion of all investments from around 30 per cent in the mid-1980s to just 17 per cent in 1992 and from 20–30 per cent of the total amount invested to just 6 per cent over the same period. Meanwhile, MBOs have increased since the mid-1980s to account for well over half of the total amount invested by venture capital funds in recent years (65 per cent of the total amount invested in 1992) (Pratt, 1990; BVCA, 1993). Thus, the venture capital industry is increasingly specialising in the provision of *replacement* equity, whereby existing shareholders are bought out and replaced by new shareholders, while its role in the provision of *new* equity to start-ups and early stage businesses has become increasingly marginal (Murray, 1994).

These trends are a product of two factors. On the one hand, they reflect the evaluation and monitoring costs which must precede and accompany venture capital investments. These represent a significant fixed cost element and so makes it uneconomic for funds to make investments of less than about £250,000 (indeed, Batchelor (1993) suggests that initial accountancy and legal fees, for example, are unlikely to be less than £50,000 to £70,000, irrespective of the size of the prospective investment). On the other hand, they reflect the attractions of providing development capital to larger, established businesses and investing in management buyouts. Such investments involve known businesses with a track-record and a projected future, in usually well-understood, and frequently mature, industry sectors, and the competence of the management teams can be judged on the basis of their track-record (Murray, 1994). As a consequence, they involve lower risks, require less appraisal and monitoring, provide more scope for high fee income and have a quicker exit route than most other types of investment. Most of the venture capitalists in Murray's 1991 survey expected that MBOs would continue to dominate UK venture capital activity during the 1990s (Murray, 1991a).

The sectoral focus of UK venture capital funds has also shifted away from its initial emphasis on technology-related investments. Since the mid-1980s technology investments have become a specialist activity undertaken by a small minority of venture capitalists. Computer-related and electronic-related companies accounted for 30 per cent of the finance invested in 1984 compared with just 4 per cent in 1992, with investments in medical and biotechnology accounting for a further 3 per cent of finance invested. Investments by UK venture capital funds are now concentrated in consumer-related sectors (Pratt, 1990; BVCA, 1993). The reason for this shift is simply that technology investments are perceived by most venture capitalists as more risky than the available later stage investment opportunities. As a result, technology projects face a higher IRR threshold when compared with non-technology projects at the same stage of financing and have to demonstrate a supra-national market potential (Murray and Lott, 1992).

Similar shifts in the investment focus of venture capital funds away from early stage deals and technology-based sectors are also apparent in continental Europe (EVCA, 1993b), Canada (Government of Ontario, 1990; Standeven, 1993) and the USA. In the USA the number of start-up financings and the amount invested have both fallen significantly since the early 1980s. Proportionately, such investments have declined from 43 per cent of all investments to just 10 per cent between 1983 and 1989. Other early stage investments have also declined, although not as severely. Paralleling this trend has been an increase in the number of deals and the amount invested in expansion financings, LBOs and other later stage deals. Bygrave and Timmons (1992) attribute these developments to the displacement of "classic" venture capital by "merchant capital" funds. Classic venture capital is concerned with early stage investments and involves skills that add value in company forming, building and harvesting; merchant capital funds, on the other hand, are almost entirely dependent upon institutional investors, emphasise financial engineering know-how, transaction crafting and closing and fee generation, and are obsessed with short-term gains. There has also been a shift in the sectoral pattern of investments in favour of consumer-related deals (Bygrave and Timmons, 1992), although the US venture capital industry remains more committed to technology-related sectors than its European and Canadian counterparts.

Spatial focus

The third issue concerns spatial variations in the availability of venture capital. Studies in various countries highlight the very high degree of spatial concentration of both venture capital firms and investments in core regions and the lack of investments in peripheral, economically lagging regions. In the UK, 63 per cent of venture capital companies are based in London (BVCA, 1992). This is a result of historical and institutional forces. London has long been the pre-eminent financial centre in the UK, containing various financial and related institutions and a diverse range of investment expertise and business consultancy services. As the venture capital industry is a further specialist division of the finance industry it was inevitable that it should be concentrated in London. Most of the funds have either been established by banks and insurance companies located in London or else are spin-offs, established by finance-industry executives and located in London for reasons connected with the pool of professional labour and existence of agglomeration economies (Martin, 1989). The dominance of London is even greater in terms of the proportion of the total venture capital pool managed by funds located in the city (Mason and Harrison, 1991; Martin, 1992). However, there has been a modest growth in the number of venture capital funds in provincial cities, such as Manchester (Gibbs, 1991; Mason and Harrison, 1991), but from a very small base. The South East has also consistently attracted a disproportionate share of venture capital investments, accounting for 45 per cent of the total amount invested in 1992. Conversely, with the exception of Scotland, all other regions have attracted a lower share of venture capital investments than "expected" on the basis of their proportion of the national stock of businesses (BVCA, 1993; Mason and Harrison, 1991; Martin, 1989; 1992).

Similar spatial patterns are apparent in other countries. In Canada venture capital firms are concentrated in Toronto, the main financial centre, and, to a lesser extent, in Montreal and Calgary and investments clearly favour the Toronto region (McNaughton and Green, 1989; McNaughton, 1991). In the USA venture capital firms are concentrated not just in financial centres but also in centres of high technology industry. Silicon Valley, California, the Route 128 area around Boston, Massachusetts and New York City together account for 70 per cent of the venture capital supply. Less important though still significant concentrations of venture capital firms are located in Chicago, Connecticut, Texas, Minneapolis and Colorado. Investments are mainly concentrated in California and Massachusetts which account for over half of all investments (Florida and Kenney, 1988a; 1988b; Florida and Smith, 1990; 1993; Florida *et al.*, 1991).

Demand side factors play a major role in accounting for this spatial pattern. Indeed, the geography of venture capital investments closely parallels the locational distribution of rapid-growth firms (Mason, 1985; Wheeler, 1990). Some commentators suggest that the lack of demand for venture capital in peripheral regions reflects the greater reluctance of firms in such regions to seek equity finance (Gibbs, 1991). Others suggest that demand for venture capital is depressed by the dominance of lifestyle businesses in such regions (Economic Council of Newfoundland and Labrador, 1988). It is also suggested that firms in peripheral regions lack information about financing alternatives and have limited understanding of the role of equity and how to raise it, a failing which reflects the limited knowledge of banks, accountants and other professional intermediaries in such regions about sources of venture capital and the factors which venture capitalists take into account in assessing investment proposals (Invest North West Working Party, 1989).

However, there is also an independent supply-side influence on the location of venture capital investments arising from the spatial organisation of the venture capital industry and the perception of venture capitalists (Martin, 1989; 1992). Venture capitalists rely on personalised, informal and therefore localized information networks with other venture capitalists, entrepreneurs, large company contacts, consultants, technical experts and a range of other actors to identify investment opportunities, organise deals and mobilize resources. As a result, most investments are made in companies located relatively close the venture capitalist's office. Investing in businesses located in fairly close spatial proximity also enables venture capitalists to more easily monitor their investments, thereby limiting risk (Florida and Kenney, 1988b). Venture capitalists' perceptions arising from their mental maps of economic potential may also exert an influence on their spatial search for investment opportunities (Mason, 1987). The effect of these explicitly geographical factors is to constrain the spatial behaviour of venture capitalists (Thompson, 1989).

The consequence is that unless a region has a well-developed concentration of venture capital funds of its own, then the further it is away from the main centre, or centres, of venture capital activity the more disadvantaged will be its local entrepreneurs in terms of access to this type of finance. In the UK context this means that "the further a region is from London, the more important it is for that region to have its own circuit of venture finance" (Martin, 1992, p. 165).

Summary

The consequence of these trends is that there are now various "gaps" in the supply of venture capital. Companies at the seed, start-up and early stages of development and requiring external financing encounter great difficulties in raising equity finance from the venture capital industry. This raises the concern that growth-potential businesses, particularly those involved in technology-based activities, will be constrained by the lack of appropriate sources of risk capital. Banks are reluctant to lend to businesses with no assets, and in any case the financing needs of such businesses are likely to be inappropriate for debt finance (Binks *et al.*, 1992). Alternative financing options (such as factoring) are typically only open to more mature companies with an ability to generate cash. This problem is particularly acute in less developed regions which lack an indigenous venture capital industry, and threatens the viability of regional economic development policies which are increasingly based on the promotion of indigenous development via SMEs rather than the attraction of mobile investment. This is, for example, the main emphasis of regional industrial policy in the UK (HM Government, 1988; Wren, 1990) and of the Atlantic Canada Opportunities Agency (Savoie, 1992; ACOA, 1992).

Mechanisms to close venture capital gaps

State/provincial and local governments, particularly in regions lacking an indigenous venture capital industry, have responded to these concerns with a variety of initiatives designed to stimulate the supply of start-up and early stage finance. The objectives of this paper are, first, to critically review the impact of such initiatives as mechanisms for stimulating the supply of local sources of venture capital for start-ups and early stage businesses and for technology-based firms and, second, to suggest that the promotion of informal venture capital – i.e. direct investments by private individuals, or "business angels", in companies in which they have no family connection – provides a better basis for closing both national and regional "equity gaps". In this section we provide a brief review of "conventional" approaches that have been adopted, drawing largely upon examples of policy initiatives in the UK, USA and Canada. We suggest that such initiatives have had only a limited impact in closing these various capital gaps. In the following sections we highlight the merits of informal venture capital and propose ways in which the supply of informal venture capital can be stimulated.

Strategies for increasing the regional supply of equity capital can be classified into three broad types.

Tax incentive schemes to stimulate private sector venture capital funds

One approach, which is only possible in countries where states/provinces have the power to raise taxes, is the use of tax incentives to encourage private sources of finance for investment in SMEs, either directly or indirectly via pooled funds. This approach has been widely used in Canada where every province has a provincially-sponsored venture capital company (PSVCC) scheme, modelled on Ontario's Small Business Development Corporations (SBDCs). A PSVCC is a pooled investment vehicle which raises money from investors for investment in approved businesses. Most schemes provide investors in a PSVCC – who can be private individuals or corporations – with either a cash grant or tax credit. However, some schemes provide the PSVCC with an equity loan on the basis of dollar-for-dollar matching with the amount of equity invested by its shareholders (Moncton Consulting Services, 1991).

Globerman and Olson (1986) suggest that such schemes have had a favourable outcome in terms of the amounts raised and invested, the additionality achieved and the emphasis on start-up and early stage investments. An evaluation of PSVCCs in Atlantic Canada also concluded that they are an effective means of enabling small businesses to raise venture capital. Indeed, PSVCCs are the most important source of venture capital in the region (Moncton Consulting Services, 1991; ACOA 1992). However, this assessment went on to conclude that "PSVCCs are no panacea" (Moncton Consulting Services, 1991, p. 53). They have often been single company investment vehicles and have tended to make passive investments. There have also been difficulties in successfully exiting from their investments which, in turn, has hindered their ability to re-cycle their funds. As a result, PSVCCs have often run out of funds after making their initial round of investments. This lack of liquidity also appears to have deterred some potential investors. PSVCCs have also had a low propensity to provide follow-on finance (Moncton Consulting Services, 1991; ACOA, 1992). A further criticism is that although PSVCCs were conceived to be market driven, with governments adopting a hands-off approach, in practice they have, in some instances, "fallen prey to political and bureaucratic agendas . . . where 'public accountability' has sometimes introduced other criteria." (ACOA, 1992, pp. 83–84).

Public sector venture capital funds

In many countries local and state/provincial governments have little or no powers of taxation to influence the supply of venture capital. A much more common approach is the establishment of public sector venture capital funds using public sources of finance to make direct investments in companies. In the USA, Thompson and Bayer (1992) have identified 28 public venture capital funds in 20 states, predominantly in the Northeast and Midwest. In the UK, seven public sector venture capital funds (all of which are in Scotland or Northern Ireland) are listed in the BVCA Directory or in the *Venture Capital Report Guide to Venture Capital* (Cary, 1993). There are a further five funds which were originally created by local authorities, but following the 1989 Local Government and Housing Act which restricted local authority involvement in various forms of economic development initiatives, these funds have been restructured to become independent of local authorities by widening the number of investors in these funds (Roberts and Miller, 1993). In Canada, venture capital is provided by provincial Crown Corporations and agencies. In Atlantic Canada such sources accounted for over one-third of venture capital investments by value between 1980 and 1990 (Moncton Consulting Services, 1991; ACOA, 1992).

Public sector venture capital funds have a number of significant shortcomings and deficiencies which limits their effectiveness in filling these capital gaps. First, public sector venture capital funds generally have limited resources. As a result, their impact has often been modest. Thompson and Bayer (1992) note that the aggregate activity level and average programme size of public sector venture capital programmes in the USA remain very small compared with the private venture capital sector. Similarly, in the UK public sector venture capital funds represent a very small proportion of total venture capital activity; for example, investments by public sector venture capital funds account for only 2 per cent of the total amount invested (at cost) by UK venture capital firms. With the exception of the funds that are operated by Scottish Enterprise (formerly the Scottish Development Agency) and the Welsh Development Agency (which represent the major source of venture capital in their respective regions), public sector venture capital funds are small compared to private venture capital funds. One of the implications may be the inability of such funds to provide follow-on financing to their investee businesses.

There must also be doubts about the ability of the public sector to maintain even this modest contribution as a source of venture capital in the future. Thompson and Bayer (1992) point to the vulnerability of public sector venture capital funds in the US to budget cuts because of their lack of a political constituency and possible pressures for privatisation, with the implication that this will result in a shift away from the current focus of most funds on small scale, early stage investments. A similar concern is voiced by MacDonald (1991). Referring to the Canadian situation she argues that public sector venture capital funds are "clearly not a tenable solution over the longer term since government cannot sustain itself fiscally or politically as the primary source of equity capital for young Canadian technology companies, nor should it attempt to do so" (MacDonald, 1991, p. 14).

Second, in many cases the investment focus of public sector venture capital funds has not been to fill the gaps left by private sector funds. Rather, their investment focus and operation often makes them indistinguishable from private sector venture capital funds. This is particularly the case in the UK where the privatisation of the former local authority "enterprise boards" and government pressure on Scottish Enterprise and the Welsh Development Agency to operate their venture capital funds on a broadly commercial basis have exacerbated this feature. A detailed breakdown of the investments of nine public sector venture capital funds is provided by Cary (1993): seven of these funds had made the majority of their investments in established companies seeking development finance and management buyouts (and so their average investment size is towards the upper end of the equity gap) and only two funds had concentrated the majority of their investments in start-ups and early stage businesses. Moreover, the appraisal process of UK public sector venture capital funds is no less rigorous than that of private sector funds; indeed, they often review a smaller proportion of the propositions they receive than private sector venture capital firms (Mason and Harrison, 1991).

Third, public sector venture capital funds are generally restricted to making investments in the jurisdiction which has provided the finance. However, placing geographical restrictions on the investment activities of public sector venture capital funds is likely to constrain the deal flow, increasing the chance that poor quality investments are made, causing the fund to perform poorly. However, if no geographical restrictions are imposed then investment funds may flow to areas with better investment opportunities, thereby depleting local resources (Florida and Kenney, 1988a; Florida and Smith, 1990).

Fourth, providing finance is just a small part of what venture capitalists do. The success of investing is ultimately contingent upon the support services that venture capitalists can provide to their investee businesses (Florida and Kenney, 1988a). New and recent start-ups in particular require the active participation of venture capitalists. Murray (1991a) suggests that start-ups are likely to require at least 200 hours of input from a venture capitalist a year – more if the business is in difficulties. This limits the number of investments that a venture capitalist can handle to a maximum of five or six. However, public sector venture capital funds are likely to encounter difficulties in recruiting sufficient staff with entrepreneurial and investing experience, particularly if, as is likely, they are unable to match the reward structure of private sector funds which allows (in many cases, requires) venture capitalists to invest their own money alongside the fund so that they can share in the success of the investee businesses.

Fifth, the activities of public sector venture capital funds are open to influence by politicians and bureaucrats. This allows for the possibility that investment decisions may take into account political imperatives rather than being made entirely on the basis of commercial criteria (Florida and Kenney, 1988a).

Sixth, there is a risk that public sector venture capital activity will compete with private sector funds for good investment opportunities, and consequently driving up valuations, depressing returns and ultimately crowding-out private sector funds. Discussing the Canadian situation, Doyle (1993, p. 20) notes that "in entering the venture capital field, the provinces felt they would provide an incentive for other venture capital companies . . . to enter the high risk end of the investment spectrum. However, if an in-depth study were done, it would probably show that they are driving them away".

Finally, Florida and Kenney (1988a) emphasise that simply enhancing the supply of venture capital is not sufficient for an increase in venture capital activity. They point out that venture capitalists – whether operating in the public or private sector – are critically dependent upon technical, social and financial networks to locate investments, structure deals and support investee businesses. Thus, public sector venture capital funds need a supportive institutional environment of business support services, notably specialised law and accountancy firms, in order to be effective. In support of this argument Florida and Kenney (1988a) point out that public sector venture capital funds have been most successful in regions where there is an active private venture capital industry.

Subsidising the operating costs of private sector venture capital funds

Another approach to increasing the supply of seed, start-up and early stage capital is to provide a subsidy to private sector venture capital funds to offset their appraisal and monitoring costs. One of the major reasons for the lack of private sector venture capital funds specialising in seed and start-up investments is that such investments require a very active hands-on role. As a result, they incur high costs and uncertain returns. The appraisal of small investment proposals and the management of a portfolio of small investments requires almost as much input of professional and other resources as those which are several times larger, while the professional fees that can be commanded are lower and the risks are much greater. Indeed, the need to make a larger number of investments in order to get a reasonable spread of risk further contributes to the high appraisal and monitoring costs of seed and start-up funds. The British Venture Capital Association (BVCA) has estimated that the real cost of running a seed fund is between £150,000 and £200,000, depending upon its location, which represents an unacceptably high proportion of the funds under management (BVCA, 1989). It is therefore difficult for venture capital funds specialising in seed and start-up investments to operate under conventional commercial criteria. The objective of the subsidy is to make this type of investment activity an economic proposition for private sector organisations.

This approach has been adopted by the European Community by means of its *Seed Capital Initiative*. This initiative, which has initial funding of approximately ECU 40m, has supported the establishment of 24 new seed capital funds across the Community, including three in the UK, by contributing towards their operating costs (up to 50 per cent) and capital resources (up to 25 per cent). The intention was that the funds would become self-financing within five years. However, this initiative has had only limited success. Murray (1995) suggests that the funds are too small to be sustainable without ongoing EC support and few have the financial resources to provide successive rounds of follow-on finance that is required by successful and rapidly growing young companies.

An alternative approach is a British initiative, formally launched in November 1991 by Business in the Community, to establish a network of regionally-based development capital funds and professional advisory networks. The intention was for each regional enterprise fund to be set up with a life of ten years and a maximum of 20 corporate investors drawn from and investing in the region. The key feature of this initiative was that, in order to alleviate the burden of professional fees and vetting costs which have previously made it unprofitable to provide equity finance in small amounts, professional firms (fund managers, stockbrokers, solicitors, accountants and bankers) will waive up to 60 per cent of their fees to undertake investigative work on serious projects (McMeekin, 1991). However, this scheme – which has also encountered fund-raising problems – also seems likely to have only a limited impact on the equity gap in the UK, firstly, because the number of investments that are anticipated is limited (about 15 per region), and secondly, because the primary investment focus of the funds will be to provide finance for the expansion of existing businesses (McMeekin, 1991).

Another approach, exemplified by the BJU scheme in Germany and the PPM scheme in The Netherlands, is for government to assume part of the costs of investment losses when venture capital firms invest in types of businesses or sectors which are considered to have wider economic or technical benefits. However, this approach may encounter the moral hazard situation, encouraging venture capitalists to make less prudent investments by removing the "risk" from equity investments.

An alternative approach: Improving the efficiency of the informal venture capital market

A more promising strategy for increasing the supply of start-up and early stage venture capital is the promotion of informal investment which, it can be argued (e.g. Walker, 1989), is more appropriate than venture capital as a source of early stage finance. Informal investors – alternatively termed private venture capitalists but more commonly referred to as 'business angels' – are private investors who provide risk capital *directly* to new and growing businesses in which they have had no prior connection (i.e. it excludes investments in their own firm or in a family business).

Comparisons of informal investors in the USA, UK, Canada and Sweden reveal few significant differences in their characteristics, investment preferences and investment activity (Wetzel, 1981; Tymes and Krasner, 1983; Haar *et al.*, 1988; Gaston, 1989; Riding and Short, 1987a; 1987b; Short and Riding, 1989; Venture Economics, 1990; Harrison and Mason, 1992a; Landström, 1993; Riding *et al.*, 1993). Business angels are almost exclusively male and mostly in the 45+ age band. The vast majority are either business owners, company directors or business-related professionals (eg accountants, consultants). Most are also experienced entrepreneurs, often having founded several businesses. They are generally self-made and have a high net worth (although relatively few are in the super-rich category) (Table I). On account of their employment background angels have a fair degree of financial sophistication and are capable of evaluating the merits and risks of prospective investments (Wetzel, 1987).

There are three major reasons why the informal venture capital market should be supported by policy-makers: the nature of the investments made by business angels, the localized nature of their investments and the overall size of the market.

(i) Business angels invest precisely in those areas in which institutional venture capital providers are reluctant to invest. They typically make small investments, well below the minimum size of investment considered by most venture capital funds. In the UK the vast majority of angels invest less than £50,000 in a single deal (although deal sizes that involve investments that are syndicated between a number of investors are larger) (Mason *et al.*, 1991a) (Table II). A study of sources of external equity sources used by new technology-based firms in New England found that private investors provided 84 per cent of financing rounds under \$250,000, compared with 13 per cent by venture capital funds, but only 10 per cent of rounds of over \$1 million compared with 69 per cent by venture capital funds (Freear and Wetzel, 1988).

Investments by private investors are also relatively more concentrated in start-ups and early stage ventures whereas most venture capital funds

TABLE I
Informal investor characteristics

	United Kingdom	Sweden	USA	Canada[1]
age (years)	53	54	47	47
sex	99% male	–	95% male	98% male
annual family income	£46,000	60% > 500,000 SEK	$90,000	$176,800 (Can)
net worth	£312,000	57% > 5m SEK	$750,000	$1.36m (Can)
previous entrepreurial experience	57%	96%	83%	75%*

Sources: UK: Mason *et al.* (1991a); Harrison and Mason (1992)
Sweden: Landström (1993)
USA: Gaston (1989)
Canada: Riding *et al.* (1993); Venture Economics (1990)
Note: 1. Source is Riding *et al.* (1993), except where indicated by asterisk

provide development capital and finance for management buy-outs and buy-ins (Table II). Indeed, business angels are often the only source of early stage equity capital for businesses that have exhausted personal and family sources. More than two-thirds of investments by Canadian business angels are in the seed, start-up and early stages (Venture Economics, 1990). In their study of new technology-based firms in New England Freear and Wetzel (1988) found that private investors outnumbered venture capital funds by two-to-one at seed and start-up stages. They conclude that "private individuals and venture capital funds appear to play complementary . . . roles . . . Private individuals are most prominent at the early stages of a firm's development, when relatively small amounts are involved, and in those later stage financings involving under $1 million" (Freear and Wetzel, 1988, p. 353).

Informal venture capital is also "smart money". Business angels are value-added investors, contributing their commercial skills, entrepreneurial experience, business know-how and contacts through a variety of hands-on roles (Table II). One study of firms that had raised finance from informal investors (Harrison and Mason, 1992b) identified a wide range of support, monitoring and strategic roles played by business angels in their investee companies. Entrepreneurs regarded the angels' role as a sounding board for the management team as being their most valuable "hands on" contribution. The opportunity to be involved in an entrepreneurial venture is a significant motivating factor for angels making informal venture capital investments, as well as a means of protecting their investment.

(ii) Business angels are much more geographically dispersed that venture capital funds. Gaston (1989) suggests that angels live virtually everywhere, although in view of their entrepreneurial backgrounds they are likely to be most numerous in regions with a large SME sector. UK evidence indicates that business angels are found throughout the country although, as might be anticipated, are over-represented in the south (Mason *et al.*, 1991a) and have invested larger amounts (£35,000 compared with £19,000 in the three years preceding the survey). Furthermore, investments by business angels are characterised by a high level of geographic localisation. A majority of all such investments are made in firms located within 50–100 miles of the investor's home or office (Table II). This is largely a reflection of the 'hands on' nature of such investments, although is also a function of superior information available about investment opportunities close to home. Thus, from a regional development perspective informal investments are valuable because they help to retain and re-circulate wealth *within* a region, counteracting the effect of most investment mech-

TABLE II
Typical informal investor investment profiles

	United Kingdom	Sweden	USA	Canada[1]
number of investments	2 every 3 years	1 a year	2 every 3 years	1 a year
rejection rate	7 out of 8	7 out of 10	7 out of 9	9 out of 10
average size of investment	£10,000	500,000 SEK	$58,900	$207,000 (Can)*
% of net worth accounted for by informal investments	53% <10%	33% <10% 33% 10–24% 33% >24%	–	40% <10%
primary sources of information on investment opportunities	business associates friends	–	friends business associates	knew the entrepreneur friends, business associates*
main sectors	retail/wholesale; consumer services; high-tech manufacturing	finance/real estate; manufacturing industrial products;	retail/wholesale; finance/real estate; services; high-tech manufacturing;	natural resources; manufacturing – industrial and commercial; real estate
main stage of business development	young firms (34%); start-ups (30%); established firms (18%)	infant/young firms (43%) established firms (31%) start-ups (27%)	start-ups (56%) infant/young firms (24%) established firms (20%)	seed and start-up (30%) 1st stage (15%) expansion (43%)*
location of investments (distance from home)	67% <100 miles 54% < 50 miles	–	72% < 50 miles	53% <50 miles
involvement with investee business	69%	93%	83%	85%*
most common types of involvement	board of directors; consulting	board of directors; consulting	consulting; working part-time	board of directors; consulting
minority voting control	81%	65%	56%	(10% majority ownership)
proportion who wish to make more investments	75%	75%	54%	–
amount available for investment	£50,000	1.5m SEK	–	–

Sources: as for Table I
Note: see Table I

anisms (e.g. banks, insurance companies, pension funds) which act as a conduit through which personal savings flow out of peripheral regions to the nation's financial centres for investment in core regions and abroad.

(iii) In terms of its size, the informal venture capital market is the largest single source of risk capital for entrepreneurial companies, substantially dwarfing the institutional venture capital industry. Wetzel and Freear (1993) note that in the USA the scale of the informal venture capital market is at least five times that of the institutional venture capital market in terms of dollars invested annually and is at least twenty times larger in terms of the number of ventures financed. Gaston (1989) suggests that informal investors provide capital to over 40 times the number of firms receiving investments from professional venture capital funds, and the amount of their investments almost exceeds all other sources of external equity capital for new and growing small businesses combined. Estimates for the UK suggest that SMEs have raised about £2 billion from the informal venture capital market. By comparison, Bannock (1991) estimates that the formal venture capital industry has some £1.25bn invested in SMEs in the UK, suggesting that the informal venture capital market is almost twice as important to the SME sector as formal venture capital (Harrison and Mason, 1993).

The potential scale of the informal venture capital market is considerably greater than these figures suggest. First, a number of research studies confirm that most business angels cannot find sufficient investment opportunities that meet their criteria and so have substantial amounts of finance available for informal investments. A survey of informal investors in the UK found that three-quarters would have invested more in the last three years if they had come across a greater number of suitable investment opportunities. On average, these investors had a further £50,000 available for investment. In aggregate, the sample of informal investors had up to £10 million available for investment, equivalent to three times the total amount that they had invested during the previous three years (Mason *et al.*, 1991a). A study of business angels in Scotland also found that they have excess funds. However, it was not possible to put a figure on the amount available because the angels questioned in the study claimed not to set aside specific sums for specific investment purposes (KPMG, 1992). In the USA, Gaston (1989) found that 54 per cent of investors wanted to invest more than the volume of opportunities permitted. The surplus funds of these investors was 51 per cent more than they had invested; averaged over all investors the amount of uncommitted finance was 35 per cent more than they had invested.

Many angels contend that there is a shortage of good quality investment proposals, although this may be associated, at least in part, with poor presentation by entrepreneurs. However, shortcomings in the search process by entrepreneurs and investors also play a significant role in contributing to their lack of suitable investment opportunities. Most informal investors are not able to devote significant amounts of time to what is generally a spare-time activity. As a result, most adopt a fairly passive approach to the identification of investment opportunities, looking in an ad hoc, unscientific fashion, placing considerable reliance on friends and business associates for referrals and they rarely adopt a pro-active search (Mason *et al.*, 1991a). Thus, there is a large degree of serendipity in the number and quality of deals that come to an investor's attention. Studies in the USA and the UK indicate that a majority of informal investors are dissatisfied with their referral sources and believe that there is a need for improved channels of communication between investors and businesses seeking risk capital (Wetzel, 1981; Myers and Moline, 1988; Mason and Harrison, 1992a). New entrants to the informal venture capital market who have taken early retirement or redundancy, or are returning ex-patriots, or in some other way are isolated from informal referral networks, for example, due to employment background or location, are often particularly dissatisfied with the available sources of deal flow (KPMG, 1992). UK research indicates that investors in the peripheral regions express the greatest dissatisfaction with their existing referral sources. Meanwhile, entrepreneurs are hampered in their search for private sources of venture capital by the anonymity which most informal investors strive to preserve. As Gaston (1989, p. 1) has observed, both the search by a business for an investor, and the search by an investor for an investment opportunity "can be . . . expensive, time-consuming affair[s]. The search is studded with pitfalls and dead ends that often result in failure and frustration". This, in turn, leads him to describe the informal venture capital market as "a giant game of hide-and-seek with everyone blindfolded" (Gaston, 1989, p. 4).

Second, as Freear and Wetzel (1992) note, "virgin angels" – individuals with the same self-made, high net worth characteristics as active angels but who have not, for whatever reason, entered the informal venture capital market as individual investors – considerably outnumber active investors. According to Freear *et al.* (1992) the number of high net worth individuals – defined as a net worth of $1 million or more – in the USA has been estimated to be about two million, of whom 80 to 90 per cent are self-made. They go on to point out that the self-made characteristic of the high net worth population is significant "because it implies that many of them have acquired the kind of experience . . . that it takes to start, manage and harvest a successful entrepreneurial venture. In a sense, their entire professional careers have prepared them to conduct the due diligence necessary to evaluate the merits and the risks of prospective investments and to add the value of their know-how to the ventures they bankroll" (p. 5). However, Wetzel and Freear (1993) estimate that there are about 200,000 angels in the USA. Thus, there are up to ten times as many virgin angels as active angels. Riding and Short (1987a) estimate that active angels in Ottawa-Carleton comprise only 5 per cent of those with similar demographic characteristics. The number of active business angels is therefore only a small fraction of the potential number of private investors.

Research by Freear *et al.* (1992) in New England indicates that with the right enticements over half of virgin angels could become active investors in entrepreneurial ventures. A small-scale survey of virgin angels in the UK indicates that their inability to identify firms which require finance is the main reason why they have never invested in entrepreneurial companies. Other frequently cited factors are the high risks involved, concerns about exit routes and their lack of expertise to appraise investment opportunities (Mason and Harrison, 1993a). A slightly different set of factors for not investing emerge from the virgin angels that KPMG (1992) briefly discussed in their study of the informal venture capital market in Scotland. Their conclusion was that these individuals were not active in the informal venture capital market principally because of unacceptable risks and a lack of tax benefits. Four factors therefore seem relevant in seeking to convert virgin angels into active investors (Mason and Harrison, 1993a). First, virgin angels would be prepared to invest in companies where they knew the management team personally, a major factor in reducing the perceived risk factor in an investment (Binks *et al.*, 1992). Second, virgin angels might be willing to invest if they received information from a trustworthy source on companies which wish to raise finance. The availability of tax incentives is a third factor that might encourage virgin angels to invest. Both the KPMG (1992) study and also US findings have noted that reduction in the capital gains tax would be the most influential factor in inducing virgin investors to become active investors (Freear *et al.*, 1992). Finally, US evidence indicates that opportunities to participate with other, more experienced, investors was seen by virgin angels as a major inducement to becoming active (Freear *et al.*, 1992). In contrast, UK virgin angels were not influenced by this consideration, a finding that is consistent with the much lower levels of syndication of investments reported by active informal investors in the UK compared with their US counterparts (Harrison and Mason, 1992a).

Research findings from a number of countries therefore clearly indicate that there is considerable scope for assisting those angels with substantial uncommitted sums of money available for informal investments in finding suitable investment opportunities and also for increasing the population of business angels. The policy implication is therefore that efforts to increase the supply of small amounts of venture capital for start-up and early stage ventures, especially in areas where institutional sources of venture capital are lacking, should be directed towards initiatives which will overcome the information gap between entrepreneurs seeking finance and business angels seeking investment opportunities. We consider an appropriate mechanism in the following section.

Business introduction services: A mechanism for stimulating the informal venture capital market

The most promising strategy to promote informal venture capital involves the establishment of business introduction services – or "financial marriage bureaux". There are examples of such services in the USA, Canada, the UK and Scandinavia (see examples in Harrison and Mason, 1995). Business introduction services attempt to overcome the two major sources of inefficiency in the informal venture capital market, namely the invisibility of business angels and the high search costs of angels for businesses and businesses for angels, by providing a channel of communication between informal investors and entrepreneurs seeking finance. This enables entrepreneurs to bring their investment proposals to the attention of a number of private investors simultaneously and provides investors with a timely and confidential means of identifying and examining a range of investment proposals.

The most straightforward approach to "matchmaking" is through the production and distribution of an investment bulletin giving a brief description of companies seeking capital which is circulated to potential investors. Another method involves investor forums at which entrepreneurs seeking to raise finance make short presentations to an audience of potential investors. A more sophisticated approach involves computer matching which was pioneered by the *Venture Capital Network* which was established in New England in 1984 (Wetzel, 1984; Foss, 1985; Freear and Wetzel, 1995).

The experience of business introduction organisations in the USA and Canada suggests that such services cannot be operated as a profit-making activity. The creation and rapid disappearance of a considerable number of private sector matchmaking services in the UK in recent years would also seem to confirm the difficulty of operating such an activity on a commercial basis. A business introduction service requires professional staff to market the service to businesses and potential investors and to provide counselling and advice to businesses seeking to register with the service. A business introduction service will also require a sizeable marketing budget. The main source of revenue for business introduction services is the subscription fees levied on firms and investors. Operators have set fees for investors and businesses in the £100/$200–$300 range on the assumption that potential clients would be unwilling to pay significantly higher charges. The amount of revenue that can be generated from subscription fees is therefore limited and unlikely to be sufficient to cover the operating costs of a business introduction service. Thus, business introduction services have had to rely on government funding, or, in its absence, sponsorship from the corporate sector and their sponsoring organizations (eg chambers of commerce, universities).

Venture Capital Report, a UK private sector initiative, has sought to operate profitably by charging the business a "success fee" calculated on the basis of the risk capital raised (defined broadly to include loans and loan guarantees) in addition to the standard subscription fees levied on businesses and subscribers to the magazine. However, this method of raising revenue has not enabled VCR to operate on a commercial basis (Cary, 1992). Moreover, many US and Canadian commentators argue that it is inappropriate for business introduction services to have any financial interest in the outcome of the negotiations which follow the introduction since it might be perceived by businesses and investors as compromising their impartiality, while any attempt to run a business introduction service on a for-profit basis is likely to reduce its credibility amongst both investors and firms (Mason and Harrison, 1992b).

Business introduction services remain at the experimental stage and so far most have had only modest success in unlocking the substantial sums of uncommitted money that most business angels have available. This is illustrated by the case of LINC, a UK initiative which currently operates through local enterprise agencies in nine localities. It has a small client base which has recently stabilized at about 200 investors and about the same number of businesses. This reflects LINC's low awareness amongst informal investors, small business owners and professional intermediaries (e.g. accountants, bankers, solicitors) (Mason *et al.*, 1991b; KPMG, 1992) which is, in turn, a function of its lack of financial resources which has limited its marketing and promotion efforts, allied to its patchy geographical coverage. Many LINC agencies do not even have any dedicated staff or marketing budget to promote the service locally. More fundamentally, the scale of informal investment activity resulting from LINC's endeavours has been limited. Between 1987 and mid-1993 only about 80 businesses have raised finance from informal investors to whom they were introduced through LINC, with the total investment amount-ing to £3.75 million. Thus, participation in LINC has not significantly enhanced the ability of investors to find suitable investment opportunities. Indeed, 86 per cent of LINC investors would have invested more if they had come across sufficient investment opportunities. They had an average of £100,000 still available for investment. In aggregate, the amount that the sample of LINC investors had available for investment exceeded the amount that they had invested during the preceding three years by some 40 per cent (Mason and Harrison, 1993b).

Computerised business introduction services in the USA and Canada have also had a limited impact on the flow of informal venture capital. With only a few exceptions computerised matching networks have had limited success in attracting investors and entrepreneurs, with an average (based on responses from 10 networks) of just 42 investors (ranging from 3 to 163) and 73 entrepreneurs (ranging from 3 to 223). These low figures are attributed partly to the short time period that most have been operating but primarily to their limited budgets which has restricted their marketing efforts to the production of a brochure and little else (Brown and Stowe, 1991).

VCN's performance in recruiting investors and clients is more impressive, reflecting its longer period of operation, and demonstrates the potential of business introduction services. VCN has attracted a cumulative total of approximately 1200 entrepreneur clients and about 800 investor clients over the period 1984 to 1990. About 35,000 initial computer matches resulted in about 3500 investor requests for introductions to entrepreneurs. Moreover, three out of every four entrepreneurs have received at least one introduction to a potential investor, and most have received five or six introductions. However, only a small number of successful matches appear to have resulted. VCN is aware of only 31 companies which have successfully raised finance from investors to whom they have been introduced, although it should be noted that this will be an under-estimate as, under Securities and Exchange Commission regulations governing the operation of the service, VCN cannot do any systematic follow-up of the results of meetings between investors and entrepreneurs and must rely on ad hoc word-of-mouth, third party and press reports of successful matches (Wetzel and Freear, 1995).

Thus, while the concept of a business introduction service remains sound the way in which it has been implemented has been sub-optimal. Case studies of various business introduction services in North America and the UK highlight four factors critical to their success (Mason and Harrison, 1992b; Wetzel and Freear, 1995). First, there is a need to build a critical mass of investor and entrepreneur clients. Private investors are a diverse and dispersed group who are difficult to reach through traditional marketing techniques. A business introduction service is an unfamiliar concept. Like all such concepts it does not immediately sell itself and requires to be explained, ideally on a face-to-face basis (Wetzel, 1987). Various studies indicate that when the concept of a business introduction service is explained, the majority of business angels express an interest in participating (Wetzel, 1981; Riding and Short, 1987a). Building a client base of businesses is less problematic. The challenge here is to attract *quality* business opportunities and filter out businesses that are obviously "lemons" (Riding *et al.*, 1993): without a flow of good quality investment opportunities, it is unlikely that business introduction services will be able to retain their investor clients for very long. Recruiting investors and entrepreneurs to a business introduction service therefore requires energy, creativity and missionary zeal (Wetzel and Freear, 1995). The key is to achieve high visibility and credibility in the local/regional business community, for example, by speaking engagements at all kinds of professional and civic organisations, developing networks with organisations that can be a source of high quality referrals and maximizing public relations opportunities that will lead to articles in newspapers and magazines and coverage on TV and radio. Inevitably this takes time to achieve.

Second, business introduction services must be well resourced. Since it is not possible to run a business introduction service on the basis of fees from investors and entrepreneurs alone (Mason and Harrison, 1992b) they must rely on public sector support and/or sponsorship. Their effectiveness depends upon the size of their budget. Brown and Stowe (1991) have demonstrated that there is a direct correlation between funding and the number of investors and entrepreneurs recruited to the service. Few of the match-making services that they studied in the USA had sufficient funding to allow any marketing beyond producing information brochures. However, without sufficient funding it is not possible to run an ongoing high profile marketing campaign which is necessary to maintain a flow of new investors and investment opportunities.

Third, a business introduction service should not rely on passive approaches to match-making. Successful match-making is a very hands-on and pro-active process: "passive networks drop the ball just when the real work begins" (De Jordy, 1992, p. 208). KPMG (1992) report that the business angels in their study would welcome some form of prior vetting of investment opportunities. However, Wetzel, who founded VCN, argues against vetting on philosophical, practical and regulatory grounds (Wetzel and Freear, 1995). From a philosophical position investors themselves can be presumed to be the best judges of investment opportunities and entrepreneurs should be advised to do their own evaluations of potential investors. The practical consideration is the cost of employing qualified staff to screen investment proposals and investor qualifications. Finally, the decision not to undertake any screening enabled VCN to operate without registering as an investment advisor or broker/dealer with the US Securities and Exchange Commission. However, VCN did recognise that investors and entrepreneurs need information about the process of making investments. In response to this need, it has run a series of workshops designed to raise investor and entrepreneur competence and confidence in their ability to negotiate the price and other terms and conditions of a venture investment. Workshops for investors have included such issues as structuring equity investments, valuation and exit routes while those for entrepreneurs have covered the issue of "dealing with investors". These workshops have also been effective in enhancing VCN's visibility and credibility and in reaching potential clients (Wetzel and Freear, 1995).

Finally, we believe that in order to be credible with both investors and firms a business introduction service needs to be managed by a respected but disinterested third party with broad-based community support which operates on a not-for-profit basis. Examples include local enterprise agencies, chambers of commerce (as in the case of COIN in Canada), universities (as in the case of VCN in the US) and Training and Enterprise Councils (TECs) (as in the case of the DTI informal investment demonstration projects in the UK). Both entrepreneurs and investors need to be comfortable that the managers of a business introduction service are genuinely interested in fostering local economic development, have no vested interest in encouraging inappropriate matches and would maintain strict confidentiality. Such organisations also need to have a high profile in the local community, be well networked and be perceived by investors and entrepreneurs as accessible and approachable (Government of Ontario, 1986).

Conclusion

There is widespread agreement that an equity gap exists for companies seeking small amounts of risk capital which constrains the development of the SME sector. While this is a national problem, evident in the UK, USA and Canada, it is particularly acute in peripheral regions which lack an indigenous venture capital industry. Various policy initiatives designed to increase the regional supply of venture capital have, at best, provided only a partial, and costly, solution. In these circumstances, encouragement of the informal venture capital market becomes an important option for small firm policy-makers. The pool of informal venture capital is already significant, and there is considerably scope for expanding the size of this pool, but it is largely untapped by SMEs because of inefficiencies in its operation. To expand the informal investment market, therefore, requires a mechanism which overcomes the high search costs incurred by investors in seeking investment opportunities and entrepreneurs seeking private investors. The most appropriate means of achieving this objective is through the establishment of a network of locally or regionally based business introduction services. By providing an efficient channel of communication between business angels and entrepreneurs this can help improve investment flow from both active and virgin angels.

The experience of existing business introduction services indicates that their impact is a function of three key factors. First, they must be well-resourced. In view of the economics of operating such services, which are unlikely to be capable of operating on a non-subsidised, for profit-basis, public sector support will be required. This can be justified in terms of the wider economic and technical benefits that will arise by enabling businesses to overcome the financial and know-how constraints to start-up and growth. Moreover, the financial commitment required is minuscule compared with the costs of alternative strategies for closing the regional equity gap. Public sector support for a business introduction services therefore gives "a bigger bang for the buck". Second, business introduction services must devote considerable energy and creativity to the ongoing marketing of the service to potential investors and entrepreneurs. Third, they need to undertake pro-active matching, including providing training courses to teach investors the techniques for successful venture investing and entrepreneurs the techniques for successfully raising venture capital.

However, it is important that local and regional efforts to promote informal venture capital by means of business introduction services are undertaken in the context of supportive national government initiatives. First, it is important that measures are enacted to make the treatment of equity investment in unquoted companies no less favourable than other forms of saving and investment. The treatment of capital gains and the availability of roll-over relief for capital losses are particularly relevant in this context. Second, the regulation of investments (Financial Services Act in the UK and the Securities and Exchange Commission in the USA) should have sufficient flexibility so as not to deter informal venture capital activity.

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