MARK ABERNETHY

WITH DAVID S. HEIDTMAN

BUSINESS ANGELS

HOW TO BE ONE · HOW TO FIND ONE · HOW TO USE ONE

The rise and the methods of private equity investors and the small businesses they save

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1
What is a business angel?

In the beginning

Sydney was still a youngster well into the 1820s. Convict shipments made weigh through 'the Heads', running water was an unheard-of luxury, and sewage disposal consisted of strictly open-air technology. Crops were erratic, natives were still launching raids around the upper reaches of the Parramatta River, and what currency there was in circulation had proven hard to come by and even more difficult to ascribe a value to. Drunkenness, violence and corruption reigned. The fledgling colony had already endured its first revolution and its first taste of illegitimate military rule; shipments of manufactured goods from England, China, India, the USA and Cape colony were still less than regular, and often marred by extortionist captains and greedy land-based merchants whose mark-up was between 500% and 1000%. In 1823 Sydney's total imports arrived in just 55 ships.

Sydney's first Chamber of Commerce was formed in 1826, with Governor Darling's blessing, but it did not last long. The second, more successful Chamber would have to wait until 1851. Even the concept of an exchange, first floated in 1837 as the Royal Exchange Company, would not be realised until

1857 when it was finally opened for business. Australia's first insurance company, Australia Marine Assurance Company, was not established until 1831, and for five years it was the only one.

In this environment, capital was everything. To the capitalist went the land, the manufactured goods, the wealth in the ground and the ear of the Governor. To the bonded settlers, the ex-convicts and the unskilled workers went the labour. The penurious complained of their lack of capital, while the capitalists complained of the lack of skilled, motivated workers willing to travel out of Sydney Town and work on the lands they were being granted ever westward and north of Sydney.

The skilled shepherd or 'wool-grower', at this stage in history, was sitting on the edge of an industry which in the next 30 years would see production grow from subsistence and experimentation to a colonial export comprising half of England's total wool imports. But the small wool-grower was usually not in possession of the capital required to receive the giant land grants being handed out to the gentry — handouts usually made in proportion to their capital. The land grants continued throughout the 1820s, with the result being too much land owned by too few and not enough skilled labour to work it. In 1830 the grants stopped, and westward land was sold at 5 shillings per acre in order to stop too much land being taken up.

The end of private land grants to a wealthy few created the incentive for an aggressive new class of colonial to take to the disused land farther inland. There he could attempt to make something of himself rather than taking wages from the landed gentry for what was a harsh and isolated life. Known as the squatter, he was to change the face of Australian agriculture and, in the process, become the target of what we today call the 'business angel'.

In the first 20 years of the squatter, Australian wool production grew from 2 million pounds exported to England to 39 million pounds by 1850. And at the heart of the squatters' expansion and then dominance in the agrarian economy was a simple form of equity investment known as 'thirds'.

The wealthier wool-growers could buy grazing land from the grantees of the 1820s. But skilled shepherds with little money could get backing from the capitalists who wanted to make money from wool-growing without leaving Sydney. The shepherds needed stock to fatten and capital to live on. The capitalists saw not only a burgeoning wool export market but also adventurous men willing to pursue its riches. The combination of skill and capital was a snug fit.

> A man with the smallest capital could acquire a flock, either by buying the sheep if he had the means or by going into partnership with a more wealthy city dweller if he had not...
>
> A popular method was to buy sheep on 'thirds', with a loan from a Sydney capitalist who would take a third of the profit.
>
> A.G.L. Shaw: The Story of Australia, 1954

Equity investment at its purest had taken a hold in the bustling colony of New South Wales, but business angels had their eyes on more than just a share of the woolclip.

As Sydney Town grew, so did the informal capital markets. While the formal investors such as British banks were investing in explorers, land, plant and graziers, the informal equity investors were waking up to the commercial possibilities of this aggressive new colony sitting on the edge of seemingly endless square miles of land. Given its size, environmental virginity and burgeoning population, there had to be opportunities for capital to find the right place to 'go to work'.

One such early Australian equity investment was plagued by the same problems so often seen in the 1990s' informal capital market (some things, it seems, never change). But eventually this early colonial venture was so successful that its scion is still with us today.

By the 1830s, British capital was flooding into the new colony of New South Wales, which then stretched from Cape York Peninsula to Bass Strait. Much of that capital was from

London, Liverpool and Glasgow banks, funnelled through land companies that had been established to find land and develop wool production. One British business angel, however, was not lured by wool; he literally sold the farm to finance an entrepreneur's vision of a sugar-refining industry in NSW. The investor's name was William Knox Child, the Deputy Lieutenant of Kent. In 1839 he sold his county estates and put the resulting capital into the ambitious scheme of one Francis Kemble, a fast-talking London businessman. The company, as formed by the business angel and the 'ideas man', was called the Australian Sugar Company.

It was the classic model of the sometimes rocky road enjoyed by the combination of wealth and dreams. Child put £20 000 into the venture, which bought boilers, steam engines, plant and machinery. These were shipped to the banks of the Cook's River south of Sydney, where they were supposed to be assembled and then emerge as a refinery to process raw sugar cane from the Philippines. The putative refinery never became operational, as trade conditions and a quarrel between Kemble and Child temporarily put the nascent venture to the sword. History does not tell us what this argument was about, but if equity investment has enjoyed the same basic problems for centuries the spat probably went like this:

KEMBLE: Don't panic, William, all we need is another £10 000 from you and we can ride this out. The refined imports won't be this cheap forever.

CHILD: What!? I've already put £20 000 into this crazy scheme and you want another £10 000? What else haven't you told me about?

Whatever the exact basis of the quarrel, the dispute was not terminal. In March 1842 Kemble and Child were back in business as the Australasian Sugar Company. Only this time Child had realised that being the sole provider of such large capital outlay was not the most relaxing of commercial roles. In one quick step, he became an 'ideas man' with his partner, and together they raised £230 000 by persuading 60 Sydney business angels to buy equity in their sugar dream.

Child and Kemble's earlier experiences had also taught them the need for proper management — an imperative as valid then as it is today. They settled on Edward Knox, a 24-year-old German-educated accountant whose precocious talents would see him become Official Assignee of Statutory Insolvents at age 25 and Chairman of the Commercial Banking Company at the age of 28. Under this accountant's auspices, the Australasian Sugar Company became a minor success, and actually started refining raw sugar in competition with cheaper imports from Java, Mauritius and the Philippines. However, further arguments between the shareholders saw the company's dissolution in 1854. When the dissolved company was reinstituted as the Colonial Sugar Refining Company a few months later, there was no Francis Kemble or William Knox Child on the directors' Board or in the list of shareholders.

Whatever their fates, the original Kemble/Child match of ideas and capital certainly started something. The company that moved on without them would later venture into Queensland, Western Australia, South Australia, Fiji and New Zealand as it grew, faltered, expanded, consolidated and became what we know today as CSR — Australia's and the South Pacific's largest sugar company.

This pattern of ideas/investment/dissolution, and later resurrected success in the hands of larger capitalists, is an equity investment pattern that would play itself out for the next 150 years of Australian commercial history.

Angels of theatre

The term 'business angel' is not entirely appropriate in the cases of the early 'partners' of the squatters and William Knox Child. In the 19th century such people were, in reality, known simply as 'investors', or more commonly 'capitalists'. The business angel monicker would gain currency some decades after Sydney capitalists began investing in wool-growing squatters, when it would emerge in Victorian England and then in the USA in the 1920s in a quite different context.

The business angel was originally a cash-rich investor, who encapsulated the strange bedfellows of entrepreneur and philanthropist to the arts. Wearing his snide term of endearment, the 'business angel' was a last-minute saviour of Broadway and West End stage productions that had run into difficulties before the first night. Theatre production was and is a notoriously mercurial enterprise, and productions could find themselves threatened by low subscriptions, lack of pre-sold tickets, late-start penalties, a star falling ill, fire, or failure to spark the imagination of the critics. Enter the business angel, who would write the cheques, hold the theatre-owners at bay, and see off the creditors in exchange for a cut of the receipts. In time, the business angel was sought out before the producer even committed to the production, and many stage producers would not launch their entertainments without the underwriting of an angel.

The relative philanthropy of the business angel could be judged by the way he structured his deal. He could take a percentage of gross box office receipts with no ceiling, in which case he was betting that the production would be a success and provide more than a return on the monies forwarded (a deal similar to the Sydney capitalists, who took 'thirds' of a squatter's wool profit). An angel could agree to a cut of net receipts, he could buy a percentage of the actual production company, or he could demand that his investment be repaid 'above the line', whereby he was guaranteed repayment of the invested money plus his 30% fee from the 'top' of the gross receipts. In other words, no-one in the production company would see a single cent until the undertaking to the angel had been fully discharged — a deal that could create the very cash-flow problems the company had found itself in before it was 'saved' by the business angel.

The name 'business angel' lives on, but not in the entertainment industry. The angels of the stage have given way to specialised entertainment industry insurers who underwrite the risks inherent in theatre and film.

Migrant angels

While the term 'business angel' was coined in the Northern Hemisphere, equity investment in small business ventures continued apace Downunder long after the wool squatters turned into their own 'squattocracy'.

In the late 1940s and into the '50s and '60s Australia underwent a huge population inflation, as restless postwar Europeans abandoned their lives in Athens, Naples and Liverpool to begin anew in Perth, Sydney and Melbourne. In these migrant populations of British, Italian and Greek settlers, a nationality-specific culture of business angels emerged as often the only viable way for small-business operators to become established, grow, or hold off the threat of bankruptcy.

Finance avenues for new ventures were usually the banks, but migrants with no banking history, no property and lack of a proven business record could find the traditional finance routes unfruitful. In this climate, the informal capital market played an important part in allowing migrants to establish their small businesses and to expand.

In Sydney, the Italian community's APIA Club became a hotbed of business networking, where a cash-strapped business owner could attract capital to his business in exchange for equity. In Melbourne, the various Greek social clubs served as similar exchanges of businessmen and business angels, and the numerous British clubs around the country did the same for their constituency. These days we would call them business networks. As this wave of migration quickly instigated its own base of professionals such as solicitors and accountants, the network of informal capital flow to small businesses was further enhanced.

The latest wave of migrants from places such as Vietnam and Cambodia has followed a similar pattern of informal capital allocation to small and medium-sized enterprises (SMEs).

In all of these examples of business angels in migrant communities, the problems and the objectives are the same as in any other part of Australia's informal capital market: business owners need to know where to find business angels and the angels need a way to find the best prospects for investment. This is a problem British academics Colin Mason and Richard Harrison often refer to as 'business angel invisibility'.

Angels today

Because there were different breeds of theatre angels, the term business angel is sometimes rejected by modern-day Australian equity investors, for fear of being associated with the more ruthless elements of that 1920s community. In this book 'business angel' refers to the current usage in Australia, New Zealand, North America and the United Kingdom: the person who seeks equity in an unlisted company in exchange for his capital.

The business angel is external to the business, is a high-net-worth individual, operates informally (outside the auspices of an institution, corporation or other investors), and seeks a measurable share in the company in exchange for his capital.

The nexus of business angel and company is a relationship where the goal of both parties is to grow the company to a new level. 'Exit strategies' may differ and the investor's involvement in the actual operations of the company may not be the same on a deal-by-deal analysis. But what business angels all have in common is a specific, targeted investment that is aimed at growth, whether it be for export, increased production capacity or interstate expansion. The aim is to have capital working for a capital gain.

The term business angel is used in 1990s Australian investment circles to differentiate the 'passive' investor, who puts his money into property, managed funds or the stock market, and the private equity investor, who wants to buy into a small firm.

> High net worth, non-institutional, private equity investors are distinguished from high net worth institutional investors because they are willing to make a direct equity investment in an entrepreneurial venture.
>
> Robert Wenban: Australian Business Angels: How to Find Them and How to Catch Them, 1995 (unpublished)

'Business angel' has also grown in use to exclude the term 'venture capitalist'. Venture capital is not private investment as such, because venture capitalists are investing or managing institutional funds. Therefore, the venture capitalist is primarily investing on behalf of other investors, whereas the business angel is investing his own funds in the fortunes of the company. In fact, often a business angel does not want merely to invest in the company, he wants to work in it as well.

This distinction between business angels and venture capitalists is made by the Australian Institute of Company Directors, which uses the discriminators of 'direct' and 'indirect'.

> Venture capital emanates from private individuals, both directly through so-called 'business angels', and indirectly through managed funds, referred to as 'institutions'. These venture capital funds are also supported by those institutions which allocate a proportion of their total funds under management to venture capital investment.
>
> In assessing current attitudes to the venture capital market, both elements need to be considered: (a) Business Angels — Direct Investment, (b) Institutions — Indirect Investment.
>
> David Baillieu & Simon Marks-Isaacs:
> *Venture Capital Initiatives,* AICD, 1996

There is also the question of scale. While both the business angel and the venture capitalist are taking equity in growing SMEs, there is a sizable gap between the markets they are servicing. Business angels are usually wealthy individuals or syndicates of the same, whereas the venture capital funds are the specialist equity investment managers that administer fund allocations from insurance houses and pension funds. Consequently they have different amounts of money to invest and so, as outlined in the 1995 report from the National Investment Council/Marsden Jacob Associates, *Financing Growth,* the business angels and the venture capitalists occupy distinct equity-investment niches.

Because of the cost of searching for and scrutinising the cash-poor SMEs that need equity investment, venture capitalists will typically invest between $1 million and $10 million, so that a reconciliation of investment cost and divestment return produces a greater profit. Indeed, most Australian venture capitalists have a minimum investment threshold of $2 million, yet are more interested in the $5 million deals.

Venture capitalists are investing other people's money and therefore adhere to conservative prudential requirements. This means they invest in companies that have moved beyond their start-up phase and into the expansion stage, which is considered a much lower risk than companies in start-up or early stages. Business angels, on the other hand, are typically investing their own money — usually between $50 000 and $200 000 — and are often targeting their investments at the early-stage, small companies. They are also more interested in entrepreneurial, high-tech firms than are the venture capitalists.

A motley crew

If business angels are a breed apart from other forms of financiers, they are also a breed apart from one another.

In truth, there is little known about Australian business angels in the empirical sense. We do not know how many there are in Australia, or how many there have been. We do not know why they decide to become business angels, except for their own anecdotes and evidence from those organisations which 'match' angels with companies. We do not know much about their investment patterns or what other investments they are likely to be involved in. The business angel is an idiosyncratic beast — hard to pin down, a law unto himself.

One reason for little forthcoming information about business angels is their lack of an association, a professional group or a sector grouping at a central data collection agency such as the Australian Securities and Investments Commission (ASIC). They don't have to 'list' anywhere, or to appear on any department's register; even ASIC's attempt to rope in business angel matching services under the corporations law seems to have met with failure. They are beholden to no-one except the Australian Taxation Office, which takes a great deal of interest in their capital gains. Business angels do business in a private manner.

What numbers and categorical breakdowns that are available come from matching services, such as South Australia's *Ideas and the Investor* program and Victoria's Business Finance Support Program. When the Australian Stock Exchange's national, Internet-based meeting system for angels and entrepreneurs — the Enterprise Market — is operational, it should generate reliable statistics on this sector.

Other sources that contribute to what we know about Australian business angels are organisations such as David Millhouse & Associates in Brisbane and the Australian Business Equity Exchange in Perth, which runs a 'matching' publication for equity investors called Exchange Register. A company in Sydney, Pollitecon Publishing, puts out *The Australian Venture Capital Guide,* which includes some business angels; Pollitecon also publishes a periodical which is a clearing house for investors and companies seeking equity investment.

However, all the services guarantee absolute confidentiality to the business angels, and many angels access their investment opportunities through their own networks anyway. Business angels answering ads in specialist publications are not tracked, and neither are the companies seeking such investment.

> Most angels find companies through intermediaries because
> they want to avoid being inundated with cranky proposals.
> This makes them hard to contact.
>
> Andy Coghlan, writing in *New Scientist,* August 1996

Evidence suggests that the majority of introductions between business angels and companies still take place privately through personal referrals from friends and business associates. Some matches are sourced through accountants and solicitors — a phenomenon almost impossible to track due to the client confidentiality granted by these two professions. Even the most quoted paper on business angels and equity finance undertaken thus far in Australia admitted difficulty in fully comprehending the business angel community:

> Very little is known of the processes by which Australian business angels make their decisions to allocate capital to SMEs. Indeed ... not much more is known about business angels in general. In the light of the overseas evidence on the importance of business angels as sources of capital, management advice and market development, this is a major deficiency.
>
> National Investment Council/Marsden Jacob Associates: *Financing Growth, 1995*

Only recently did the Commonwealth realise a need for further data on business angels, perhaps as a response to the comments of the NIC/Marsden Jacob report.

The Productivity Commission released its report on Australian business angel activity, *Informal Equity Investment,* in early 1997. It estimated that around 6800 Australian businesses had received informal equity investment at an average of \$150 000 per investment. The total value of informal equity investment was estimated at around the \$1 billion mark, which is equivalent to the total value of venture capital invested in Australia. These estimates were conservative given that the investigation eschewed equity investment where the recipient was a close friend or relative of the business angel.

There is also research carried out by a 1995 *Yellow Pages* Small Business Index survey, which found that 97% of small businesses seeking external equity finance for growth needed \$500 000 or less, and the majority of this equity investment came from business angels. However, another *Yellow Pages* survey conducted in 1995 found that only 12% of the small businesses surveyed were exclusively seeking equity finance.

When the Victorian Employers' Chamber of Commerce and Industry (VECCI) launched its business angel/equity investment matching service, the Business Finance Support Program (BFSP), in December 1994, early figures confirmed an SME reluctance to yield equity. After six months of operation, the

VECCI scheme had 560 registered business angels and only 40 small businesses.

Look also to the Commonwealth Bank's decision not to provide equity finance to SMEs after the government announced changes to the law in 1995, allowing banks to take equity without being caught in certain tax clauses. The ANZ stated a similar reserve in pursuing equity investment in SMEs. The CBA's reasoning for its reluctance was simply that not enough of its SME business clients wanted an equity arrangement.

> Our approach is open — any opportunity to help the clients is something we want to provide. But if the clients don't want ownership as part of the deal, then we don't want to push that on them.
>
> Dennis Roams, chief manager of business banking, CBA, reported by *Australian Financial Review,* 26 March 1996

Notably, at the same time as Mr Roams made his comments, the National Australia Bank was creating an equity finance division because of a putative demand from SME business clients for equity finance. The NAB subsequently committed $300 million to the venture capital markets through its VC vehicle, National Australia Investment Capital Ltd.

Perhaps the most telling study of business angels so far undertaken in this country comes from Dr Robert Wenban's Masters thesis at University of Swinburne's Centre for Innovation and Enterprise, Australian Business Angels. Wenban, a business angel himself, surveyed 36 business angels that he accessed through his own network. The surveyed business angels intended to invest $7.4 million in the next 12 months, with a weighted average of $160 000 spread through two to three investments. The angels were all male, half were aged 30-39 while the other 50% peaked out at 59 years. University degrees were held by 53% with the most common fields of study being science and business. On average they expected a 19.6% annually compounded return on their investment, and the preferred exit point was at three years.

Wenban takes pains to call his research 'qualitative' rather than ‘quantitative’. In other words, he does not present his findings as empirical or widely indicative. For instance, his finding that 50% of the surveyed angels were aged 30-39 is a figure he doubts is definitive. However, his results showing the financial and non-financial motivations of these informal investors make for an important general description of Australian business angels, and we return to them in detail in Chapter 2.

We can also look to impressions garnered from those who work with business angels, which can give us the most general of profiles. For instance, we know that they are fiercely independent, often shy of publicity, and generally dismissive of investors who cling to blue chip stocks.

> Business angels are looking for blue sky, not blue chips. They don’t distrust the stock market, they just think there’s a smarter way to invest their money.
>
> Bob Beaumont, coordinator, Business Finance Support Program

We can generalise that angels are often middle aged, usually men, of a business or professional background, and cashed-up. They are self-confident, and trust their abilities to scrutinise a business and add value to the enterprise through their experience, expertise and contact book. They usually invest in businesses whose activities they understand, and despite being self-starters and ‘go-getters’ are not afraid to use the services of accountants and solicitors for specialist tasks such as contract drafting and due diligence.

> Angels recognise the link between risk and opportunity for exceptional capital growth. The risk-reward equation provides a clue to the type of person likely to become involved.
>
> Paul Beber, from accounting firm H.W. Fisher, writing in *Banking World,* April 1995

Overseas business angels prefer geographical proximity to their investment, probably due to their ‘hands-on’ interest in the company. In the USA this proximity is typified as less than a 50-mile radius, but the Wenban study suggests that Australian business angels are not constrained by issues of distance: ‘A possible explanation for this could be that Australians are accustomed to travelling long distances for all aspects of their daily lives’.

Another explanation is that Australian business people are used to dealing with relatively small populations, and are therefore likely to think of expansion in terms of state and regional growth. They are ‘strange birds’, at once conservative business people while also being mavericks who operate outside formal finance structures.

The foreign examples

The example of informal capital and business angels as they operate in the USA can be somewhat breathtaking to the Australian reader, yet the US picture may point to similar commercial proportions among this country’s business angels.

> In the United States, there is a population of about two million individual investors, each of whom has a net worth of more than $1 million, excluding principal residence. Their equity investments, in which they have no management interest, lie in the range $100 billion to $300 billion. Individual investors invest more than $30 billion each year in over 100,000 ventures. (all US dollars).
>
> William E. Wetzel jr & John Freear: ‘Promoting informal venture capital in the United States: reflections on the history of the Venture Capital Network’, 1996

Perhaps more relevant for the purposes of Australian comparison, US business angels in any one year provide up to US$20 billion in 30 000 ventures, as opposed to the venture capitalists, who invest US$2 billion in only 2000 companies.

These are big numbers, but Freear and Wetzel give the human profile of the American business angel thus: male, median age 48, typically university educated, seeking a median annual return of 32.4% over a typical five-year investment, and willing to have up to 50% of the investment portfolio in informal equity. They seek to invest in companies not more than 50 miles from where they live. They reject seven out of nine proposals.

In the United Kingdom, problems similar to Australia's exist in quantifying and tracking the business angel community. However, some extrapolations have been made by business academics.

> Further evidence from surveys of sources of finance used by small business indicates that private individuals are the most important source of external equity capital after family and relatives. Extrapolation of these findings suggests that the size of the UK's informal risk capital pool is in the £2 billion to £4 billion range. To put this figure into some kind of context, the formal venture capital industry has invested about £1 billion pounds per annum in recent years ...
>
> In other words, informal venture capital is at least twice as important to the entrepreneurial small venture sector as formal venture capital.
>
> Richard T. Harrison & Colin M. Mason:
> 'Informal venture capital: evaluating the impact of business introduction services', 1996

The human profile in the UK is not unlike that of the business angels in the USA. They are 99% male, average age 53, with £312 000 net worth; 57% have previous entrepreneurial experience, they aim at young and start-up companies not more than 100 miles from their homes, and they hear about the investment opportunity through business associates and friends. They have £50 000 to invest but typically invest only £10 000 in any one venture. The average rate of investment is two every three years. They reject seven out of eight proposals (Mason & Harrison 1994).

It should be cautioned that one of the authors of the UK study, Colin Mason, is unsure about the business angel community in his own country. He told *New Scientist* (August 1996) that he estimated there were 60 000 angels in Britain investing between £2 billion and £4 billion a year. But: 'They are really ropey figures, and this whole area lacks data'.

Australian angels: an overview

The Productivity Commission says that probably 1.9% of small businesses use informal equity investment (business angels), which translates as 6800 companies with $1 billion invested in them as equity. According to the US and UK examples, the angels should account for a much larger total investment fund, taken proportionately against formal equity investments. In the US example, business angels should have invested at least 10 times the funds of their formal counterparts. In the UK, the model would have the business angels' investment at least twice as large. In Australia, the *Australian Venture Capital Journal*/Price Waterhouse survey of venture capital for 1996 found that Australian and New Zealand venture capitalists had investments to the value of $1.3 billion.

Another guide to the size of the informal equity investment pool in this country starts with the Reserve Bank figures for lending to small businesses as stated in the Bureau of Industry Economics' July 1996 *Industry Brief:* Reserve Bank data show that lending to small businesses by banks operating in Australia increased by 4.3 per cent to $51.4 billion in the March quarter 1996.

If Australian small businesses have taken debt from the banks to the value of $51.4 billion, what does this say about the size of the alternative: external equity?

The 1995 NIC/Marsden Jacob report, *Financing Growth,* gives a clue: '... only an estimated 2 per cent of all Australian small businesses are growth firms currently seeking external capital'. If the total lending to small business by banks (debt) is $51.4 billion, then the value of informal equity could be $1 billion, which is also what the Productivity Commission estimates.

Industry insiders estimate that there could be as many as 2500 serious business angels in Australia, with SME market demand for equity finance standing at about 10 000 companies.

The Australian business angel community is a broad church, comprising one extreme of the aggressive capitalists who are attracted to entrepreneurial, innovative start-up ventures, through to the other extreme of the neighbourhood angels, perhaps retirees, who put capital into small businesses in the most informal and passive of ways.

As we discuss in Chapter 2, the make-up of the business angel community is becoming further complicated by the injection of 'new blood'. New types of business angel, who may once have invested purely in shares and property, are joining the informal capital pool. Some anecdotes suggest that being a business angel is becoming 'trendy'. In Britain, for instance, the numbers of business angels have outstripped the number of businesses officially listed as being interested in informal equity investment.

New business angel groups include business and professional women attempting to buy their way out of unrewarding but lucrative corporate careers; Asian capitalists, who are very comfortable with equity investment in small firms and see Australia as a land of highly innovative but cash-poor companies; cashed-out corporate managers, who are taking their redundancy cheques and putting them to work in small companies. Within the decade the first retiree 'Baby Boomers' could form a new wave of business angels, who are cashed-up but not necessarily interested in property and stocks.

The important thing about Australian business angels is that they provide a crucial capital-raising alternative for growth SMEs. And however many there are at the moment, there will be many more in the next few years.

2
Business angels: one name, many breeds

Even in the 1920s, when the business angels were flourishing on Broadway, they were a diverse bunch with different styles, different methods and a whole range of deals. But what they had in common was available capital in exchange for a 'cut' of the business.

In Australia the diversity of this group is extraordinary. Business angels span the age spectra, racial divides, gender barriers and class structures. Their typical picture is of predominantly middle-aged men from scientific, professional and business backgrounds. But the real business angel demograph differs from that revealed by the relatively well-organised world of matching services and surveys. Angels are a private breed who may choose not to leave a statistical trail. Perhaps the people who shape the statistics are precisely those who do not mind being measured — that is, middle-aged men from scientific, professional and business backgrounds (and, even then, not universally).

The data from matching services and the Wenban study do not tell us about the informal capital market that flourishes in ethnic communities, or the flows of informal capital in women's networks, or the extent of business angel activity in the gay and lesbian communities and other distinct economies.

Similarly, is there any measure of informal capital allocations in what are commonly known as the 'old boys' network' and the rural sector's 'green economy'?

Nonetheless, business angels do fall into distinct groups — the retired and the redundant.

Retirement

The retired professional or business person is ostensibly the most popular of business angel groupings, perhaps because he is so readily identified.

The retiree might be a person who has succumbed to the societal pressure which says a person is redundant after they turn 60. For many of the people who are forcibly retired there are still challenges to mount, and a store of skill, experience and capital to invest in another generation of companies. Perhaps these business angels are early retirees who have taken the opportunity to sell their own business, or see equity investment as a means to break away from the corporation or professional firm.

Informal equity investment is, and always has been, a people-based enterprise. Knowing and understanding the people you are investing in is one of the strongest indicators of how well an equity investment will fare. For this reason retired doctors, lawyers and accountants have not only created a long client list — they have usually developed a 'bedside manner' for dealing with sensitive issues, conflicts and people of all stripes. They are also likely to have accumulated capital and retained strong social links in their communities, and to want to 'put something back in'. This is especially the case with community practitioners. With their people skills, capital and contacts in the community, doctors, lawyers and accountants who retire become prime targets for small firms looking for an equity investor.

These retired professionals — especially the accountant and lawyer — not only bring capital but contribute a base of skills to the company that would otherwise have to be paid for and a list of contacts that reflects their profession and age. Accountants can prepare business plans and deal with the banks; lawyers can draft contracts and perform convincing tasks; GPs are owed favours all over town. Usually they want to stay busy and continue to play a useful role in the community and often, but not always, they invest in a new generation of small practitioners in their particular field. Retired pharmacists, optometrists, real estate agents, hairdressers and funeral directors are all known to invest capital in oncoming generations of the businesses they once made their livelihoods from. Many of these neighbourhood business people will 'leave something in' the business when they sell so that the younger generation can buy the business. In this scenario, the business angel is moving on but may retain diminishing equity in the business for another five years or more. These are the investments that will never show up in the surveys of business angels; they do not even call themselves business angels, preferring to identify themselves as people who are just helping to get a youngster started or a cash-strapped business out of difficulty.

Another strong group of business angel retirees are the scientists/engineers. When an engineer or scientist retires, it is unlikely that he or she will suddenly lose interest in the technical and problem-solving aspects that drew them to their professions in the first place. Moreover, once they retire it seems they are more likely to be on the lookout for new challenges, and the interesting new ideas and projects of a new generation of inventors. They are likely to be drawn to small firms engaged in inventions, innovations and new intellectual properties — the very small companies that find it so hard to attract formal capital in their start-up and establishment stages. Such businesses do not just need capital, they need 'wise heads' who know how to solve problems and foresee pitfalls. This type of innovative small company also attracts the retired business people. Business people who have spent their working lives building market share for products and making a science of product commercialisation are particularly drawn to the possibilities of new or underperforming products. Again, provision of capital may play a secondary role to the contacts, experience and expertise that the retiree can bring to the young business.

The small company with an innovative widget on the drawing board may benefit immensely from the injection of $100 000. But the business angel's true worth may be revealed in finding the best manufacturing deal, sourcing the widest distribution network, and having the contacts and knowledge to take that widget into export markets. Such a business angel is particularly sought-after in small manufacturing firms wanting to grow. A thousand and one small things can go wrong in production that will quickly turn the racehorse into a camel. A manufacturing business angel offers experience rather than mere tertiary qualifications, and that experience can be invaluable to the young manufacturing firm. Non-monetary resources also figure in equity investment. One South Australian angel recently invested in a company by providing a manufacturing site instead of capital. This angel with an empty factory won out after the company's accountant held an 'auction' among several prospective investors who had responded to an advertisement. The company, which was engaged in making seaweed fertiliser, needed an immediate upgrade in premises more than it needed money.

The same thing goes for those business angels who have retired after a successful career in the construction or mining industries. They have capital to invest, but it is their qualifications from the 'school of hard knocks' that young companies may really be looking for.

The retiree business angels are also strongly represented in the trades. Motor mechanics, plumbers, electricians, builders, boilermakers and panel-beaters have worked hard for their success over the years, and may not be comfortable with their retirement investments being placed wholly in the stock market. Tradesmen who retire are still intimately familiar with the commercial realities of their former careers, and can feel more comfortable having their capital 'working' in a small, neighbourhood business than being at the mercy of the institutional fund manager. Where retirees from the trades and professions invest as business angels, they not only provide capital to a business but they bring an on-call 'locum' service, allowing the principal business partner to take the holidays unavailable to so many small-business folk.

Redundancy

Redundancy used to be something that happened to blue-collar workers, most notably in the manufacturing sectors. In the 1980s, with the coming of computerisation and automation in the workplace, redundancy shifted to what had unfairly been called 'unskilled white collars' — those involved in secretarial, clerical and general office duties.

The mid- to late-1980s saw the beginning of what came to be known as 'downsizing'. This was a management-driven movement, which sought to bolster profit figures by minimising the most expensive component of any business — people. Downsizing did not cull personnel because the company was necessarily losing money or because a worksite was overstaffed. Downsizing made the executives look good, with impressive and often artificial profit figures, which were fleeting at the very least.

Downsizing as a business practice has targeted management — senior and otherwise. Moreover, corporate Australia has lost thousands of its best and potentially best (as yet undeveloped) managers because downsizing typically allowed for voluntary severance before the forced-redundancy purge followed to get a corporation 'rightsized'. Anecdotal evidence from executive search and placement agencies suggests that downsizing saw many of the ablest managers take their redundancy payouts and either 'hop' to another company or go into business for themselves. A 1994 survey by Ernst & Young showed that 80% of redundant people maintained or improved their salaries and 90% maintained or increased their job satisfaction. What downsizing took from one corporation in terms of smart, motivated people it gave back to another corporation. Downsizing has also swollen the ranks of the business angels.

Business Finance Support Program coordinator Bob Beaumont calls the downsized managers 'the new business angels', and identifies them as a distinct group. Typically, he says, they have between $100 000 and $150 000 to invest in a likely business, have already paid off their homes, and maintain a shareholding and superannuation package. They are men, aged 40-50, often with contact books crammed with names that the average small business operator would never get to meet, let alone do business with. Again, as with so many business angels, they have experience, contacts and expertise to share, as well as capital.

> A sizable pool of experienced ex-managers already exists. In addition, many middle-managers in larger corporations who see their current positions as limited would welcome the opportunity to manage a smaller enterprise.
>
> These managers possess the marketing, operational and financial skills which many SME owner-managers lack. SMEs generally cannot pay the salaries commensurate with such experience, but could bring these managers into the business as equity participants.
>
> NIC/Marsden Jacob Associates: *Financing Growth*, 1995

As of June 1997, downsizing has taken up where it left off in the early 1990s. Telstra Corporation is mooting 22 000 redundancies in the next two years, many of which will occur at middle- and senior-management levels. Privately, analysts tell you that the telecommunications giant will shed more than twice that number. Telstra already shed 7000 jobs in 1996 and BHP shut down an entire steel operation in Newcastle in June 1997, taking 2500 jobs; in early 1998 the ANZ Banking Group announced 1700 redundancies. Other corporations are downsizing more quietly, and the consultants hired to perform the cull are often the people originally downsized in the 1990-92 round.

All of the matching services for informal equity investors are seeing an upsurge in inquiries from corporate managers who are still in their high-paying jobs but are already planning their futures as business angels — which is where the next category comes in.

Cash-out angels

> With merging and purging, downsizing and our favourite euphemism of all, rightsizing, many of the best and brightest in big business are — or should be — leaving to do their own thing.
>
> Faith Popcorn: *Clicking,* 1996

> They see many of their best people leaving, and those that stay are only energised by their own fears.
>
> Dwight L. Gertz & Joao P.A. Baptista: *Grow to Be Great: Breaking the Downsizing Cycle*, 1996

The cash-out business angels are still in work, aged in their 30s and 40s, earning at least $150 000, and have some sort of business specialty. They also have a 20% stake in a small company for when they opt out of corporate life.

The true picture of these people has not yet formed because they are a new and growing group. Some have not even made their equity investment yet. However, their demographic patterns and investment behaviour may be slightly more obvious because they are prepared to use matching services to investigate a broad range of equity investment options. Many operate in syndicate.

This is the younger generation of corporates who will take the salary, benefit from their experiences, but keep their eyes on opportunities outside the office walls. They often distrust the senior strata on which their futures rely, and they are prepared to make contingency plans for a stymied promotion or the threat of a downsizing purge. Some people whinge about bosses and the prevalence of corporate incompetence; cash-out angels are doing something about it. Where their senior made a salary leap in his late 30s and bought a Porsche or a yacht, this group is forgoing the luxuries and investing in a small company rather than that third house. Some are 'just-in-case' investors, while others have a time fixed for leaving the company and going to work on their own small company, probably from home.

Remember that the cash-out angels are largely in their 30s and early 40s. They have come to corporate life at a time when big business has demonstrated repeatedly that it owes its managers, even its very talented ones, no loyalty. They are notable for three features, which set them aside from other angel groupings:

1. They comprise relatively high ratios of women.
2. They are prepared for a lower standard of living in order to work on growing a small enterprise.
3. Their equity investment is likely to be a prelude to a buy-in.

We devote a later section to point 1, younger female corporates who are investing equity in SMEs while they still work in large companies. This group is a phenomenon in itself.

On point 2, some questions present themselves. For instance, if the cash-out angels know they will not get rich overnight from their equity investment, why are they doing it? Why are they planning to jump from a high-paying job, with all its power and prestige, to an uncertain venture in which their own money is tied up and therefore at risk? Why the cash-out?

The answer, as with most groupings of business angels, lies in the fact that informal equity investors do not do it purely for the money. Sure, they would like to make a million, and to do it fast. But in the meantime they are setting themselves up for a future that will probably be conducted out of a room in their home, will involve long hours, disappointment, and little of the comfort they enjoyed when they finally landed that corner office at the corporation. But what they also want is 'real challenge', 'real life' and 'real achievement'. The cash-outs are different from the redundancy angels, because they still have their jobs. But they are not waiting around to be downsized or to get stuck with a difficult boss.

This leads to point 3. While most business angels see their equity investment as a capital gain of 20% and over (few angels aim for returns less than 30%), there is anecdotal evidence to suggest that cash-out angels are looking for a greater involvement in the business, either while they are still in their job or further down the track.

One syndicate of two Melbourne business angels we spoke to were in their late 20s and early 30s. Their backgrounds were marketing guru in a large firm, and analyst with a multinational merchant bank. In their first two 'investments' they did not invest any capital because their input was in the form of reorganising the companies, especially their management and marketing strategies. They retain equity in one of those companies, and are still looking for an equity holding of 30% in the right company.

What are the cash-out angels already doing in their jobs? Many are working at nullifying creeping market share from a small upstart competitor. Others are due diligence experts, specialising in investigating smaller companies. Others are assigned divisions or departments, which they run like a small company, albeit without the same pressures as a small firm. Quite simply, there are some very smart, highly educated young managers working in corporations, and much of what they do is preparing them for a successful life as an SME owner. At the same time, they feel undervalued and insecure in their corporation.

Cash-out angels are a growing group. In a few years' time young, ambitious managers may not be asking themselves why they should cash out into an SME — they may be asking themselves why they ever bothered to buy into the corporate dream. Which brings us back to women angels ...

Women angels

Women do not feature strongly in surveys of business angels. They make up 1% of the business angel community in the UK, 2% in Canada and 5% in the US. In Australia various estimates put women business angels at between 1% and 3%

of the community, which could put their number as high as 100. Robert Wenban's study of 36 Australian business angels was an all-male affair.

At Business Angels Pty Ltd, a Melbourne-based matching service, numbers of inquiries from potential women angels tripled in 1996. They were in their 30s, 40s and 50s, were professionals and businesswomen, who equity-invested for much the same reasons as their male counterparts. They typically fall into three subgroups:

1. former business owners with lump sums to invest;
2. current professionals/managers looking to develop a business interest outside their workplace;
3. those re-entering the workforce.

Group 1 is the largest. Often in their 40s and 50s, they have owned their own business or have owned a business with their husband. Either they have sold up their business, divorced and split the proceeds of a business, or sold a matrimonial business and taken half of the proceeds to do their 'own thing'.

They want to invest in a business much closer to their home than does the typical male angel. Male angels, according to Robert Wenban's study, are prepared to invest anywhere; women are more likely to invest equity in their neighbourhood or community. The female angel has capital — similar amounts to the men by all accounts — but is also prepared to advise or mentor the investee.

Group 2 is small but growing. These women are aged 35-45, work in corporations or large professional firms, and have made or are making the leap into high salary structures. They are not happy with the culture of large corporate environments or their prospects of getting to 'the top' — neither do they feel they have a proper chance of both being a corporate success and having a good life.

If the corporate world is starting to 'leak' its bright young women, then this is the route some of them are starting to investigate. They are educated, motivated, and have business acumen. If they are being undervalued by big business, they are beginning to see investment in exciting, high-growth-potential

SMEs as the answer to their problems. They are looking to invest in young SMEs (often run by women), and are prepared to donate their skills to grow the enterprise to a new level. Informal exchanges with these angels suggest that some are looking for a capital gain but most are buying a 'parachute' out of the corporate world. Most of these female angels are still 'lookers' rather than actual investors.

Group 3 — women re-entering the workforce — are those who have had children and now want to take a financial interest in a small firm, probably also to work in that firm. Their capital comes from several sources: inheritance, the sale of a business before child-rearing started, a favourable divorce settlement, savings or realisation of share holdings.

This group is not well documented because their networks are gender, community or family-based.

The studies tell us that female business angels do not figure in the overall picture of equity investment in SMEs. While this is probably so in broad terms, it is hard to believe the figures are as low as suggested. In later chapters we will discuss why some groups in society, which are not male, heterosexual and WASP, may chose to stick to their own networks and therefore be largely unquantified. While many men regard money as an outward indicator of their true worth, it is equally true that many women regard their personal wealth as nobody's business but their own.

Career angels

Given estimates that Australia's business angel community numbers 2500 active investors, and only 1.6 % of all Australian SMEs have taken informal equity investment as finance, there is plenty of room for the career angel.

This group — sometimes a syndicate of two or three associates — is more interested in an organised exit strategy than other types of angel who may be interested in buying a job, helping out with finance or securing long-term equity in a company which they believe will be successful and provide an income stream in the form of dividends and directors' fees.

Career angels rarely take equity in a company for more than five years, and they will make between one and three investments per year in various firms. Some of these investments will be 'top ups' on existing capital allocations, but mostly they are looking for early-phase SMEs with the ability to benefit quickly from a capital injection. It is not uncommon for a career angel to have five or six investments at the one time.

According to Rob Inglis, a business angel consultant from Sydney-based Amgun Holdings, 'They look for the high-potential companies that can quickly grow from management and capital — they want a big bang for their buck'. Career angels are growth savants, who are not interested in steady progress through an established or saturated market. They are even less likely to invest in a local 'mum and dad' business that needs some help. Many of these angels have a background in marketing, product development, manufacturing or engineering and so are experts in developing underperforming products for market re-entry, or commercialising prototype products to market.

The career angels are a particularly important group because their confidence, their understanding of the risk/return equation and the amounts they have available pave the way for more business angels to become active.

This group may have financial as well as non-financial motivations driving their investment patterns. Crudely put, they are mostly interested in rates of return on their capital and the quality of people running the company. Robert Wenban's Australian Business Angels study provides an interesting insight into this career angel grouping.

The chosen field of the career angel is the early-phase, entrepreneurial and innovative company. These are highly risky areas of business — not for the faint of heart. Bob Beaumont, from VECCI's Business Finance Support Program, tells us that these battle-hardened angels will often tender their skills and experience to a small company before they inject any capital.

This introduction period allows them to carry out market research, product testing and feasibility studies, and to familiarise themselves with the business. If everything stacks up they will invest capital, but usually not in one hit. Experienced business angels may invest in tranches, or funding rounds, rather than in a single lump sum.

It is this type who is represented so strongly in the Asian business angels. Recently there has been a quiet upsurge in the numbers of angels from Hong Kong, Taiwan, Japan, Malaysia and Singapore looking for investment opportunities in Australian SMEs. They are similar to the Australian career angels in that their backgrounds involve successful track records of getting good ideas onto the shelves. Some of these Asian professionals also have manufacturing interests in their home countries, and want to put their imprimatur on a worthwhile invention at an early (and therefore cheap) stage of development. These are people who have made a career of SME equity investments in Asia and are now seeing the 'green field' possibilities of Australian companies, especially those involved in high technology, innovations and niche agribusiness. By all accounts they are successful people with a lot of equity investments and no time to waste. They may be more confident than their Australian counterparts.

> We are now seeing the investors from Hong Kong, Japan and Malaysia. They are coming and they're ready. The Asian investor has money in his pocket and he knows what he wants — he doesn't muck around. These people are professionals. The Asian investor just says 'what have you got? Don't worry about the rough edges, they can be made to work'.
>
> I've heard of $100,000 committed to a small business with a hand shake over lunch. It was their first meeting.
>
> Rod McInnes, coordinator, *Ideas and the Investor*

The commercialisation of inventions and innovations is one of the highest risk of all business enterprises, and those who can make it their career are smart, courageous and tough people.

They fill the finance gap that exists for innovative and high-tech SMEs overlooked by venture capitalists and the banks.

The career angel is also successful. Robert Wenban's sample of 36 angels had between 10% and 14% of their capital invested in entrepreneurial ventures, but the majority wanted to increase this exposure to between 15% and 24%. Their net worth as a ratio of their annual family income was also higher than that of overseas angels. The UK angels' average net worth is 6.78 times their annual family income, in the USA the ratio is 8.33, and in Canada it is 7.69. The Australian business angels ('true angels') have an average net worth of 11.70 times their annual household income.

There is another type of career business angel who does not always enjoy a good reputation. Known in investor circles as the 'rape and pillage men' or 'business vultures', they have also been called 'business devils' by overseas commentators. Typically, they are brought in by solicitors and accountants when a client is about to go out of business and all other avenues of rescue have been exhausted. The business devil, should he agree to buy in, will take more than 50% of the company in exchange for his money and his expertise. If the company survives and prospers, which it often does, this angel is in a much stronger position than the original owner. Which leads us to another category.

Buy-out angels

Most business angels want a short-term investment through a minority share of a company. Their involvement is a value-adding exercise, where expertise and capital are used to take a company to a new level at which point a capital gain can be made. But there is a small group of angels whose interest, on occasion, will be to actually buy the company. Whether this happens in a hostile environment (i.e. business devil) or through consensus, there are some angels who see the right opportunity and want to own the entire company.

Where a buy-out occurs, it is often through an approach from the original owner. Having seen the future possibilities of his business (after it has been worked on by the business angel), he sees a chance to cash out. Another factor, from the investee's position, is that many SMEs in this country are family businesses. When family assets are split or reallocated for a variety of familial reasons, sometimes a family wants to dispose of a company entirely rather than negotiate fractional interests in it.

At other times the buy-out happens from the business angel's approach: he may decide that the ultimate success of the company will involve *his* time, money and *his* contacts. He may bring other angels (silent or active) into a syndicate and make a bid for the whole company. The buy-out angel does not always plan it that way. Often the buy-out occurs through the angel making the best of a bad situation; some angels have put/call options built into the contract. The put option states a date on which the original owners have to buy back the angel's shares at the new valuation. If the other shareholders cannot make the purchase, the put option turns to a call option, which gives the angel the right to buy the whole company from the shareholders.

But the angels most likely to be consciously heading for a buy-out, or a majority holding, are the cash-out angels still working in their own corporations. Most of them want to work in their investee company when they leave their current employment, and many have a long-term goal of buying it outright.

Money-only angels

One of the primary factors in the growth of franchising as a business option is that it provides an opportunity to those with money but no ideas to buy into an established business.

This is a factor too in decisions to become a business angel. People may have significant lumps of capital for different reasons: sale of a business, inheritance, redundancy, retirement, divorce settlements are some of the sources.

There is no single investment vehicle that suits everyone. Property and shares are modest performers, but not all investors like modesty. Or perhaps they are already content with their holdings in these areas and want an investment with some excitement or real growth potential. These angels will not be looking for the nascent ventures that attract the expert career angels. They may invest in a small, innovative retailer that wants to establish a new shop, or a niche manufacturer that needs to expand to keep up with new supply contracts.

Most likely, though, the money-only angel is connected to a network and is regularly invited to invest in a syndicate's investment activities. Obviously this breed of angel is the most secretive of all; he is not looking at proposals or pitches and he is on no-one's 'books'. Moreover, he is the ultimate insider — an equity investor who is close enough to other professional angels to hear of the opportunities and trust the people who want to make the most of them. This type of angel is often called 'silent', and is probably the smartest of the lot.

3
Angels: why do businesses need them?

Imagine: you have a small manufacturing business on the outskirts of a major city. You employ 30 people making widgets for a large car manufacturer. You've been five years in business, churning out widget components to the one buyer. You keep costs down, prices and quality up, and try to turn the resultant margin into something that makes it worth being in business in the first place.

You've been thinking about growth for some years, but the timing and conditions have never been quite right. Then the day comes when another small manufacturer, who supplies gadgets to another car-maker, goes out of business. The supply contract is up for tender. This, you decide, is the time for growth.

Your accountant crunches the numbers, the deal looks good on paper. Raise costs by 50% percent and in three years you'll raise revenues by 100%. There's just one snag: to chase those doubled revenues will require money — a great big black hole of capital. You'll need more staff to make the gadgets, with a lead time of four months between being hired and producing revenue from the car-maker. You'll need to retool, with a lead time — given Murphy's Law of manufacturing — of at least six months to engineer the gremlins out of the production process. You'll need more floor space; you'll need materials, which will be supplied on 60-day terms, while output is still nil. You've never made the gadgets before so you'll need an engineering consultant at $1000 a day while you perform quality trials for the client.

The black hole gets bigger as the accountant factors a 20% overage for the first year and a 10% overage for the second year of production. (Murphy's Law of manufacturing: the untested Ferrari production line always produces a tractor.) You are now facing a cash discrepancy of about $800 000, just to be in the hunt.

You approach the bank with your business plan, projections, forecasts and trading history. 'Sorry', they say, 'a $50 000 business overdraft is one thing. But a half-million dollar development loan? Forget it, that's a specialty. You need a venture capitalist'. The venture capitalist listens politely and passes. 'Nice numbers', he says, 'but we have a threshold of $2 million, and even then we're looking for niche or green field'.

Back to the drawing board. The accountant can strike a factoring deal for $100 000 and the existing widget business can cross-subsidise the gadget production to another $200 000. But that leaves you $500 000 short. At this stage, to commit to the new contract would be an invitation to bankruptcy. You're too big to bridge with an overdraft and you're too small to attract venture capital. Your margins and existing revenues are too small to finance growth internally and, on top of that, you realise there is need for a management team of experts to make this whole scheme work.

The more you look at it, the more it looks like a bottomless bucket that you throw money into for at least two years.

This is only a hypothetical, but situations such as this are occurring all over Australia on a weekly basis. The following is a breakdown of the specific needs of the private equity investor.

Cash flow

> Equity is important to SMEs due to the nature of their cashflows. The critical factor is a long period of negative

> cashflow. It is in these circumstances that equity is paramount to survival.
>
> Martin Madden: *Capital Market Deficiencies and Impact on Small and Medium Sized Enterpri*ses, Arthur Andersen, 1995

There are few small companies in Australia that have not at some time experienced cash-flow problems. For some companies it is a cyclical problem that occurs in March and August. In manufacturing, mining and construction the cash-flow problem areas exist according to demand and economic factors. In the agricultural sector a cash-flow crisis can exist for years, dependent on weather conditions, commodity prices and trade factors.

Generally speaking, small firms bridge these cash-flow problems with loans, overdrafts and credit facilities from the banks. They also seek other institutional finance or they enter into factoring arrangements where, for a fee, agencies credit the company up front with the value of unrealised invoices.

However, the facilities available to small businesses do not always solve the problems they sought to solve in the first place. Credit lines cost money; banks require security — usually the home — for business loans. Factoring, while putting income on a more immediate footing, also costs money, and does not necessarily solve all cash-flow problems. Credit has to be paid back, meaning that businesses which trade on credit and finance maintain a fine balance between survival and the downward spiral of debt and credit shoring up negative or erratic cash flow.

Small-business spokesman for the Society of Certified Practising Accountants Greg Hayes told us that his most common 'bank reconciliation' task for clients was unhitching a business from short-term financing of long-term overheads. Another sure sign of a cash-flow crisis in a small business, says Hayes, is the use of personal credit cards to finance business overheads. And it happens a lot more than many business operators would have you believe.

If small firms are either trying to untangle themselves from this spiral or are running shy of the banks to stay away from it, the problem still exists in SMEs of tight cash flows. These established businesses are in the market for a business angel just as much as the innovative, high-tech start-up companies which are not even trading yet.

It is significant to note the results of surveys such as the *Yellow Pages* Small Business Index. In a 1995 study, *Yellow Pages* found: 'In the past two years, 72% of small business proprietors have required additional capital for their businesses. This is almost identical to the 70% figure for August 1993'. Now 72% of about 900 000 small businesses is not an insignificant number of firms on the lookout for extra cash, and suggests a huge scope for Australian business angels. Also bear in mind that not all small firms with terrible cash-flow problems are a losing bet — they may just be trying to grow to a level where a strong cash flow can be sustained. Below is a tale of a young, American magazine publisher with a negative cash flow who found a very big angel:

In July 1993, Kenneth Felberbaum, aged 23, joined forces with a friend, Lawrence Schwartz, to publish a new business magazine called *Vietnam Business Journal*. With $5000 borrowed from each of their parents, the young duo met with limited success, and by November 1993 they had published their third edition of the journal and their first 1500-page directory of Vietnam businesses, financed by a further $17 000 from their parents. They hadn't sold enough advertising or subscriptions to publish another issue of the journal, and Schwartz quit the business. Felberbaum was snowed under with a $27 000 debt and only 450 subscribers. But he stuck with it and by April 1994, with the US trade embargo finished, he managed to finance the fourth issue of the journal by selling the remaining business directories. With the trade embargo lifted, the tyro publisher still wasn't in the home strait because other, wealthier publishing houses were launching magazines in the burgeoning territory of Vietnam. He needed more capital and, after writing to some Asian investors he had met on previous trips, he struck it lucky. A former fund manager from Drexel Burnham Lambert, Marc Faber, put up an estimated $2.5 million for a 40% slice of Felberbaum's company. That's one hell of a way to fix a cash-flow problem.

These days the magazine circulates at 20 000, has projected revenues of $1 million per annum, and has corporate advertisers like Ford, Toyota and Digital.

Source Forbes, 21 October 1996

Growth capital

When companies need growth capital, the problem is not one of how to make a profit. As a company grows from start-up and then consolidates past its fifth birthday, considerations of actual survival usually become a thing of the past. Few companies that can pass the five-year mark are in dire financial difficulty. At the expansion stage the question becomes how to grow without going bust.

Accountants say that the stage at which small companies try to grow into medium-sized firms is as risky as the start-up. The growth usually demands a giant leap rather than incremental steps, and basic insolvency conditions can often define the business in this phase.

Small-business spokesman for the Institute of Chartered Accountants Curt Rendall tells us that this stage of small-business growth involves long periods of expenditure with comparatively little revenue, and an overreliance on credit and lenient creditors. In other words, a tightrope act. Ongoing surveys from SME-tracking organisations such as *Yellow*

Pages' Small Business Index report that significant proportions of the Australian SME sector are approaching such a dilemma. Often the decision to grow (or how to grow) is made for them by the banks. That is to say, they want to grow their business but feel constrained by lack of available capital.

Yellow Pages' 1995 'Special Report on Finance and Banking Issues' showed that three-quarters of Australian small-business operators were planning to grow their business; 9% sought 'significant expansion' while 63% sought 'moderate growth'. Unfortunately, it is these growth companies that feel constrained by lack of capital. Of the 'high-growth' companies 51% felt constrained by lack of capital, as did 38% of the 'moderate-growth' companies. This compared with just 19% of the 'no-growth' companies who felt constrained.

The simple picture is of an SME sector that feels more constrained by capital availability in proportion to the degree of growth it seeks.

This grouping of small growth companies that feels constrained by lack of capital is hardly a rapacious seeker of funds. *Yellow Pages* reported that 49% of them were looking for less than $100 000 and 41% wanted between $100 000 and $500 000. So if you are small and want to get bigger, you will make the banks nervous.

The alternative for the majority of SMEs is the business angel. Because venture capitalists seek an investment minimum of $2 million and the business angel traditionally will not exceed $500 000, the SME growth companies and the business angels are playing in the same field. This is where business angels are in demand from small businesses. Either the small firm wants to grow but cannot attract support from a bank, or it sets sail into a growth phase with potentially crippling debt levels.

> Very high growth firms exhibit similar financial structures to bankrupt firms. Their financing needs are a threat to their solvency, notwithstanding their profitability.
>
> NIC/Marsden Jacob Associates: *Financing Growth,* 1995

The problems inherent in growth for small business and the paucity of support from banks creates a ready demand for business angels in the SME sector. That only 12% of growth firms are looking for equity finance may hint at the 'angel in a haystack' syndrome rather than an educated resistance to this form of finance.

SMEs need capital for general growth, but they also need it for specific innovations that may be a prelude to growth. Australian Bureau of Statistics figures show one-fifth of all SMEs undertaking at least one innovative activity. In small manufacturing, companies spend an average of $280 000 on R&D. This activity has to be financed, and we have already seen what SMEs think of their banks.

The demand for growth capital will only grow as banks continue to baulk at high-risk endeavours and innovations and superannuation funds source capital to SMEs only by placing it under management with venture capitalists. The following is one example of where development capital is needed by small business for growth and innovation.

Nexus Technology Pty Ltd is a small Adelaide engineering firm, owned and operated by Neville Whiteley. Since 1970 Whiteley had been trying to attract enough capital to manufacture and distribute his original designs of gym systems for the disabled. In 1982 he destroyed the five prototypes he had built throughout the 1970s. By 1984 he had built another prototype of his gym equipment for the disabled, this one called Alpha Training Unit Mark I. He sold the licensing rights for the unit to a Canadian company, but the Canadians stole the prototype and attempted to build it as their own intellectual property. After working for NASA on rehabilitation exercises and machinery Whiteley returned to Australia and set about building another prototype, but still the partners and the business angels came and went and still Whiteley was broke and unable to manufacture his gym equipment.

In October 1996, after listing his concept in *Ideas and the Investor,* he was contacted by some 125 potential investors. One of those was a business angel from Hong Kong. When he spoke to us, Whiteley was in the process of selling 25% of Nexus Technology for $600 000: 'I have had more than 1000 approaches from investors and so I knew what I was looking for ... I wanted an investor with his feet on the ground and his head well and truly out of the clouds. I also wanted someone with an accounting background and someone who would allow me to take control at a middle-management level'.

Neville Whiteley expects the sales 'life' of the gym equipment's latest design — 'Everybody Access Gym System' — to exceed $500 million. Obviously the Hong Kong business angels agrees.

Although his idea had been around for a few years, Whiteley's company was certainly classed as a start-up proposition. While it is not normal to see business angels invest capital in innovative start-ups, there is a similar example from David Millhouse & Associates in Brisbane. In October 1996 a high-innovation start-up designer and manufacturer of specialist dry cell batteries attracted a significant investment from a Hong Kong angel.

Also significant about these two examples is the ease with which racial stereotypes can be dispensed with once you start looking. The conventional wisdom in the Australian informal capital markets is that Asian business angels are not interested in our companies. The accepted reasoning is: (i) they do not like dealing with Australians because we cannot be trusted: and (ii) capital gains tax, reduced R&D tax concessions and unruly unions make it not worth their while to look south of Indonesia.

However, there are enough angels from Hong Kong, Taiwan and Japan already making investment searches in this country to suggest that their cautious approach is a relative matter. The Asian investors are certainly cautious (as are angels the world over), but when they strike they are known to do so very quickly. Recently David Millhouse & Associates mailed 48 potential business angels in Singapore. Replies came back from 44, asking to join the Australian information network. If Asian angels are not interested in Australian SMEs, no-one has told them that yet.

Management skills

As mentioned in Chapter 2, the demand for business angels does not merely involve capital, just as business angels are not always in it purely for the capital gain. The demand from the growing or innovative company is often for management skills, the very thing so many of them lack. The ABS statistics bear this out. 'Only one in four small businesses in Australia had an operator with some form of small business management training.' (Australian Bureau of Statistics: *Characteristics of Small Business,* 1996) The picture of a small-business community lacking in management acumen is further compounded in the same ABS document, which shows that only 18% of small businesses have a business plan and only 89% of them adhere to it. Furthermore, the 12-month survey found that 76% — or 605 000 businesses — consulted some form of external advisory service in the survey period; 65% of small businesses consulted an accountant.

At the same time, one of the major concerns of the potential business angel is the quality of management. The respondents in Robert Wenban's Australian Business Angels study listed 'management team' as their greatest non-financial factor in investment, ahead even of 'growth potential of market'. Clearly, while many businesses on the lookout for informal investment may also want management skills, business angels are unlikely seriously to consider investment in companies without good management.

This quandary may be partly reconciled by the observations of the Business Finance Support Program's coordinator Bob

Beaumont, who says it is not uncommon for professional business angels to invest their time and management skills in an innovative company before allocating capital. This paints an interesting picture: one where the career business angel actually applies his management acumen to an immature company with a good idea, and then invests capital in that company when he is happy with its inner workings. In other words, the professional investor who is impressed with an innovation or product is prepared to make the company 'investment-ready' with his own management skills. Quite an arrangement if you can find it.

Not all companies will have the product or service or innovation that will attract this type of angel — they are not 'green-field' companies but established firms in need of management skills. Some of these companies may be caught in a bad financial cycle or in an economic downturn, or have been through a turbulent period caused by the death of an owner or a split in the partnership. However they got that way, they are companies in disarray or without leadership, and in need of management services that they could not afford should they source them on the open market.

Such companies may be in need of 'free' management services. We know of cases involving accountants, management consultants, merchant bankers or industry experts who work on (or in) the business for a share of the company rather than a fee — the understanding being that the management angel will sell that share back to the company at a time when the company is healthy again or retain the equity and take an annual dividend. One such example comes via an investment that did not go according to plan.

Doug Crichton, having held senior positions in a large company, became a business angel in 1995. Doug, who had an engineering and finance background, was matched with Gerontic & General Products Pty Ltd, which wanted to manufacture innovative hospital beds having bought the licence for the technology. The patent was worldwide and the selling point was that no other bed could be lowered so close to the floor. Gerontic & General was looking for $200 000 in exchange for 20% of the company, a cash injection the company would use to fulfil orders.

By December 1996 Doug Crichton had spent nine months working with Gerontic & General but had not bought equity despite lending the company $20 000. He said the company was more in need of professional marketing consultants than his expertise. The product, he told us, was world's best; what the company needed was to stop making minor improvements to the product and start selling units. He got the company to develop a better product brochure, reworked the business plan, and sought AusIndustry finance for further development work on the hospital bed: 'This company had a great product but they weren't concentrating on how to sell it to as many people as possible. That's not an uncommon problem in small companies'. However, Doug said he would probably seek equity for his managerial input rather than investing money.

This is an example of external expertise (consulting or mentoring) being worth a slice of the company.

This sort of business angel involvement also manifests itself in deals where the management expert brings some capital as well as his acumen. This angels sees an opportunity to turn the company into a success with the application of professional management techniques and then to benefit from that turnaround. He may be buying himself a job, investing long term, or be intent on a quick cash-out and capital gain. Many of these types of angel are the corporate refugees we discussed previously. Typically, they are professional managers, have a lot of money, and have a contact book worth its weight in gold to the aspiring small business. Most professional business angels have interesting and powerful contacts, which is one of the fruits of sticking to a network and abiding by its rules.

Any way the angel structures it, the important aspect is that the company needs expert management most.

Essential skills and expertise

Are you a computer expert? Are you an engineer specialising in manufacturing processes? Have you spent a successful career in agribusiness marketing, have you managed bio-tech labs or are you an expert in metal-casting techniques? Whatever your skill, there is a chance that a small company with big plans for its future is on the lookout right now for something other than your bank balance — your intellectual capital.

Throughout the early years of the 1990s, Australian business underwent obvious growth in its innovative and R&D activities. Universities and TAFEs saw an explosion in enrolments for courses in advanced technologies, as the 'Lucky Country' attempted to become the 'Clever Country'.

At the same time, small Australian companies were busy with innovations and R&D projects. In the 1995 ABS *Small Business in Australia* survey, the number of small businesses undertaking R&D grew by 21% in the period 1991/92-1993/94. In the same period, small-business human resources for R&D grew by 22% and expenditure by 23%.

The same ABS document reported that 30% of small manufacturers (less than five employees) were innovative between 1991 and 1994. In the same period, manufacturers with less than 100 people employed spent an average $132 000 each on innovations, while in the less than five employees sector they spent an average $63 100 each on innovations.

Innovation and R&D activities are on the rise in small business, but technological advances need people: educated, experienced, clever and expert people. Most of these people are not cheap when sourced through the open labour market. But where their services can be traded for shares of an innovative growth company, they can become angels. A classic example we found of this sort of angel contributing skills and expertise for a 'cut' of the company comes from the USA.

Sanjiv Sidhu, an Indian immigrant, left his job at Texas Instruments in 1988 and started a company called i2 Technologies from his Dallas apartment. For two years he worked on inventory flow software which he hoped to sell to large manufacturers. He attracted another computer expert, Ken Sharma, to join him by offering 18% of the company. In order to stay ahead of the larger software companies, Sidhu lured star computer programmer John Hogge by offering him shares in lieu of wage rises.

Last year, i2 Technologies made $US26 million in sales. Ken Sharma's shares are now worth $US151 million; John Hogge's are worth over $US50 million.

Source: Forbes, 21 October 1996

Tales like this show how the business angel can contribute expertise - not necessarily capital - to the right venture and still make a capital gain. The small company gets the vital skills it needs without having to pay outlandish salaries, while also having key staff with their own interests tied up in the success of the company.

The expertise angel takes a risk, but he has some control over that risk through his own endeavours. Moreover, this sort of intellectual investment frees highly credentialled people from corporate environments and puts them to work in the places they are needed most — small companies with good ideas.

Risk capital

The demand for business angels exists along the whole size spectrum of private Australian companies. We have largely concentrated on the smaller firms because this is where most business angels are looking. The nascent company needing seed capital to develop an idea or to target an export market generally provides greater potential for returns than the larger company, which needs larger amounts of capital and may not have the potential for growth of its smaller counterpart.

In the larger of the private companies — the medium-sized firms — the search for growth or development capital may have placed them in a different market. In the 1980s, these companies may have raised capital through a public listing known as 'the second board' — a sort of mini-ASX (Australian Stock Exchange) for recently listed small companies. Usually this second board was a means for venture capitalists to realise their investment as well as a way of attracting capital to the company. It closed in 1992, having failed to attract any new listings after 1988. Following the failure of this exchange for small and start-up ventures, companies may well have looked at two other ways of raising risk capital — venture capitalists and a public float.

Going public

The most common reason for medium-sized companies to seek a listing on the ASX is to solve liquidity problems or raise liquidity to a new level. Some succeed. However, Ian Armstrong of the Institute of Chartered Accountants says not all medium-sized companies are ready for such a move, and others that go ahead with listing can be in for a rude shock. The following are just some of the extra hurdles for a small business going public:

- reporting to shareholder requirements;
- reporting to ASX requirements;
- auditor fees;
- registry fees;
- directors' fees;
- annual reports;
- public and media scrutiny/lack of privacy;
- concern about market interest in stock;

- underwriters' fees;
- no support from underwriters;
- distractions from getting on with main business;
- need to meet with, and talk to, key shareholders;
- time spent in correspondence and questions from shareholders generally;
- risk of takeover; and
- extraordinary increase in operating costs generally.

It is not every small company's cup of tea, and Armstrong says many ambitious medium-sized companies are advised against public listing. Those companies that go through with it can find the culture of the public company to be at odds with the 'hands-on' atmosphere of the private company. It is not every small-business person who can comfortably cross into the arena of public and institutional scrutiny.

The costs of running a public company can also be daunting, and the newly listed company can find the wished-for capital flows from the market disappointing or non-existent. The ASX sees the vast majority of its activity in the volume-traded, blue chip stocks which are the preferred investment vehicles of the massive pension funds. A new, small company can find its listed stock ignored for weeks or even months at a time as the mass of private shareholders and their brokers slavishly follow the buy/sell patterns of the institutional shareholders.

The inappropriateness of going public does not suggest anything weak or unsuccessful about the business. In 1986 a growing British media and transport company floated to finance its new airline. The market did not respond, and the company had to buy £6 million of its own shares to keep the stock alive. The company's float was then hit by the 1987 stock market crash and the airline company bought the stock back from the public for £248 million. The company was Virgin Atlantic Airlines, Richard Branson's business, which is thriving today.

We know also of a case in Brisbane where a private video and television production company was seeking massive expansion and exploring the option of floating on the ASX, an option that was not entirely suited to its circumstances. At the last minute, in 1996, an offshore business bought 80% of the Brisbane company, injecting large amounts of capital but leaving the original management team in place.

Venture capitalists

The other common avenue of risk capital for the medium-sized company is venture capital but this can be a fruitless exercise in Australia. According to the 1995 NIC/Marsden Jacob Associates report, *Financing Growth,* venture capitalists assisted only 2% or 3% of the growth firms seeking external equity. An industry standard for these capitalists is that for every 300 proposals they will make two investments . . . maybe!

Furthermore, venture capitalists source two-thirds of their combined capital from the superannuation funds, which in turn allocate less than 1% of their funds to total SME investment. Some of these superannuation funds are small and cannot justify relatively high-risk investment. But *Financing Growth* reported that only 17 of the more than 160 large superannuation funds invested in SMEs, either directly or through venture capitalists.

If these vast funds of publicly conscripted savings are conservative, it is for good reason. Legal constraints on super fund trustees talk of 'diligence' and 'care' in the way the funds are managed and invested. And so it should be. However, the paltry trickle of capital available to growth SMEs from the super funds means that many companies are called, but few are chosen.

The lack of capital made available is exacerbated by the investment criteria for those companies able to get their 'foot in the door'. Venture capitalists (as discussed in Chapter 1) are most interested in advancing capital in the $2 million to $10 million range. Most small companies are not in the market for this size of equity investment.

Recently, there have been signs that the larger superannuation funds may be warming to SME investment. Venture capitalists such as Hambro-Grantham and Greenchip Investments both instituted new venture capital funds in 1996 that were designed for subscription by the large managed funds.

Both believed the funds managers were prepared to increase their equity investment exposure to SMEs.

Nevertheless, risk capital is as hard to come by in the medium-sized strata as it is in the strictly small businesses. For these medium-sized growth companies, their advisers may have warned them away from public listing or they have found no success with venture capitalists. The demand for equity investment in Australia's larger small companies is therefore probably large. It not only includes all those companies searching for between $500 000 and $2 million but takes in companies looking for capital but shy of going public.

In this market, the business angels who form syndicates have virtually an open run on the cash-hungry small companies. Below is an example of the business angel conglomerate, from the USA.

David Ogilvy was a 38-year-old Englishman working in the USA when he decided to form his own advertising agency in 1948. He had thought of applying for a job with Young & Rubicam but decided not to because he felt he had no credentials. He had only $6000, no clients, no office and no real track record. He persuaded his brother's British advertising firm to invest $45 000 and an advertising firm from New York to invest another $45 000. What started with an 'ideas man' and two business angels turned into Ogilvy & Mather, which eventually went public and was sold in 1989 for $US864 million.

Source:Daniel Gross, Greatest Business Stories of All Time, 1996

Accountable staff

How often have you heard the businessman lamenting that if each of his staff had a stake in the company, he would get a much better day's work out of them?

Now multiply that sentiment 1000 times, and you have the reason behind so many corporations giving stock options and profit shares as part of the packages to their senior executives. Simply put, people with a stake in their own performance are more likely to ensure that they perform well. This is one of the reasons why many companies are on the lookout for a business angel who wants to work in the business. What they get, as well as the capital injection, is a person who stands to gain from adding as much value to the company as possible.

This demand is well understood by Australia's business angels. According to those who work with private equity investors, one of the reasons angels prefer the informal capital markets is that they get to make a difference to the company they invest in. Indeed, for many angels, the role they play will not only make them accountable because their own money is in the business, but they have already selected a specific area of accountability in which they can add value and grow the business.

Rob Inglis, one of the facilitators of Sydney's Australian Business Ltd's business angels meeting service, tells us that both the companies and the angels see capital as the first point of commonality: the business needs it, the angel wants to make it grow. However, Inglis says businesses and angels always have, as a secondary concern, the expertise of the angel and how it can be applied to the company. That is to say, to what degree will the angel be willing to work in the company to add value to his investment? The answer, usually, is 'a lot'.

There are 90 businesses in the Australian Business Ltd program and 70 angels. In one of the matches, an angel put capital into a company that was making bathroom basins with robot technology. Inglis says the investor, a marketing guru with strong international contacts, backed himself to distribute the basins in Asia; he will work on the project until the export market is opened up. In another investment deal, an angel bought into a food manufacturer which he believed he could put into overseas markets. In both these companies, the new distribution and marketing managers are probably the most accountable and motivated people in the company because they are trying to make their own investments grow.

Succession

> It doesn't matter whether it is a family business of two or a family business of 22. The bigger-picture issues are really the same: what are you going to do when you have had enough? What's going to happen to the business when you are not around?
>
> David Smorgon, chairman of the Family Business Council, reported in *The Australian,* 6 November 1996

The idea of succession in the family business is often dismissed as one of those old-fashioned disputes that is hardly relevant in the brave new financial world of deregulated markets, leveraged buy-outs and junk bonds. But family businesses are very important in the economic picture of Australia, and the disputes that arise from them (most commonly succession) are equally important.

While more than 75% of all Australian businesses are single-family enterprises (Commonwealth Bank Survey 1994), 63% are run by the first generation, only 7% are run by the third generation and only 4% of family businesses are in the hands of the fourth generation.

There are many reasons for this attrition rate in family businesses, not all of them concerned with succession. But succession is the 'big one', as evidenced by the growing number of solicitors, accountants and consultants specialising in this field. There are two sides to this topic, which can broadly be typified as succession and non-succession. In the family-owned businesses of Australia, conflict can flare from a succession as readily as from a non-succession. When the business owner who is also the head of the family dies or retires or becomes an invalid, the family (in the most simplistic examples) either sells the business or one of the offspring takes it over.

But it is not always that simple. In the case of selling the business, the family may have a sentimental attachment to its company, and it will be prepared to sell off a percentage as equity but not the whole thing. Enter the business angel.

The involvement of the business angel also occurs where there is disagreement in the family. Perhaps the father has died and the offspring are divided into factions: some want to sell while the others want to stay in business. At this stage one of the family becomes the business angel and buys out the other family shareholders; or a third party to the proceedings buys into the company, whereby his capital will probably be consideration for the shares held by the family members who want out.

It is obvious why this involvement of the business angel can mean succession or non-succession. Few families agree on the fate of a family business when its principal operator dies or retires, and the business angel is often the capitalist who can provide options as well as tend to his own interests.

The postwar years have played havoc with the so-called 'old' social fabric. Families do not dwell in the same neighbourhoods any more, let alone the same cities or countries. And more often than not, they do not want to succeed their parents in the family business. The younger a career-minded person, the further afield he or she must be prepared to travel as the labour market becomes regional and international rather than city based. On top of this, the human resource landscape is pulling sideways at itself, allowing some workers in the right careers to ignore the retirement age and work as long as they want, while others are forced into early retirement to make way for the voracious generation known as the 'Baby Boomers'.

While succession is one of the most obvious dilemmas capable of being reconciled by the business angel, changes to the way society interacts with the workplace in general will create an ever-expanding demand for the angels, in ever more niches.

(As an aside, it is worth noting that the man we quoted at the beginning of this section, David Smorgon, himself is the scion of a large Australian family business. He is also an active and well-known business angel.)

4
How do they meet?

> . . . business angels could not find enough investment opportunities, while entrepreneurs found it difficult to identify and locate business angels because of their passion for anonymity.
>
> Richard Harrison & Colin Mason:
> *Informal Venture Capital,* 1996

Now that we have discussed business angels, their various backgrounds and why it is that companies need them, we get to the obvious questions. How do they find one another? How does the cash-strapped company find the investor who is not listed and is notoriously shy of publicity? How does the business angel source good investment leads without wasting months — possibly years — of his precious time on people who are no more than dreamers, flakes and cranks? There's not exactly a telephone book for this sort of thing.

The information conundrum has been covered with some mirth by those who have studied the angels and the companies they target. The phenomenon has been given the descriptions of 'information inefficiency', 'investor invisibility', the metaphoric 'angel in a haystack', and the colourfully accurate Americanism 'a giant game of hide-and-seek with everyone blindfolded'.

The system by which angels find entrepreneurs, and vice versa, is a gloriously unscientific blend of contacts, networks, gossip, referrals, luck, and classified advertisements not unlike those used by lonely hearts in the newspaper. But, like capitalism and love, somehow it works. Somehow, the business owners manage to track down and tempt these secretive, high-net-worth individuals who are prepared to invest in dreams of growth, just as the angels find a way to sift through mountains of rubble to find their ruby.

Notwithstanding the information inefficiency that exists between entrepreneurs and business angels, connections, marriages and investments are still made. In Robert Wenban's 1995 study, Australian Business Angels: How to Find Them and How to Catch Them, a sample of 36 professional angels showed an average $200 000 to invest in entrepreneurial ventures, which would be invested in two or three ventures over the following 12 months. Wenban also found that his angels wanted, on average, to increase their equity investment exposures by about 5% in the future.

This is hardly a picture of passive angels, sitting around waiting for the phone to ring — more of investors who are prepared to locate and negotiate with small companies, and who would increase this activity given the chance. Any perceived information inefficiency in the informal investment field has not stopped them finding equity investments. Nor has it stopped the start-ups and growth firms finding this vital source of informal growth and venture capital.

Below we examine the ways in which the angels and entrepreneurs find one another.

Personal networks

Most business angels find investment opportunities through their friends and acquaintances. How this random system of referrals, gossip and 'tip-offs' works hardly needs to be explained. Attempting to track the personal ties of investors who are already very secretive is an almost impossible task.

Remember, when Robert Wenban sent his 74 questionnaires to Australian business angels he did so through his own angel networks, among which he was known and trusted. Even then only 36 'true angels' replied.

What we can say about the personal networks that funnel business angels to growth SMEs is that they work, work successfully if inefficiently, and comprise the essential spirit of what is, after all, an 'informal capital market'.

This personal network of business angels and SMEs was once nicknamed the 'golf club network'. It may have seen the accountant and the businessman playing a round of golf, and the accountant mentioning that a client needed \$100 000 to develop a new product, and the businessman saying that it sounded interesting. Maybe it was the bank manager relaxing at the clubhouse with the solicitor, and the banker telling of the client who needed another \$200 000 for an exciting new venture. The bank could not help, but the solicitor says he has a cashed-up client who might just be interested. Perhaps this seems too simple, but conversations with business angels and their advisers such as solicitors and accountants suggest that the personal networks operate very simply, and that business angels are comfortable with that simplicity.

The days of the 'golf club network' may not be as they were. As we have seen, society has become more fluid, families move more often, and businesses no longer stay in the same place for 50 years. There may no longer be the same extent of social referral and vetting in the business angel community. However, the personal networks survive. There are good reasons for this: they are a priceless cross-referral system for a form of investment that is very much people based. The business angel who can come to a deal knowing not only about the company but its management is a person who has already passed through the mistrust stage, and is more interested in the product or the innovation or the expansion plans. Angels may be investing in high-tech start-up entrepreneurs who want to take the IT revolution by storm, but these angels are still interested in the old questions: Is this person smart? Do these people know what they're doing? Do I trust this person?

The personal networks draw the angel into discussions from a knowledgeable standpoint, rather than subjecting him to business plans and projections from a total stranger. Business angels are creatures of experience, usually self-made and always successful. They are not the type of investors who appreciate being ambushed.

The 'people angle' of this type of network is crucial because so many angels believe they are ultimately investing in people first, ideas second. This point is put strongly by Robert Wenban in his study Australian Business Angels (1995): '. . . the depth interviews revealed that Australian Angels place a very high level of importance on "investing in the people, not the product"'.

If business angels and their methods are a mystery to most commentators, their highly informal networks could be a major reason. And where they do not glean opportunities from their friends, they are doing so among business associates.

Business networks

> They learn of investment opportunities primarily from friends and business associates.
>
> Richard Harrison and Colin Mason: *Informal Venture Capital,* 1996

Again, there is no reliable evidence of how business angels and companies seeking investment meet through this type of network. But regardless of its relative disorganisation and inefficiency, the business network is the angels' preferred source of investment leads, largely for the above reasons. It comes down to interpersonal concerns such as trust, disclosure and feeling comfortable with the people in the prospective company. In the case of business rather than personal or social networks there is an added quality of vetting and discernment in the type and quality of information passed on. The question of why so many angels still source leads from their business colleagues can be answered against a backdrop of Australian business events in the past decade.

After the coming and going of the 1980s, the corporate cowboys, the mismanaged bank loans, the failure of the 'second board' and the lawsuits still coming to court over corporate audits, there is not a lot of trust among business folk. Indeed, the rise and rise of due diligence divisions, forensic accounting teams and investigative accountants in the accounting profession suggest an unheralded commercial paranoia in Australia. If this is the atmosphere pervading the business scene, it is no wonder that those with most to lose — the informal investors — keep their money close to their chests and swap information in circuits of trusted and like-minded business associates. There are no prospectuses, statutory reporting requirements or signed-off audits in the world of informal risk capital.

James Paulsen, of David Millhouse & Associates in Brisbane, told us that due diligence reporting for the companies signed up as ready for a business angel were now exclusively carried out by 'second-tier' accounting houses. This is because the 'big six' firms will not sign-off on reports on unlisted companies because of liability insurance problems.

In this atmosphere the business angel must have his guard up, and will be most comfortable with falling back on informal information flows in a business network. The quality and extent of information that can be dragged up with just a few phone calls is astounding. Some of this information may sound like old-fashioned gossip, but the important thing is that the business angels believe what they hear and trust who is saying it. It gives them an invaluable 'picture' of a company, its needs and weaknesses, before they even pick up the phone. This weeding-out process can become important to the career or professional business angel. If an angel has five or six equity investments in his portfolio he is a busy man, and may have little time for unsolicited approaches for capital. He will have even less money and inclination to investigate these opportunities if they have not come through the network he knows and trusts.

Moreover, when the business networks and personal networks are taken together, they make up easily the commonest method through which angels make an investment. They also provide for the 'information inefficiency' described in the NIC/Marsden Jacob Associates' report, *Financing Growth,* because they are necessarily exclusive: 'you're either in or you're out'.

Harrison and Mason went further when describing the business angel situation in the United Kingdom (*Informal Venture Capital,* 1996):

> . . . they generally adopt an *ad hoc,* unscientific and passive approach, placing considerable reliance on friends and business associates for referrals. Thus, serendipity largely determines the number and quality of investment opportunities that come to an investor's attention.

Networks in the subgroups

In both the business and personal networks — which can be one and the same — the strength of these connections in societal subgroups cannot be underestimated. There are significant networks in Australia organised on social, racial, ethnic and lifestyle predications.

In Chapter 1 we touched on the importance to Italian and Greek migrant communities of business angels who were/are prepared to invest capital in their countrymen's business expansions. Such networks are also active in the Jewish, Arabic, Chinese and Indo-Chinese communities and in the large gay and lesbian cliques that exist, for instance, in specific areas of Sydney. In fact, any subgroup that bands together for strength will have its own capital allocation mechanisms, of which 'outsiders' may be totally ignorant.

In the USA, these networks have emerged publicly. In California's Silicon Valley there are such networks as the Indus Entrepreneurs (Indian and Pakistani business people and investors); the Asian American Manufacturers Association, which meets at a Californian Chinese restaurant once a month; and the Iranian-American community, which sports a very aggressive business angel ethos. When women business angels become more populous they will probably find a rich source of leads through the numerous businesswomen networks that are already being established.

In Australia's 'WASP' society a similar closed-circuit of investment may apply. Dr John Marsden, the economist who advises *Yellow Pages'* Small Business Index, says that WASPish golf and yacht clubs have particularly high proportions of business angels and therefore their own networks. The existence of these networks, and the major role they play in business angel investment, support the idea that for business angels money is the thing but it is not everything. The personal aspect of equity investment is every bit as important as the expected return or capital gain.

Possibly the strongest business angel networks in Australia - the Jewish and Chinese business communities - are still strong and relevant because, where personal investment is concerned, the preferred investment will always be the one that comes with the best referrals. That is to say, a businessman in these communities will always feel most comfortable investing in people he trusts rather than just in ideas that look good on paper.

In the Productivity Commission's 1997 information paper, author Barbara Martin makes the point that in Australia's ethnic business networks the 'problems of asymmetric information' do not arise to the same extent as they do among people from outside the network (*Informal Equity Investment,* 1997):

> Here, the investors have acquired virtually free much of the information needed to evaluate whether to invest or not, and they also have some additional sanctions against dishonoured claims.

It sounds simple, and it is. Yet it has not sunk in with many business folk. Australian business people trying to do business in Asia are still surprised that their counterparts want to get to know them, want to talk about unrelated topics and ask them personal questions.

If all business and personal networks of business angels are to a degree exclusionary, it is nothing to take too personally if the networks happen to be delineated along ethnic or lifestyle lines. Business angels may decide to 'stick to their own', but the rationale is always that they prefer to deal with the people and contacts they trust. And who would blame them?

Accountants and solicitors

Accountants and solicitors have the two components that make up the informal capital market: high-net-worth clients looking to increase their wealth through investment, and small-business clients that need capital for growth. They are also the professions called in to 'crunch' the deals, write the contracts, audit companies, perform due diligence, create business plans and advise on safeguards, protections, exit strategies and all the other peripheral activities associated with informal equity investment. If these two professions decided to create their own business angel/equity investment networks, they would quickly run away with the whole game.

These two professional groups do not figure highly in the source of leads for business angels, although, when a lead does come through an accountant or a lawyer there is a greater chance that the business angel will invest. The Corporation Builders program in Brisbane, which makes companies 'investment-ready' and then finds investors for them, saw a classic example in 1997 of how strong the professionals' network can be.

A growing sports clothing company, with export orders but no money to tool-up to meet those orders, was about to go into receivership. As with many small companies, the business loans and overdraft had grown faster than revenue, and the bank was about to pull the plug.

As it happens, one of the sponsors of Corporation Builders was a national law firm. Three days before the clothing company was due to close down, the law firm's Sydney office sent through a lead. That lead was the CEO of a large, multinational corporation who was looking for an offset equity investment against his relatively conservative superannuation and share packages. He invested $250 000 in the clothing company for an undisclosed shareholding. These days the company has a flourishing business, exporting to the USA and Japan.

Why these two eminently suitable professions should generally provide so little in the way of investment information for angels and companies is something of a mystery. One angel told us that accountants often had business clients that were in serious financial trouble and were looking for a last chance. Lawyers, it seems, attach 'too many strings' and are overly defensive about the welfare of their client. Moreover, business angels we spoke to seemed to think that accountants and lawyers would always (and conservatively) put the interests of their client ahead of the greater good of 'the deal'.

James Paulsen from Corporation Builders told us a story of accountants and lawyers both jealously guarding their clients' interests, often to the detriment of an open equity investment market. In one case, Corporation Builders (which runs a deals board for matching investors and entrepreneurs), found that a law firm and an accounting firm had each put their clients into the 'deals board' — one seeking to raise capital, the other to invest it. When interest was raised, and a market price was ascertained, the two firms withdrew their clients and did the deal between themselves: 'Basically they were in on it from the start. It was just part of their own negotiations'.

Still, accountants and lawyers do network information between business angels and companies looking for capital, and when they do, the deal is far more likely to go ahead than if the lead had come from another source. In all fairness to these professions, they operate under legal and ethical duties to their clients, and some of them may feel there is little to gain by being seen to support activities with one client that may lead to a conflict of interest with another.

In the future, however, these professions could play a much greater role in creating information flows between investors and companies. In Britain, the chartered accountants' firm Blackstone Franks has started a private matching service for angels and businesses. In Australia, accounting houses and law firms have shown tentative interest in supplying support for such services. In Brisbane, the Corporation Builders program (which also covers Sydney) is supported by accountants Grant Thornton and a major law firm; and a nascent matching service at Swinburne University of Technology is in partnership with Ernst & Young.

If accountants and lawyers have been overly protective of clients in the past, there may be a slight change in attitude that means they are looking for ways of reconciling perceived conflicts of interest.

Introduction registers

> Indeed, it is not so much the lack of funds which leads a potential investor to reject an investment, but rather the lack of adequate information.
>
> Mary Kay Sullivan: *Local Networks and Informal Venture Capital in Tennessee*, 1996

The more information the business angel possesses, the more likely it is that he will invest.

This is hardly an earth-shattering revelation. Even the largest corporations spend millions each year measuring, monitoring and investigating all aspects of their own business and those of others. Information, as they say, is power.

It is no different for the informal equity investor. Yet in this country an information gap has existed in equity investment on two levels: (i) lack of information about investment opportunities; (ii) companies lacking adequate information about their own affairs. Crudely put, the business angel has a hard enough time sourcing investment opportunities; yet when he finds them they usually have insufficient amounts and types of information. It is this syndrome that time and again forces the business angel back to the safety of his network — which is exactly where Australian businesses do not want him to be.

Several services have been established recently to remedy this breakdown in available information. They are known as 'matching' or 'introduction' services, and have largely been developed along the same lines as those in operation overseas. They have different aims and criteria, but their overriding purpose is to create a centralised flow of information between business angels and companies looking for equity investment.

Here we list seven examples:

Ideas and the Investor

Ideas and the Investor started in 1989 on the instigation of Rod McInnes. McInnes was an Adelaide finance broker who found a gap between what businesses needed and the type and amount of finance he could source for them. He decided there were more than enough entrepreneurial projects being carried out by Australian small businesses, yet there was a lack of bank support for their ideas. At the same time, he knew of high-net-worth individuals who would invest equity in small high-potential companies if they could find such firms. In some cases he became a de facto broker of deals between business angels and companies needing growth capital, although at the time he had not heard of the term 'business angel'.

He knew angels and was aware that they loathed having their names or details listed on anyone's computer. So he decided on the simplest of systems: publish a newsletter listing of businesses needing a business angel.

The first newsletters were carried in the periodical magazine of the South Australian Employers' Chamber of Commerce and Industry. McInnes' concept was completely original. His listing of companies and their ideas was totally one-sided: the companies, or in some cases the inventors, would simply list their plans in an 'eye-catcher' box, not unlike a boxed advertisement in a newspaper. Then the advertisers would sit back and wait for the phone to ring or for a letter to come through the post.

McInnes devised *Ideas and the Investor* (I&I) as a very simple sort of published window-shopping for business angels. But while the simplicity of the medium was important to its success, the fact that the angels did not have to register anywhere was a crucial consideration; McInnes felt that the business angels he knew would baulk at a system where they had to register and supply personal details about themselves.

I&I has now been through several 'lives'. Originally supported by the SECCI, it attracted Commonwealth funding under Labor, which it lost in 1996. At the time of going to press, I&I was being carried by *My Business* magazine and had created its own international website on the Internet.

McInnes, when we spoke to him, was riding on a surge of interest in business angels and his service was close to becoming self-funding, charging businesses $125 for a single listing. The concept had proven so popular that he was looking for a new publishing vehicle with a regular national circulation: this meant *Business Review Weekly, The Australian* or the *Australian Financial Review.*

The current figures for I&I since February 1995 read thus: 459 advertisements, 416 serious negotiations, 124 'marriages', from 2536 calls. This does not count the Internet experiment, which in its first seven months of operation logged more than 10 000 'hits', including 2000 from overseas.

McInnes told us that the strengths of his listing system outweighed the weaknesses. On the upside, I&I allowed business angels and, more importantly, potential business angels to browse through a concentrated grouping of innovative and growth companies that might otherwise never come to their attention. With a national, high-profile vehicle such as *The Australian* or the *Financial Review,* the I&I listings would create their own dynamic whereby more companies and potential business angels would be drawn to informal equity investment. The biggest 'plus' could be its very simplicity and the anonymity afforded the investors.

The downside? Many companies would be loath to list their interest in a business angel lest a competitor find out. The I&I system also allows companies and individuals of wildly varying degrees of 'readiness' to advertise for funds. This caveat alone may keep many first-time or potential angels away — it may be the sort of matching service that favours the professional or career angels who are not scared of 'rough edges'. Indeed, Rod McInnes' service saw the first influx of East Asian business angels, suggesting that I&I is the type of service the professionals prefer. McInnes told us that the Asian angels liked the service because they just wanted a good idea backed by people they liked and trusted. They were not overly concerned with business plans and projections. Not surprisingly, many of the transactions that result from this service see the patent being bought, and nothing else. Ideas funded by angels through I&I have included a portable sun shelter, bullet-resistant glass and computer accessories.

All up, *Ideas and the Investor* is a very successful method of bringing angels into contact with investment opportunities.

Business Finance Support Program

The BFSP was started in 1994 by the Victorian Employer's Chamber of Commerce and Industry (VECCI), with joint funding from the Commonwealth's Department of Industry, Science and Technology. Director of policy and research at VECCI Steven Shepherd says the system was based on the best practices in use in the United Kingdom. He says the BFSP will eventually be rolled into the Australian Equity Association, which will be a not-for-profit organisation overseeing matching on a national basis.

From the beginning, the BFSP was intended to be unlike the matching service in Adelaide. Using sophisticated computer databasing built on Microsoft 'Access' software, the Program was devised as a brokering service to put investors and cash-hungry companies into the same system. Both parties would contribute detailed information about their companies and/or investment habits and their track records. Questions could be as detailed as asking whether you had your depreciation schedule computerised. Further to that, the companies would be asked to submit information right down to full profit/loss and balance sheet disclosures.

The database of companies looking for equity investment is separate from the database that holds listings of potential angels. They never overlap, except at BFSP headquarters.

With sophisticated software, the computer makes a 'match' between a company and an angel. The angel is sent a floppy disc with the listing of a company wanting funds. The company owner gets a floppy disc with the salient information on the potential angel who has been 'matched' with him. The discs contain germane information but without names or other identifiers. Both parties must agree to negotiate before their identities are revealed. The safeguard for this information is a confidentiality undertaking by VECCI and a coding in the BFSP computers that does not allow full disclosure of any of the information to anyone except the three staff at BFSP.

There are no guarantees that a company will be listed on one of these discs, just as there is no guarantee that anyone calling themselves an angel would be listed. The Program takes only investment-ready businesses and angels who are serious and understand their role and responsibilities. When this requirement is satisfied, the applicant pays an annual $200 listing fee. If the entry requirement is not met, the company may be supervised through the development of a business plan.

Coordinator of the BFSP Bob Beaumont wanted this program to be based on the COIN system in Canada. In eight years of existence, the nationwide Canadian introduction service for companies and angels has matched 21 800 companies and angels.

Beaumont says that, although there seems to be a lot of work in listing with the BFSP, it is for good reason. He said he had not wanted an all-comers system — if that were the case the serious angels would quickly identify the BFSP as a place where their time would be wasted: 'Our number one priority is not to waste their time'. Such an attitude means that the BFSP has seen one 'marriage' for every four every four introductions, as opposed to the British matching services which boast only one marriage in 10.

He also believes that the process of self-investigation that companies are asked to perform before they are listed is good for the companies, regardless of whether they end up taking equity investment. Some companies that have been encouraged to develop a business plan and improve their reporting systems could suddenly find themselves in a position where the banks are prepared to talk to them.

As of September 1996 the BFSP had 152 businesses and 68 business angels on its books. 'Capital inflows' were listed as $3.4 million and the Program had 17 matches. Yet in 1996 BFSP had $106 million wanted by companies and $209 million available from angels, with 38% of angels prepared to invest between $100 000 and $500 000. There are more than enough funds for small companies, but a paucity of propositions for angels.

In Britain, where there are 35 'venture capital networks', the numbers of business angels outnumber the businesses almost as much as the businesses outnumber the angels in the BFSP.

The strength of the Canadian COIN introduction service is that it is national and unified. The BFSP is Victoria based. This is a problem that may be solved for Australia by the time this book goes to press, due to the fact that the Commonwealth has called for tenders to create a national matching system for business angels and companies.

Business Angel Meetings Program

Started in 1995 by the Australian Business Chamber (formerly the Chamber of Manufacturers of NSW), the Meetings Program is an interesting type of matching service for business angels and small businesses.

The meetings are held once a month in Sydney. Through the Australian Business Chamber's member database, the Program sources business angels and potential business angels to form an interested audience for the meeting. Up to 30 of these angels — but usually about 20 — turn up and watch five small-business operators give 10-minute presentations on their ideas or companies, which are followed by 10-minute Q&A sessions.

The Program is interesting because it is similar to the *Ideas and the Investor* concept of listing (or presenting) ideas to potential investors. Yet this Sydney-based matching service is also concerned with the preparedness of the companies. While the face-to-face meeting system makes the service cheap and flexible with seemingly little pressure on the interested parties, the Program is not interested in fly-by-night operators with grand ideas and little else. A facilitator of the meetings, Rob Inglis, told us that the majority of the business angels were middle-aged men who had made their money the hard way, and in order to have them support the meetings the calibre of companies on show had to be high:

> The more successful the business angel, the less he wants to be pestered. We insist on the companies being real companies with real systems and real revenues.
>
> The value of the meeting system is that experienced business angels like to meet the people involved. They know that a company can have a great patent but still be run by a lunatic. They prefer to see something like that up front rather than waste their time.

The Australian Business Chamber currently has 90 companies on its books and 70 business angels. After 30 of the face-to-face presentations, there have been four angel and company 'marriages', most of them in the manufacturing/exporting areas.

Corporation Builders

David Millhouse & Associates is a management consulting and investment banking house in Brisbane. In 1994 the State Treasurer approached the firm about accessing alternative sources of capital for larger small companies needing growth capital, which had been searching for capital but coming up empty-handed.

David Millhouse & Associates started a program called Corporation Builders to help the troubled companies find business angels. On the surface, Corporation Builders was a simple network designed to match companies with equity investors. On another level, the program would prepare companies and gear them to the point where they were ready for negotiations with a business angel. This preparation would take the form of advice and seminars focusing on making companies 'investment-ready'. Topics covered included quarterly reporting, monthly meetings, developing a team and 'corporatising' a business. James Paulsen of Corporation Builders tells us that other problems of this type of investment were also covered: these included family businesses, personalities, and the expertise/power differential between desperate companies and shrewd businessmen.

In Chapter 6 we cover in more detail the preparation required by businesses seeking equity investment. For now, it can be said that the Corporation Builders program is very strict about the companies it allows onto its 'deals board', which is a newsletter filled with companies wanting equity finance. Along with their tough criteria, however, there is support from the scheme's sponsors, which include an accountants' firm, a law firm, a bank, two finance companies and a stock broking firm.

The Corporation Builders idea also operates in Sydney and, although it is one of the least publicised of the business angel matching services, its success rates — and amounts invested — are impressive. It currently has more than 700 businesses on its books trying to connect with the 130 business angels registered. In the space of two years it has had 12 matches of angel and company, worth a total of $20 million.

The strength of the Corporation Builders system obviously lies in the quality it demands of companies (in order to keep the interest of the quality angels), but the fact that this service operates in two major cities rather than one magnifies the scale of its service. A northern expansion could also be on the cards.

After Corporation Builders mailed 48 letters to known Singaporean business angels, asking if they would be interested in the Brisbane matching service, 44 letters came back saying 'yes'.

Business Angels Pty Ltd

While most services highlight the personal and 'people' aspects of equity investment, this is the only matching service that attacks the task from the human resources angle.

Started by Chris Kaine in 1992, the Business Angels service grew out of Kaine's human resource consulting and housemate matching service. Her housemate search business had become somewhat famous in the late 1980s and into the '90s, and her database of clients was spreading to people in other cities who wanted a *pied à terre* in Melbourne. Kaine essentially placed well-paid professionals — who for a variety of reasons were single — in semiluxury share-house arrangements. This service was (and still is) used by high-income-earning men and women who did not want to live alone and did not want to try 'pot luck' on the open share-house accommodation market.

This highly delicate matching service necessitates the use of a coding system used by HR professionals for certain tasks. The code is a set of nine numbers that 'tells a story' or 'paints a picture' of a person. It is created by specialised questionnaires on many aspects of the person's life. It was the efficacy of this code-matching system that brought Kaine into the business angel matching arena. She realised how many of her existing clients were business angels who could not find worthwhile investment companies. The more she investigated business angels and their habits, the more she realised that they were a group who wanted to get along with their prospective partners; in short, angels would rarely, if ever, invest in a company where they felt antagonism for the company's owner. This was not just because they did not trust people they did not like, but because many business angels invest in a company when they see what their skills and experience could do for the prospects of the business.

Thus was born the business angel matching service. Business Angels takes registration from both angels and entrepreneurs at $300 per person. A database is kept on each group separately, as naturally they yield different information.

Among the personal details that may indicate a match, the parties look at resources available to the angel, the experience and track record of the business, the type of deal required and the amount being sought or available for investment. Both business owners and angels list their details on a database, but it is the angel who is steered towards a selection of companies until a match is found. While confidentiality is guaranteed for all parties, Kaine felt that business angels would be loath to join the service if businesses made the approaches to them.

Australian Equity Business Exchange

The Equity Business Exchange is a privately owned and operated matching service that operates out of Perth but has an Australia-wide reach through a network of business brokers. The Exchange has a computer-generated matching function, much like the BFSP in Melbourne, but it also has a monthly listing magazine such as with the *Ideas and the Investor* program.

The investors and the companies are listed on separate databases and matched to their closest fits through anonymous yet salient information. The three closest matches are sent on to the registered parties. If possible matches occur between the monthly editions of the magazine, 'Express Bulletins' are faxed out. The registered clients of this service also get to use the services of a business broker in their own area who has taken an Exchange franchise from the head office in Perth.

This highly tailored and personalised service comes at a cost — $595 for business angles and $695 for companies to register, plus a 5% success fee on the transaction with a $5000 minimum.

The scope of what the Exchange is attempting without government support is ambitious. In the January '96 issue of its magazine, the *Exchange Register,* equity funds sought by companies ranged from $23 000 wanted by a Western Australian car repairer to the $14 million sought by a steel-rolling mill.

The operators of the Equity Business Exchange have started a serious push into East Asia, where they believe the really serious populations of business angels are working.

The upshot of the Perth scheme, so far, is a claimed database of more than 200 business angels with available capital of about $800 million. The completed marriages have seen average amounts invested of $200 000.

The Equity Portfolio

This privately owned and run matching service is slightly different from other services. The brainchild of Melbourne businessman Warren Lester, The Equity Portfolio (TEP) concentrates solely on the needs and wants of high-net-worth investors. TEP puts the ideas and capital requirements of entrepreneurs on monthly bulletins, which are mailed to a network of accountants around Australia. When the accountant sees an investment opportunity that may suit one of his wealthy clients, he can approach the client.

Lester says the strength of TEP is that it keeps business angels off the databases that other systems are built on. Many wealthy investors were scared away from database-driven matching services because they were convinced they would end up on a 'rich person's' list and then be hit with endless junk mail and 'opportunities'. In TEP the investor always has his anonymity protected by his accountant, and his name need not go on a database.

Lester says that if the world of informal equity investment is dominated by personalities, and business angels are publicity-shy, then he will provide a service that suits their demands.

Conclusion

How business angels meet is an interesting question. Wherever possible we have attempted here to provide figures, statistics, dollar amounts, anecdotes, quotes and interpretations to explain the quirky, untested and largely hidden world of the business angel's mating habits. It is not easy to generalise.

While all agree that the business and personal networks are the commonest way for an angel to find an investment, that accountants and lawyers provide the best success rate for investment, and that ethnic or subgroup networks are the 'safest' way to source leads, there are still enough angels joining matching agencies to suggest that these have a role.

There is nothing unreconciled or contradictory about this scenario; all of these elements can coexist. It merely demonstrates the point that business angels are individuals who make deals with other individuals: 'it's a people thing'. While one angel will be happy sourcing investment leads through his Chinese community, another will be more comfortable joining a computer-matching service; and for every angel who waits for his accountant to call with a hot tip, there is an angel who prefers the window-shopping aspect of the *Ideas and the Investor* listing.

The interesting aspect of how angels search for opportunities will be the rise of new business networks (i.e. women and corporate refugees) in the years to come. As this book was going to press, three new initiatives were being launched that have the potential to change the equity investment community very quickly. The first was the launch of the Australian Stock Exchange's Enterprise Market project on 20 August 1997. The Enterprise Market is an Internet-based 'look-see' device whereby business angels can search for companies to invest in and company owners requiring equity finance can fish for an angel. The Enterprise Market is fitted with sophisticated search engines which allow an unprecedented number of people to converge on one electronic site. This creates a 'market' where before there have been loose affiliations of networks, databases and introductions. It also helps to ameliorate the geographical problems associated with such a large country and such a small private equity investment community.

The second change to the equity investment scene in Australia came a month after the Enterprise Market. Called the

Australian Equity Association, the new body is made up of banks, accounting houses, law firms, stock brokers and professional and industry bodies from around Australia. Its aim is to create standards and codes of practice that will provide greater security for potential business angels.

The third change came the day before Christmas 1997, when the Australian Securities Commission released its 'Class Order' relief for business angel introduction agencies. Previously, introduction agencies for investors and small businesses were caught in the provisions of corporations law: which said that attempting to sell, or acting as agency for the sale of equity in a company (shares), brought the vendor and the agent within sale of securities guidelines. These guidelines held that if more than 20 people in a year would see the advertisement for the sale of the shares, the company needed a prospectus — a very costly, time-consuming way to raise equity finance. The Class Order [97/2329] says that registered introduction agencies can now bring investors and companies together by publicising opportunities, and they will not require a prospectus as long as the deal is worth less than $5 million. The Class Order also exempted professionals from some aspects of corporations law, meaning that lawyers, accountants, engineers etc. have had the status of their endorsements and opinions clarified in law, which will allow them to offer their services to small companies at more realistic prices.

At this time it is unclear what impact these three developments will have on private equity investment, except to say that they are all changes that help rather than hinder business angels and the companies needing equity finance.

5
The courtship and the deal

Realistically, an entrepreneur has no more than two minutes to impress the investor.

Bob Beaumont, Business Finance Support Program

By this stage we should have a picture of a relatively large and disorganised group of cashed-up business angels and a huge population of small and medium-sized businesses which need capital and expertise for growth. We know that this loose community of informal equity investment applies to about 1.9% of the 900 000 Australian small businesses. We also know that the angels want opportunities to invest.

There are many ways for these business angels and entrepreneurs to meet. One entrepreneur we spoke to found his business angel through a real estate deal. When the deal fell through the angel, who had become aware of the entrepreneur's inventions, decided to buy into the company instead.

But finding a prospective match for your capital or your company is the easy part. It does not take much to pick up the phone and be given a lead; there is not much risk involved in joining a computer-matching service for business angels, and there is no price for sitting in on a business conversation at the golf club. In such cases the business angel is merely being given or hearing the information. It is the starting point. An illustration of how easy it is to listen to a proposition, as opposed to how hard it is to strike a deal, can be judged by the example of the Australian Technology Group (ATG). Although technically a venture capital firm, ATG invests in companies that need about $500 000. These are high-tech start-up companies which are usually the domain of the business angels. In the two years to June 1997 ATG went through 3000 propositions from cash-hungry companies but invested in only 15.

All investors are able to put themselves into a business angel matching program and subject themselves to a torrent of information; what they do with the information is the interesting part. If they decide to investigate the lead, there is only a small chance they will take it any further than cursory analysis. In the United Kingdom, angels reject seven out of eight investment opportunities, in the USA they reject seven out of nine, in Sweden seven out of 10 are rejected and Canadians reject nine out of 10 proposals. And bear in mind that these are professional and 'sane' proposals, not the 'pests' and 'cranks'.

In terms of raw ratios of untested or unvetted proposals to take up, a UK example of a business angel syndicate is outlined in the book *Informal Venture Capital* (Prentice Hall, 1996: Ch. 9). Here Andrew Blair outlines his attempts to start a syndicate of business angels - Metrogroup - in 1980s London. Even with sophisticated deal generation and company investigation procedures in place, Metrogroup vetted more than 150 companies without a single investment being made.

In Australia, the founder of Corporation Builders, David Millhouse, estimates that only 2% or 3% of all SMEs are 'bankable' as equity investments — although his estimate covers venture capital and strategic partners as well as informal equity investment.

Robert Wenban's study of 36 business angels (Australian Business Angels, 1995) found that in 1994 the sample business angels invested in just over 30% of the investments they considered. However, Wenban's sample was 'true angels', with strong information networks and effective filters by which 'dud' proposals could be culled without being taken seriously. In this community of professional angels, 'considering' a proposal translates as being ready to sit down and talk. In other words, the figures take no account of the number of proposals that are dismissed out of hand or never make it into the network in the first place.

The success of the courtship relies on knowing how to avoid the bad deals, judging the people and the ideas that come with the deal, and then appraising the deal. Next we look at the three stages of the courtship: screening, getting to know you, and weighing up.

Screening

Screening is the process whereby the angel narrows his search down to the leads that best fit his criteria of sector, industry, location, monetary and expertise needs. The same process sees the entrepreneurs weeding out prospective investors until they find the right fit of money, shareholding and expertise for the business. Screening takes a large selection of 'possibles' at the beginning and aims to create a short list of 'probables' at the other end. While 'facilitators' like to accentuate the positives and the human dimension of equity investment, this stage is essentially concerned with the angels' and entrepreneurs' rejection of deals.

Screening can take a week or a month or year, depending on the angel's criteria, the quality of the leads generated and the source of the leads. Some angels can move through a pile of leads very quickly and still find nothing they like. Others can agonise for weeks over three or four leads and come to the same result. There is nothing wrong with either approach: angels have usually worked hard for their money, and there is no rule to say that they have to invest it in a business they feel only lukewarm about; entrepreneurs may feel they have nothing to lose by holding out for the angel with the right blend of money, talent and attitude.

We have already discussed why most experienced angels prefer to source leads within their known and trusted networks; these reasons make their impact at the screening stage. The angel who sources investment leads through his network may be considering only 25 leads in a year and investing in two or three. In this case the screening legwork so many investors have to go through has already been done by the business network. The checks and balances within that business or social circuit have already rejected the people who do not make the grade, so the angel does not waste his time. The entrepreneurs will probably not have the luxury of a network, so they rely on their accountants, solicitors, introduction agencies or industry associations.

An angel who is working through introduction services, or who is moving into a new sector of investment or a new part of the country, may encounter an exhausting process of culling the mad, the bankrupt and the dreamers from the deal flow before he gets to a proper screening. If the angel is looking at high-tech start-ups — without the natural filtering of a network — the screening can go on for a year, such are the numbers of deals he will be exposed to. The leads that come through an introduction agency are usually in written form, so unless the angel has a facilitator who insists on narrow criteria he can be deluged with proposals that must be taken at face value.

The angel who is given a lead through his business or social networks already has a wealth of background information on the potential investee, which may fill in such subtle determinants as family background, schooling and the entrepreneur's past associations. This network information is priceless, because during the preliminary screening most angels are not only trying to cull the people they would rather not deal with but are trying to pick the technically insolvent, the financially desperate and dishonest from the pack. In this respect, sourcing leads through solicitors and accountants is another early screening mode that is very successful. Accountants and solicitors do not account for a great percentage of equity investment leads, but the ones they give have the highest chance of being acted on because they have already been vetted by the professions' networks.

Regardless of where the leads are coming from, potential investors must have a fast but effective way of narrowing the field down to the businesses they would like to look at in more detail. Screening is not a destination in itself: it is a system which, in its first phase, will get the angel to a meeting with a few of the best leads, and in its next phase will take the angel up to the business he wants to invest in. Screening is important because it is the system that focuses the angel's search onto what he wants. If unsuccessful, screening exposes him to time-wasting disappointment.

The Business Finance Support Program has figures that show how important the screening process is. The Program's twice-yearly surveys of 100 angels demonstrate that some of the biggest issues are at their most important to angels in the screening process. Such issues include trust in the business relationship, reliable and realistic business plan, time frames, opportunities for new markets, rates of return and funding requirements, and the entrepreneur's understanding of the market in which his company wants to succeed.

If the potential angels have not been so already, this is the time for them to be completely honest with themselves. First, angels should have a clear idea, possibly written down, of what final outcome they want from this process. Second, they should have, in list form, criteria for investment, which should include money to invest, length of investment, size of holding, type of industry, age of company, experience of owners and turnover of the business — anything that is important to the investor. Even if these criteria are used only as a loose guide, at least they provide some sort of focus. Third, angels should know how to say 'no' to the alluring growth projections and the fantastic marketing plans that are attached to some companies' proposals. Most important of all, there is no rule saying that business angels have to be sealed off while screening their investment leads. If the angel is looking at a proposal from a company that makes kryptonite widgets, why should he not ring his friend who knows all about kryptonite widgets and learn about the market? If the name on a proposal rings a bell, what is wrong with ringing around and seeing what the name means? Perhaps it last appeared in the newspaper in connection with a fraud trial. If a lead looks interesting but the angel has a funny feeling about it, why should he not ring his solicitor or accountant and have a chat about it?

Let us say that this first phase of screening has narrowed the angel's search for small, unlisted sporting goods companies with less than $100 000 turnover from 100 down to 10 companies. The angel has set his long-term goal, codified his criteria, and been able to say 'no' to 90 of the leads.

Now the angel wants access to more detail on these businesses. He has a right to ask for trading histories, profit and loss statements, tax returns of the company, growth projections, business plan, marketing plan and copies of major supply or service contracts. The business owner also has a right to decline to show some documents, and certainly has the right to demand a non-disclosure agreement (which his solicitor can draw up before he embarks on his search for equity investment). If the lead has come through a solicitor or accountant, the angel probably already has access to these documents. If the leads have come through the networks, the angel already has a general idea of such details and that they are correct.

When sourcing leads through an introduction agency, the arm's-length relationship of the meeting means some businesses on the lookout for equity finance will agree to send some documents to the angel, but perhaps not all. A general trading history, business plan and growth projections would be typically surrendered information. There are some angels, however, who do not want this type of documented, financial information until they have met the person or people involved in the business. There is a breed of experienced 'old school' angels that wants to meet the entrepreneur and listen to the person articulate the history, goals, strengths and weaknesses of the business without recourse to the type of business plan that a consultant or accountant could dummy-up. This type of angel wants to fathom the people involved.

Whether there is much documented information handed over at this intermediate screening stage is not really so important. Because the next stage - the third stage of the screening - is really the most important: the first meeting. This is where the angel's 10 possibles are narrowed to two probables.

The formula for the first meeting is simple: you both sign a non-disclosure agreement and then you talk. The non-disclosure agreement binds both parties to a pact of confidentiality on the ideas and data that will be brought up in conversation. Such an agreement is essential to a full and frank exchange; both entrepreneur and investor need information that will never be forthcoming if doubts about security exist. Non-disclosure agreements are usually drawn up by a solicitor. But effective non-disclosure agreements can be manufactured on a PC. If these home-made non-disclosure documents are clearly worded to show the intent of the people signing them, then they are as effective as one drafted by a lawyer. A non-disclosure agreement cannot prevent people behaving unethically but if the matter ever gets to court the non-disclosure agreement may be found to create the basis of a contract, or at least evidence that a conversation took place on a confidential basis.

This first-meeting end of the screening period has about it a serious yet informal air. Bob Beaumont, who has dealt with hundreds of angels through the BFSP, says experienced angels will want the entrepreneur to be able to discuss the issues in conversation rather than doing a presentation or referring to a business plan. Business angels place a premium on a good business plan, but they know that accountants produce them for a fee. So the business angel wants the entrepreneur to be so familiar with his proposition that he can discuss it informally and answer any questions.

The person who actually matches the investors and the entrepreneurs at BFSP, David Lee, goes even further with the entrepreneurs who approach the BFSP:

> If they seem a bit disorganised, I say 'convince me' and then I get them to sit down and write a two or three page summary of why their idea is so good. If they can't

> convince me, then they won't get anywhere with one of these investors.

Of course, the first meeting depends on the people involved and the nature of the business. But usually this is the stage at which such basics as the equity available, capital required and business and marketing plans are discussed. The idea itself should have sparked enough interest to get the business angel to this point in the first instance, and what documents have been available should not have repelled the wary business angel.

Where screening stops and the next steps start is not always simple to distinguish. Where there is a good idea for technology but no working prototype, the screening processes may be drawn out to the point that the screening process overlaps the next evaluative phases. Business angels in this position may invest their time and their expertise in order to see how viable an entrepreneur's idea is. The capital may come later, or a service may be offered in return for equity in the project. This turns the whole process back-to-front.

Tool-makers and engineers are a distinct class of angel because they can assess a project and offer their services in exchange for equity. Product commercialisation experts (of which Australia has few) and marketing gurus also like to work on the actual product before investing their capital. In these cases the entire sequence of screening, getting to know you and weighing up the deal blends into a single process of courtship.

In a recent equity deal in Melbourne, a specialist machinist who performed a specific task in plastics manufacture bought a machine and went out on his own. His goal was to fulfil the specialised manufacturing function as an outsourced supplier to the industry. To fill the orders and pay off his start-up costs, he needed machinists with the same specialty from the other companies to join him. Two joined him for equity in the business, but only after they had spent their weekends working at the business owner's new set-up, seeing if it was all the owner had said it was.

In the Australian Stock Exchange's new Alternative Capital Markets service on the Internet, which will disseminate information to entrepreneurs and business angels, the information requirements are such that investors and entrepreneurs can screen leads quickly to avoid what both parties dislike most: time-wasters. Head of Alternative Capital Markets Dr Barry Westlake says that ensuring a streamlined process of screening is one of the most important ways of keeping business angels and entrepreneurs interested in the market:

You may be able to get an investor to get in a plane and fly a few hundred miles to talk to a company owner about his idea. But then he may be a few minutes into a conversation when he realises that this is not the deal he wants. Then he has to get in the plane and fly all the way home again. An investor may do that a couple of times and then decide that it's too hard.

The ASX's Enterprise Market will aid efficient screening by allowing angels to enter their criteria (as detailed as they wish) in a sophisticated search engine. When a match for the angel's criteria is entered on the EM Internet site, the system automatically e-mails the angel with the information.

The problems of an efficient screening period are very real for entrepreneurs also. Melbourne entrepreneur Tim Carroll saw off 40 potential investors during a period in which he was trying to raise money to expand his marketing company. He now advises any entrepreneur looking for an equity investor to stop being the 'fall guy' and even up the power equation by being more assertive:

> People who go through this will have to sort through a lot of idiots and sharks before they get what they want. I

> know that when I first started looking for a business angel, so many of them would spin me a whole lot of BS about their wealth, then show me their Porsche or their Rolls and then do little things like refusing to let me pay for lunch. I didn't realise it until later, but they were all playing mind games, trying to make me feel small and insignificant.
>
> My advice would be that only you can make yourself insignificant. Take more control of the relationship, set timetables for the investor to make decisions. Otherwise, you'll spend weeks hanging around a telephone waiting for these people to call — which most of them don't.

Carroll's problem was not in generating the leads — there was a lot of interest in his business — but in dealing with personality issues and the politics of power of first meetings. During one meeting with a duo of angels who seemed serious about investing, he handed over his business and marketing plans for their appraisal. The marketing plan, in particular, was a detailed account of how Carroll's databasing idea could be made to work (it later worked very successfully):

> They were a Sydney outfit and they seemed pretty switched-on. Anyway, they took my marketing plan and tried to pitch it to Channel 10 as their own idea.

While the screening process is usually seen through the eyes of the investor, Tim Carroll's experience shows that if the angel thinks he is giving up his time, the entrepreneur is often giving up a lot more, including intellectual property, financial details and personal history.

It can be a harrowing time for both parties, which is why so many potential deals falter at screening and at later stages in particular. When rejections happen at the early, proposal stage of screening, the investment concept is dismissed without the angel meeting the entrepreneur. However, there are situations where the paperwork — the 'diagnostics' — have been impressive enough to have led to a first meeting which has subsequently repulsed the investor. (In a recent case in Melbourne, the entrepreneur got to his second meeting with the angel before the angel said ‘no’ and walked away because he had decided the entrepreneur was essentially bankrupt. The business was actually quite healthy and the entrepreneur, undeterred, entered the VECCI program; he now has a business angel and a growing export company.)

Preliminary meetings can be arranged so that angels and company operators come face to face in the very first instance, before they have even had a chance to look at their profiles on a matching service’s database. This is how the Business Angel Meetings (BAM) work at Australian Business Ltd in Sydney. Every two months five companies looking for equity investment display their wares to about 20 business angels. When the presentations are over, the company owners and angels mix in an informal setting. One of the facilitators of BAM, Rob Inglis, says the decision to make the initial meeting the very first step towards an investment was taken for several reasons. First, many business angels do not appreciate more bureaucracy than they have already suffered from Canberra; second, the personality aspects of informal equity investment are so important that the organisers of BAM put the first meeting - in a ‘presentation’ and then informal format - at the forefront of the system. I think the meeting format is a very valuable concept because at the end of the day you’re backing people; you must take account of the people’, says Inglis.

The screening stage is when the angel will sound out the entrepreneur on his exit options, which will usually consist of trade sale, sell-out to venture capitalist, public float, or sell-back to the original company owner. This is also the stage at which the entrepreneurs can make their evaluations of the investors and the deal being offered. There are many entrepreneurs who may be hard up for money but in the end will take on the equity partner who can bring goods and services to a company.

One Melbourne entrepreneur with a new retailing system that needed more development before the major retail chains would commit to orders had many offers from money-only angels. Although he had been almost bankrupted by attempts to complete the development of his innovation, he resisted money-only investors, knowing that his best interests would be served by an angel who was more involved.

In the end he opted for a tool-maker as his angel. He decided his idea would come to fruition faster and more reliably with an investor who had essential skills as well as suitable premises for basing the development.

Some of these examples may demonstrate the importance of the screening process as much for who and what is weeded out as for who and what is left in. But the screening, culminating in the first meeting, is only one stanza in what can be an extended and frustrating period known as the 'courtship'.

Getting to know you

> If you can't get the money in a month, forget it.
>
> Tim Carroll, Melbourne entrepreneur, on business angels

If a business angel and a company owner can get past the proposals, the business plans and the first meetings and want to meet again, then they are out of the screening stage and into the stage where the people and the nitty-gritty of the deal are being appraised from both sides — getting to know you.

On the personal side, many views are expressed on this delicate phase and how it should play itself out. The best advice is often 'let them sort it out among themselves', which is a fine example of free-market thinking but pays little attention to the imbalance of power, experience, acumen and wealth that exists between most angels and entrepreneurs. James Paulsen, of Corporation Builders in Brisbane, is particularly mindful of this imbalance and the intimidating personal dynamics that can be brought to bear because of it:

> The personality problems in a basic equity transaction can be enormous. The company is often desperate for capital and the business angel is an extremely shrewd business person who has already picked up on that desperation.

This is the point at which entrepreneurs and angels have to be prepared seriously to consider changing the course of their lives. Up to this point the exercise may have been academic or even a glorified window-shopping — waiting for an idea or a brave expansion attempt to leap out of the computer screen and present itself, yet secretly hoping for a great big reason to cancel the whole thing. Getting to know another person or people is beyond merely sourcing ideas, trawling through the business plans and showing them to your accountant for a second opinion. Having to appraise the personality dynamics is what some experts call 'the people thing', where all the best business plans and projections in the world stand no chance against two people who cannot talk or who do not trust one another. There are two schools of thought on what happens next.

The first may be referred to as the 'American technique'. In this model the business angel has already had his first meeting with the prospective company and is very interested. So at the next meeting with the entrepreneur he introduces his lawyer and his accountant, throws all his 'cards' on the table, tells the company owner what he wants, how the deal is going to be structured, and then tries to 'close' the guy in the same way as a used-car salesman closes a buyer. In this style of negotiation the business angel thinks he is being open and frank, but he is probably just trying to assert his dominance. He expects the company owner to behave in a similar way, thereby setting up an adversarial approach where the most macho or aggressive party will 'win'. At these types of meetings the investor wants the business plan, the marketing plan and accounts of the company if he has not had a look at them already.

The other type of second and third meeting may be labelled the 'Asian way'. In this type of get-together the business angel will go out of his way to make himself less intimidating than his status allows. The meeting will revolve around personal issues such as family, background, history, education, dreams and ambitions. Conversations may seem to be leading nowhere and have little to do with the matter at hand, but in the Asian way the success of the personal has everything to do with the success of the business deal. These meetings may even occur on several occasions over a period of time, and the decision to proceed as partners may be made with a handshake rather than with lawyers and accountants. The purpose of this type of meeting is to let each party know enough about the other to see whether they can get along.

The Asian way infuriates practitioners of the American technique, because the latter think time is being wasted and at the same time they are losing control of the process, even though the lesson of equity investment is that both parties have to lose a little control in order to gain something bigger.

In Australia there are still many people in business who use the American technique. Many of the angels who behave this way are those we have already described as 'business devils' and 'business vultures'. Often their primary function is to perform rescue missions on the clients of solicitors and accountants — usually as a last measure before they are forced to go into receivership. These business vultures are in the driver's seat, and do not mind who knows it. Their deal is always more than 50% equity in the company, with a specified date for a trade sale or a guaranteed buy-back from the original proprietor, usually at no less than 100% on their investment.

But not all angels who use the American technique are vultures. Some think that having the capital to invest puts them in control. Others may prefer the adversarial approach because it has worked in the past.

We found a broad consensus among angels, investee businesses and matching facilitators that the Asian way is the most effective for ensuring a successful marriage between the angel and the small company. Most agreed that a relaxed, no-pressure meeting at a neutral location was the best way to begin proceedings. This is hardly science. However, time and again the business owners and investors we spoke to made it clear that the fruitful courtship hinged almost entirely on the first meetings — for both sides.

Because the angel has to work in or on the company to make it perform in a way that creates a capital gain on his investment, the personality issues are crucial. Likewise, the entrepreneur is taking on an equity partner — someone who has a say in the direction of the company and has a seat on the Board — and he must be comfortable with the person he is allowing into his business and his life.

There are no rules for how you evaluate a person or people so that you are comfortable about having them as business partners. But second opinions should not be ruled out, and neither should instincts. Facilitators at the big introduction/matching agencies can be helpful, but it finally comes down to what the angel and entrepreneur feel happy about. People who have been in the equity investment game for some years advise investors and entrepreneurs alike to break off negotiations with people they genuinely do not like. If someone rubs you up the wrong way when everything is just talk, how are you going to feel about them when you are partners and the disagreements turn to money?

Getting to know you means getting to know what you do not like, just as much as what you do like.

Weighing up

In many of the investments we discussed, people told us that the decision to go ahead was made in the first week of discussions, if not at the first meeting itself. However, this speedy process was followed by a period of 'a few months' during which time the deal was put to bed.

There are as many ways of weighing up an entrepreneur's proposal as there are proposals in the first place. The same goes for an entrepreneur's avenues for appraising the potential angel. Beyond the interpersonal issues of whether they like someone, trust them and feel they can work with them, most business angels will evaluate the nature of the entrepreneur. They will test the major points of the business plan: Is there a prototype? Does it work? Is there a market for the product? Is there competition for the product? Are there intellectual properties attached to the deal? Are they protected, and who will own them should I invest?

These are just samples of the hundreds of questions an angel may want answered as he weighs up the risks and rewards of investing. Other points of the business plan may be picked apart to see if they are substantiated by third parties. For many business angels who operate in networks, such tests may consist of a phone call to someone with expertise. This is all before a formal due diligence by accountants and solicitors, which is a concern only when the deal is actually finalised.

The marketing plan, especially, will be investigated through unrelated parties. Some of the world's great works of fiction are the marketing plans of entrepreneurs on the lookout for capital, and no-one knows that better than an experienced equity investor. The marketing and business plans are of particular interest to business angels because these investors are looking for growth or 'blue sky'; and if the business and marketing sides of the planning are clear and sensible the investor gets a stronger picture of where the company is and where it can go. Unfortunately, according to angels and facilitators, marketing planning is one of the weakest aspects of Australian entrepreneurs and the point at which many investors lose interest. This relates back to the screening stage and the first meeting, as many entrepreneurs lose their chance to show their business and marketing plans if they cannot simply and articulately verbalise their plans to the angel.

The entrepreneur also has his own say in the final appraisal — the weighing up — of the business angel. Is his wealth real? Has he made his money in the way he says he has? Is he an expert in the field he says he is? What other factors or people may have accounted for his previous commercial success? How do those factors differ in this economic climate and this particular industry?

Becoming investor-ready

Usually, however, the ultimate decision to go ahead lies with the investor. And the chances are he will be looking for a suite of factors in the company that amount to being 'investor-ready'.

Investor-ready means different things to different businesses. Essentially, this is a state of documented preparedness for equity investment, and may end up forming the backbone of an investor's final weighing up. If the company is at a seed stage, with a prototype or development product, the investor will want to be satisfied with the quality of management and the thoroughness of strategic planning. Here the company looking for capital should have sound management, an R&D plan that highlights milestones, and a clear, documented strategy for meeting those milestones.

Beyond the seed stage is the start-up. At this point there is a completed, tested product, but it has not been commercialised. To be investor-ready the company should have a business and marketing plan that takes more than one option for getting the product to market. The investor will want to see some thought from management. Business plans should cover personnel, information systems, finance, management and operational as well as several marketing strategies.

With expansion-stage businesses the business angel wants to see that the company is strongly constituted for a difficult time ahead. Small companies do not fail just at start-up; this also happens at the expansion stage, where revenue in growth companies can fall shy of expending costs for many months at a time. The canny investor will know this and will be looking for a plan not only for how to expand market share or geographic markets but for how to do it with the least risk possible. Again, it goes back to management and what they have done to properly prepare the company for growing pains. Business angels are always comfortable with strong management teams. Some of the best business stories come from investors willing to back a management buy-out (MBO). Before venture capitalists will partner an MBO team they will want the management team to have equity in the project, and this is where a business angel can become involved. In one case, a business angel invested $200 000 in a Melbourne MBO team so the team could get to the line with the venture capitalists. That was six years ago; the subsequent company was successful, went public, and the business angel's investment is now worth about $20 million.

Investment-ready is really a concept designed to bring small-business owners up to the level of the business angels, who are usually sophisticated, successful people with good business acumen. However detailed the attempts to become investor-ready, it should be noted that, beyond the entry price/exit mechanism questions, investors are simply concerned with the two things small companies are bad at: management and marketing. Or, to put it another way: Who are these people, and how are they going to make money?

The exit

All the months of searching, screening and evaluating how to get into potential investments leads to the biggest issue — how to get out of the investment.

The exit timing and mechanisms are possibly the most important parts of informal equity investment and are certainly pivotal to a final decision on whether to invest. But questions of exit strategies, in truth, are germane to the entire courtship process, from screening to weighing up. Because the question is always in the minds of the entrepreneur and the angel we put the issue in a single section, although its position as a subject in this book by no means suggests that the issue is placed here in the minds of all investors or all entrepreneurs.

The thing to remember is that, because business angels are interested in the short-term capital gain produced from their investment (usually five years or less), the way in which they realise such a capital gain is crucial to the way the whole deal is structured. There are business angels who are happy to keep a long-term position in the company and to draw dividends or director's fees as a generator of cash flow. But most angels want the investment followed by the capital gain.

Bob Beaumont of BFSP says the entire world of equity investment runs on exit opportunities. The most thorough and in-depth business and marketing plans from the entrepreneur pale into insignificance if the entrepreneur cannot show an investor how he can divest, Beaumont says:

> We see hundreds of transactions go begging because there's no way to exit. Investors have to be able to divest, so a lot of what we do with companies is identify exit options.

To a large extent the choice of exit mechanism will depend on factors covered in Chapters 2 and 3, namely: what is it the business angel wants and needs, and what is it that the investee company wants and needs? There is a tendency for the exit mechanism to be portrayed as solely the concern of the business angel, as it is the angel who is looking for a capital gain over a certain period. But it is also important for company owners to identify clearly what it is they are trying to achieve with equity investment, lest they agree to something that is not in the interests of the company or the original shareholders. For instance, a company that needs a short-term injection of capital to meet the demands of growth in an established market may want a formula whereby the business angel can be bought out as soon as a certain sales or turnover figure is reached. A company with longer term capital needs in a market that is less certain in respect of sales may prefer a sunset clause that gives a guaranteed length of involvement by the angel.

The exit mechanism is dependent on the needs of each party, so the issues covered in Chapters 2 and 3 should be revisited if they are not entirely clear at this stage. Assuming that the parties are ready to talk about the exit, there are four popular ways in which equity investors realise their investments:

- initial public offering (IPO);
- trade sale/merger;
- put options, call options or a combination of them;
- reinvestment.

These strategies - known as exit strategies or mechanisms - are used dependent on the circumstances of the company. The following is a brief outline of how they work.

Initial public offering

The initial public offering is a float on the stock exchange. It is costly, time-consuming, and requires the backing of underwriters, chartered accountants, stock brokers, lawyers and pre-listing financiers. And if it works, it is the most lucrative way to exit an investment.

This is not a popular exit mechanism for Australian business angels, as the capital requirements to make such an exit worthwhile are usually beyond their resources. There are also prospectus risks for the business angel in the public offering option. Not only are they expensive (a *cheap* prospectus for public listing is $200 000), but business angels may be reluctant to lend their names to public offering as they may be less likely than longer standing directors to be personally aware of potential 'skeletons in the cupboards'. This can mean having to create a new corporate vehicle for the public offering, which in turn means a capital gains tax problem.

Melbourne chartered accountant and business angel facilitator Guy Bracher says the IPO option is typically taken where the investor wants a return of between $5 million and $10 million. This is the range of return expected from an initial investment of between $500 000 and $2 million over 3-5 years. Bracher says this option is used by venture capitalists more than it is by business angels because of the costs involved. In the UK and the USA, the informal equity investment markets have matured to the point where venture capitalists buy out the business angel's equity, and then it is the venture capitalists who take the company to an IPO. But such a system is not fully developed in Australia yet.

An example of the use of this type of exit is where the company to be invested in is a medium-sized company ($20 million turnover) which the business angel has helped grow to a $40 million company. But in Australia this size of deal and the choice of exit would normally be the domain of venture capitalists. Business angels in the USA who choose to exit their investments through a public listing usually do so only with intellectual property companies involved in high-tech, bio-tech and earth sciences; even then, they list in the technology-driven NASDAQ.

Even if an Australian business angel has the money and inclination to exit through an IPO, a listing on ASX is no guarantee of success. Many small companies have little to gain by listing on a fully traded market, and the ASX has launched its Enterprise Market on the Internet partly in recognition of this fact.

Trade sale/merger

The easiest way for a business angel to exit his investment is to enter the company in a trade sale or merger with another company. The strategy must have the backing of the whole company, and essentially revolves around the tactic that Guy Bracher refers to as 'making a nuisance of yourself'.

The business angel, along with his other shareholders in the company, have agreed on a time frame and a strategy to boost the company to a position in which they bring something new, improved or fresh into an established market; they introduce a perceived competitive advantage. In this market there are already players and a pecking order. The business angel's company is gambling that it can attract enough positive attention that the third- or fourth-ranked organisation in the market is willing to buy the upstart company or merge with it in order to improve or maintain its market position. Bracher calls this: 'No. 20 gets great idea, sells to no. 3, who wants to be no. 1'.

An example would see a small company in an established market develop and patent a new or improved widget which makes inroads into the established market. Through the involvement of the business angel, the company has been able to make and sell the improved widget and do well enough to attract attention without spending too much money in trying to take on all of the competition. When the third-placed company sees the potential competitive advantage of the company's widget, it becomes interested in buying the company so that it can challenge for the number one position.

It is easy to see why this appeals to so many business angels: it means that right from the beginning of the investment the business angel has an intense focus on what has to be done and what hurdles have to be jumped. And when the strategy plays itself out, the payouts to shareholders are straightforward. The investor who paid $200 000 for 30% of a company simply has 30% of the $3 million sale price. In the merger scenario, the larger company would buy out a certain percentage of the company's equity, which would actually be paying-out the business angel. Again, this is a clean piece of business, which appeals to the business angel with other deals to take care of.

The 'make a nuisance of yourself' approach is often the basis on which an entrepreneur seeks to attract an investor, knowing full well that such an exit mechanism is favoured by angels. (A classic example of this is the innovative safety-release binding for snow boards developed by a small Melbourne company. In their pitch to potential investors, the strategy to sell the intellectual property to a major - yet not the biggest - ski equipment manufacturer in Europe or the USA is built into the mission statement.)

Put option/call option

The put option or call option is essentially a contracted agreement to sell something at a specified date in the future, at an agreed price or a means of calculating that price (possibly by reference to trading profitability or turnover for an agreed period).

If the business angel likes the prospective company and can see how to help it, yet cannot see an obvious buyer in the established market, he may require a put option on his shares. If a certain period of time elapses and no other buyer can be found, the buyers of the angel's shares will be the other shareholders, who will pay a premium based on a principal and return formula.

This exit is not suitable for all investments, as many companies looking for a business angel may already be capital-constrained and not want to commit themselves to a large payment in the future. The investor is not always convenienced by the put option, because the other shareholders may not be in a position to buy his shares at the termination date. Therefore, some angels with an 'all-or-nothing' approach insist on the alternative to the put option: a call option; and some require both (sometimes with them having the choices to which is used; and sometimes with the call option only able to be exercised if the put option is carried out as required).

The call option activates as soon as the other shareholders fail to exercise their put option. Using this method the angel can buy the other shareholders out and sell the whole company. Either way, the business angel will get his money. This type of manoeuvre is usually the sign of a professional investor.

Many equity investment deals are structured this way because both parties know where they stand. A hypothetical situation would see a family company in need of capital agreeing to the put/call option exit mechanism. The shareholders may believe there is value in the company and that the injected capital will give new life to a stale company. But at the same time the family shareholders do not want to be tied indefinitely to a company that cannot be turned around. The put/call option creates time imperatives and a clear chance for both parties to either stay or go and still walk away with money in their pockets.

Similar to a put option is an agreed payout of capital (principal and return) at a certain time. This is worked out on interest percentages over, for instance, a five-year period. If an investor puts in $200 000, he may have an agreement to make 25% per annum on his investment. His payout in five years would be an agreed $200 000 (principal) plus $250 000 (return), which would equal $450 000. But the invested capital of $200 000 would actually be valued in the company as a compound, meaning that a five-year investment of $200 000 at 25% would come to be valued at $750 000. This scenario leaves the company with $300 000 retained earnings and the business angel walking away with $450 000.

Guy Bracher says that this form of exit mechanism suits only certain circumstances: the company must be a high-growth firm with high cash earnings but a low asset base, pointing to a company involved in services or information technology which grows fast without large overheads.

With this sort of agreement it is obvious that all parties must be of the same mind before the investment is entered into.

Reinvestment

Reinvestment simply refers to an exit transaction whereby the angel sells his holding to another investor. Usually this form of exit is to a larger, wealthier angel who may also specialise in the business of the company. The generalist angel may have made his original investment knowing that the rejigged company would appeal to an expert angel he had in mind.

In this scenario the business angel sees an opportunity to invest $100 000 to own 30% of a company that is developing a new specialist injection-moulding machine for the disposable plastic bottling industry. The $100 000 gives the company enough capital to finish the machine and create a fully operational prototype. At this point, the business angel contacts another angel he knows is an expert in these sorts of companies with these sorts of properties. In the eyes of the second business angel, the company is now worth much more than it was before the first business angel came along. The first business angel sells his holding to the second business angel for $300 000, at which point the first business angel has used reinvestment as his exit mechanism. The second business angel may be investing for the long term, or he may know of a bigger company or a venture capitalist he can sell to after bringing the new machine into production.

Bob Beaumont of VECCI says the reinvestment option is a relatively untracked phenomenon, because such transactions take place quietly within the networks. This occurs, he says, because there is no other place to advertise this mechanism, and so reinvestors rely on network gossip. He says that what is needed is a place where the smaller angel can put his proposition to the market: 'We don't have that mechanism yet — hopefully the ASX Internet service will provide such a market'.

Other reinvestors are the venture capitalists, who can see that a company needs a greater capital injection and is ready to go public after the angel has worked on it for a few years. In Britain selling to venture capitalists is becoming the commonest exit mechanism for business angels, but Australia has yet to mature to that point.

Bob Beaumont says the British and American angels who target venture capitalists will groom a company specifically to catch the eye of the venture capitalist. Invariably this means 'fixing the people', as venture capitalists are more interested in the personnel behind a company than anything else: 'In a market where the lowest viable entry point is $2 million, it's really about the people rather than the money'. In the future, Beaumont predicts that reinvestment by venture capitalists will be a popular exit mechanism also for Australian business angels. This is understandable considering that venture capitalists and merchant banks currently turn down 99% of proposals. The investor who can re-engineer small companies into firms capable of becoming big companies quickly may be the business angel of the future.

However, in all of these examples both investors and company owners should be matching their needs with the exit strategy rather than allowing the lure of large sums of money to push them into an inappropriate agreement.

We have dealt with the exit issue in Chapter 5 because it is one of the key concepts on which the parties must agree before there can be an equity investment. However, the question of exits and how they will be conducted is an issue that is central to the entire book. If the parties cannot get this process sorted out, there will be no deal.

6
Finalising the deal: accountants and lawyers

So far in this book, the varied approaches, experiences and goals of the people who make up the equity investment community have necessitated keeping many of the examples and accepted wisdoms very general in scope. No two investors or entrepreneurs are entirely alike: something as simple as age may determine what they are likely to want out of an equity investment. Their expertise may distinguish them: the marketing expert with the bulging contact book may want a fast turnaround on a company that already has the products but is trapped in one market; the expert in product commercialisation may have a longer view of his investment. Background, gender, nationality of either party, as well as a host of other factors, may alter the way a deal is done.

The most publicised form of equity investment is venture capital. For venture capitalists, the investment process is in most cases transparent and for most investment sectors predictable. Venture capitalists are under many legal constraints in their use of money, which is usually made available by the superannuation funds. In order to gain a dimension of certainty in what is a highly risky area of investment (investment in small business is always considered 'high-risk' regardless of the company), the super funds set codicils on the use of the money. In addition to this, venture capitalists have their own 'hurdles' which they expect their investment companies to jump at certain intervals. These are set out in writing, and there are often accepted venture capital industry standards as to how a growth company should be performing before it can be taken public or sold to another company. Venture capitalists have 'models' which show how certain companies should 'behave' within certain time frames and given certain circumstances.

The type of equity investment used by the business angels does not have the same levels of predictability insisted on by the venture capitalists. Business angels are usually lone operators, and do not have the infrastructure required to craft and shape a small company exactly to their liking. Even where business angels operate in syndicate, they are still looking for companies requiring less than \$500 000. This is the field in which few venture capitalists will dabble — in fact, the great majority of Australian venture capitalists will not become involved in deals of less than \$2 million, while the average, single investment of the business angels is \$200 000. Business angels — the informal equity investors — are therefore working in a market where the investee companies could not be expected to fulfil many of the criteria that the venture capitalists insist on as minima. This is especially so of the criterion that equity investors call 'management': whereas venture capitalists will investigate the key management personnel of a proposed investment, looking for the strengths of the 'team' and probing for weaknesses, the business angel may not have the luxury of entertaining such high ideals or expectations. In many cases the business angel will be the only high-calibre professional in the company once he takes up his position on the Board. The companies in question have often stalled in their growth plans because of a lack of management acumen or definable management structure of the type considered mandatory for a venture capitalist even to finish reading a proposal.

Business angels are also dealing in a sector noteworthy for its number of essentially insolvent companies. Many high-tech, start-up companies are entrepreneurial in the purest sense of the word. Even if they are not actually insolvent, they are certainly having cash-flow problems, and have been surviving on credit and overdrafts for some time before they are ready to consider selling equity as a financing option.

For these reasons, and a plethora of others peculiar to specific cases, the business angel is involving himself in a high-risk enterprise. Remember: this is an investment class considered so unstable and uncertain that the huge cash resources of the superannuation funds avoid investing in it. Forget for one minute all the entrepreneurs' fears about business angels who want to 'take over' and 'dominate' the small businessman; contemplate the leap of faith the angel makes when he finally assigns the money and takes up his shares in his new company. Many high-net-worth Australians simply do not have the confidence to source, investigate, invest in and then develop a business to a new level. So when the business angel gets down to the serious end of the deal he is looking to give himself as much protection as possible; he is ready for the lawyers and accountants. To counteract the less formal nature of the type of investment they undertake business angels are very careful about the legal position they are putting themselves in. The caution they exercise before the papers are signed and the money handed over can be the difference between living happily-ever-after and a complete disaster.

This is the stage at which both entrepreneur and investor seek out professional advice. There are many stages of professional involvement, but the centrepiece will usually be the drafting and signing of the shareholder's agreement (see the appendix). This agreement is many things to the deal: it is the enabler of transactions, the authority for share issues, the road map for the shareholders and the fallback for when arguments arise and impasses are reached. All business people have, to some extent, optimism about what they are doing; part of that general optimism in the idea or the business is an optimism about the people one is becoming involved with. While such positive thinking is a good thing, it does not always account for the vagaries of what equity investment essentially is: capital and people.

The point of the agreement is twofold: first, it lists those things the parties agree on; second, it creates a safety-net of contingent actions and procedures for the advent of misunderstandings, disagreements, malfeasance, death, or a simple change in economic or personal conditions. Optimism of the commercial type does not always foresee the need to consider such matters. This is when the parties in such an investment consult the professionals because the agreement between business angel and entrepreneur may have become too specific for a generalised discussion of aims and ambitions. The professions bring universally applied principles into play, which counterbalances the subjectivity of many business dealings.

The agreement is not the 'deal' in and of itself. The business owner and the equity buyer are the two parties with the interest, and only they can make the deal. If the investor and investee cannot come to an agreement as to how the deal will be structured in its broadest design of benefits and responsibilities, then there is little hope of a lawyer or accountant being able to do it for them. Business people who think their unresolved problems can be offloaded onto their lawyers are probably not at a point where they are ready to be partners in a commercial enterprise. Neither is the agreement a threat to be held over the head of one person during the business relationship. Those who think this would be better off thinking twice about what they are trying to achieve — either that, or about going into business alone.

The agreement does not stop people behaving unconscionably and neither does it act at as a moral checklist for all ethical behaviour required in the business relationship. Moreover, no agreement covers all the escape routes for the truly unethical operator. However, in the common law countries of the world, including Australia, the courts still recognise in law the concept of acting in 'good faith'.

The agreement is a contract between parties as to their respective rights and obligations in the new relationship. While contracts should be left to the lawyers, there are issues for the business angel and the potential investee to consider before they sign on the dotted line. These may not occur to them in their optimistic moments, but must be discussed at some point. In the most preliminary stages of the agreement and assessing the potential business partner, the parties should be clear about who is doing what. The first task for the investor or the investee is to have a general picture of the end result of the deal. Being clear about this from the start — before even walking into the office of an accountant or a lawyer — makes for a clearer initial brief to the professionals.

Generally, the lawyer will look after the contract and legal issues, the accountant will deal with the financial issues. This often means the accountant is performing a form of due diligence; if on behalf of the investor, due diligence will investigate the financial and commercial claims of the company he is potentially investing in. If on behalf of the investee, it will be an investigation of the viability of the investor and his other business connections. The lawyer will create the document underlying the deal, and is therefore responsible for inserting as many safeguards for his client as possible. Lawyers often deal with the ownership issues of due diligence, especially intellectual properties, leases and real property ownership.

When professionals are paid to consult and advise on equity investment, there is always a 'lead'. In order that the left hand always knows what the right is doing, either the lawyer or the accountant will be the 'lead' and will delegate specific responsibilities to the other. This need not affect the parties to the business deal; the important part is to know which of the professionals is the lead.

Also important is knowing what is to be achieved. For instance, those inexperienced in equity investment should know that due diligence is a general term for checking the claims of another party. It is a process of independently establishing the position and situation of a company as to its assets and liabilities. It is not a standardised set of checks in the same way that a Big Mac is a standardised hamburger. Due diligence can be as big or small, as wide or narrow, as the client wishes or as the conditions demand. Knowing clearly what is to be achieved makes it easier to decide exactly what has to be vetted or discovered in the other party's business affairs.

The first thing a lawyer or accountant will want to do is assess his client's potential business partner. This assessment can often begin with the confirmation and clarification of some fairly basic facts; such as, 'Is that his real name?' or 'Is the company what it seems to be?'. They ask these questions for good reason. Most people think of companies with their shareholders and with assets; but many business structures that seem to be successful and wealthy companies are really trading trusts, with the company as the 'public face' but with the assets really owned by the unit holders in the trustee. For ease of explanation, in this book 'company' is a term that may also include trusts. From there, the assessment of the other party can quickly become highly technical and very expensive, depending on what claims have been made. For instance, an investee company that claims to own certain trademarks, licences and patents, which are material to the success of the business, may come in for particular scrutiny from the lawyers. Rights pertaining to these intellectual properties can be complicated: what are claimed as 'patents' are often only patents pending, as it usually takes two to five years to register a patent from the day of application. Further complications arise from 'ownership' of international patents. These can be sought at the same time as registration of a domestic patent, and even then the international patent is enforceable only in the countries that have signed the particular patents convention. Many small-company owners who claim to own patents or other intellectual property rights do not actually own the rights they purport to have. Licensing arrangements that grant valuable rights to the investee company may have a clause that terminates the agreement if the investee changes its shareholding or control beyond a specified percentage. This is something worth knowing for an investor who is contemplating buying shares in the licensee company.

If the premises are an important aspect of the business (for example, if they have been purpose built or if relocation would be expensive) lawyers will be quite particular about the security of tenure of the business. The legitimacy of leases, and options for extensions of the lease term, become matters of great significance. Today environmental issues regarding business premises are becoming increasingly a subject of due diligence; and whether there is any litigation pending against the company in question can frequently be a very important item of inquiry.

One of the assessments insisted upon by professionals is that part of the due diligence dealing with tax liability. Tax can be delayed, offset and credited; it can be hidden and transferred, and it can lie dormant for years as a trap for the unwary investor. As soon as the business angel buys his shares in the company he wants to invest in, he buys into not only the assets but also the liabilities. The dreams of big growth can be quickly overshadowed by the discovery of a large taxation liability owned by the company, with a consequent large reduction in the value of the investment of the new shareholder.

Large accounting firms have teams of tax assessors, which assess a company's tax liabilities in the same way the Australian Taxation Office would. This is an expensive way of ensuring that there are no nasty surprises in the company, but it is also quite accurate. Remember that there are companies that may not know exactly what their own tax liability is, and the tax assessment may uncover honest mistakes rather than fraud.

While a concealed or unknown tax liability is a main question for assessment in most transactions, there are other concerns. Is the company about to go into liquidation, or be put into administration, or is it financially hindered in some other way? Is there any litigation pending or writ of execution already issued against the company? Are the people representing the company actually authorised to do so? Are the assets of the company owned by it in its own right, or only as trustee of a trust? Does the company have the legal power and right to enter into the proposed transaction? One point that can cause significant problems at a later date is when one of the parties is involved in family court proceedings. Is a new investor likely to find himself caught up in the middle of a messy family law property settlement?

Other issues for assessment may be the real value of company shares or trust units; the existence of partnerships, subsidiaries or offshore commercial operations; material changes in the company since the balance date; ownership issues with the company's intellectual properties (fundamentally important where the business angel is buying into a company with a idea or prototype that needs developing); employment contracts, remuneration issues and potential profit-share arrangements. These employee provisions include potentially expensive items such as long-service leave, contingent-bonus arrangements and profit sharing liabilities, all of which can be significant unexpected expenses if proper due diligence is not carried out.

The lawyers and accountants will tailor searches to individual clients. But these due diligence programs are important because if the results are not so bad that the business angel wants to call the whole deal off, then he at least has information that may cause him to revalue the shareholding he is taking. Equity investment is a risk/benefit equation and the greater the information, the better chance there is of getting the risk pricing correct.

Due diligence

Due diligence can be a fairly quick 'look-see' or it can be a very expensive and comprehensive audit conducted by a team from a major accounting firm, often more thorough than an ATO audit. Due diligence is essentially an investigation.

In most cases the business angel has done his own rough due diligence to satisfy himself that his time is not wasted by being interested in the business. The investor himself has generally been a success in some commercial field and has the capacity to assess aspects of the company in which he is knowledgeable. When he retains lawyers and accountants to perform due diligence he is often looking for a 'second opinion' and a dispassionate eye. He wants an objective picture of the history and prospects of the company and he also wants assertions tested.

Due diligence process can often take less than a week; it may only be spread over a day or two, depending upon how detailed it is to be, what has to be done, and how accessible the information is.

Guy Bracher, of the Institute of Chartered Accountants, says the basic due diligence financial reports wanted by most business angels will cover:

- financial statements of the past three years;
- confirmation of assets and liabilities, including intellectual property;
- risks to the company and risk-management measures;
- tax returns for the past three years;
- quality of management and key personnel;
- sales figures compared with industry average;
- margins compared with industry average;
- analysis of budgets;
- analysis of company's projections;
- analysis of future tax liability;
- valuation of the company;
- adequacy of provisions.

Bracher says most business angels have already looked over the company, and at the due diligence stage want simple questions answered: Do the numbers stack up? What are the risks? What is the value of this company?

Most business angels do not want the accountant to worry about the marketing plan. They are more worried about the raw basics of the business: Are there any accounts? Has this company lodged a tax return lately? The angel wants to look 'inside' the company. The accountant is expected to furnish details as to whether the company has been used to pay school fees, or to buy a new fishing boat. What kind of wages has the company proprietor been taking out in the past three years? In what state are the company's books and what story do they tell? If the accountant believes the figures have been fudged he reports that too, giving his own assessment of the real figures.

Assets and liabilities are important in the due diligence report, because these often underpin the valuation of the company. Those undertaking the due diligence are expected to verify key information, such as that the plant and machinery and land claimed as assets are in fact owned by the company. Sometimes they will travel to the company premises and verify that the asset actually exists. Due diligence is not an insurance policy: it is confirmation that the company owner's claims are consistent with reality. This sort of proof is particularly important in the ownership of intellectual property (IP). If there are former partners in the business or existing licensing arrangements or a former joint-venture participant that might still have a stake in the IP, then the business angel has to know. Investigation into the clear title of IP is an area in which some lawyers specialise.

The due diligence report will also identify risks to the business and the measures taken against them. Accountants are looking for issues such as public liability, product liability and environmental impact. When small companies are sued in these matters the results can be disastrous, and the due diligence investigators are looking for insurance policies that are not only up to date but also provide adequate cover, in terms of both the dollar values and the likely risks.

The sales/performance of a company are judged against benchmarks the accountants already have on software or can source from industry organisations. This gives the business angel the true performance of the company rather than the exhortations of the proprietor. The other side of this analysis is the comparison of the company's margins with industry benchmarks. A bad result in this respect is not always bad news for the smart angel: industry-worst margins can mean an easy turnaround in profits if the angel knows how to restructure the business.

The budgets are where many companies on the lookout for equity investors run into trouble. Bracher says most due diligence reports will take a differing view of the company's budgets and forecasts for the business. This is what the angel wants: an objective, new look at a company he may have been talking to for several months. Companies are known to overestimate their potential, so the investor wants to know by how much. The due diligence report will include not only the analysis of the budgets and projections but the accountant's own 'best case/worst case/most conservative' appraisal of how those budgets and projections should look. This will manifest as three columns of figures, and gives the business angel a 'spread' of outcomes.

The comprehensive due diligence may include an appraisal of the management, but many of the older business angels dispense with this because they feel they can judge the people they are dealing with. When asked, the professionals carrying out the due diligence evaluate the management of the company: the people, their track records, and the aspect of most interest to the business angel — their capacity to deliver a sustained effort. If there is reason to be suspicious, those conducting the due diligence can ask for references for management, and cross-check them for discrepancies.

After the tax assessment — which can throw up many reasons for the business angel declining to invest — comes the final
valuation. When it comes right down to it, the valuation of the company is what the angel is most interested in. He may have built up a false picture of the company's worth, based on his own assumptions and ongoing talks with the proprietors. The accountant's bottom-line valuation of the business is the reality check for an investor, and is a primary factor in what the angel is prepared to pay for equity.

Bracher says nine out of 10 due diligence reports will end with the accountant advising the business angel against investment:

> We are really looking for reasons to say 'don't do it'. We are more interested in our clients than we are in the deal. It's the same with lawyers; they'll always find something wrong with the contract.

For company owners, the due diligence on a business angel is a much smaller operation. Bracher says most company proprietors who are looking for an angel have brought their accountants into the picture from the beginning, and the accountant will already have a clear picture of the investor. Often it is the accountant himself who has brought the angel into contact with his client. But when asked the accountant will run checks on supposed business angels. The angel is asked for references, which are then checked and cross-checked through industry and professional networks.

In some cases the existing structure of the company to be invested in will be discarded and a new one constituted when the business angel invests. In this scenario the investor may want the most basic of due diligence performed, covering only key issues such as clear title of intellectual properties and ownership of assets.

The simple task of due diligence is to find proof for what is really just a claim. Only 30% of business angels want boardroom control, says Bracher. What they really want in a company is a person who can 'deliver', growth in the business, an iron-clad exit for their investment, and to make lots of money. What they need is something solid to hold onto; so they need an accountant to confirm the financial claims of the business, and they need a lawyer to protect their interests as they enter that business.

Comprehensive warranties

The warranties are a list of undertakings — promises and guarantees — to which the owner or owners of the business angel's prospective company put their signatures. It is usually written by the business angel's lawyer, and is a sort of double-safety mechanism which requires the original company owner to reimburse the company should there be any hidden costs incurred by the company before the business angel buys in.

Warranties can sometimes run into many pages, and can be quite detailed. Although still part of the agreement, a comprehensive set of warranties is often attached as an annexure or schedule to the agreement, rather than incorporated into the main body of the agreement itself.

The warranty can save the business angel a lot of money at the due diligence stage. For example, rather than paying a team of accountants and lawyers to pick over the minutiae of the company, the business angel can pay for a general due diligence which targets the major points of assessment, while the details that may prove time-consuming and costly to ascertain can be covered by the comprehensive warranty. Also, some items simply cannot be ascertained by due diligence such as matters known to certain parties. But bear in mind that a warranty is only as good as the party giving it. A warranty given by a financially weak person or company is of little value regardless of how comprehensive the warranties might be.

There is virtually nothing that cannot be included in a warranty. It is essentially the business angel's insurance against nasty surprises lurking in the business. Sometimes, given the nature of the company, it is the only practical way for an investor to guard his interests. So the warranty is a compendium of all the angel's darkest suspicions while also being a distillation of the lawyer's experience in these matters. It is important to note that the warranty gives nothing physical to the business angel; it is a list of assurances that information presented by the company is true and accurate and that the consequences arising from non-disclosure will be met by the original owner. As long as the party giving the warranty has sufficient assets to back it up, this can be an invaluable tool for the smaller investor who may consider it too expensive to engage a big accounting firm to conduct comprehensive due diligence investigations of the magnitude usually associated with public companies. Still, as lawyers always tell their clients, warranties are worth only as much as the financial ability of the person giving them to stand behind his undertakings. If the business angel wants to go ahead, even if the original owner does not have the ability to meet his undertakings in the warranties, then many lawyers will recommend the establishment of a second company that owns the substantial assets of the business while the primary company carries on the trading side of the business. In this scenario the trading company has no assets to speak of, and if liquidated by an unknown creditor it represents no great loss because the real assets are in another company or trust. Thus the business angel's capital is protected.

In a warranty, the company owners may be asked to state the very general as well as the quite specific. Undertakings range from the company being legally incorporated, and there being no hindrances in law to stop the owners performing their undertakings, to guarantees that no dividends or property or assets in the company have been distributed or disposed of. Loans repayable, taxation liabilities, valid liability insurance, provisions for foreign currency transactions and employee-related liabilities may also be mentioned. The company owners may state that the company is not bound by any long-term contracts, or by any contracts that bind it to onerous or unusual provisions. Intellectual property may have to be vouched in terms of issues such as licensors, licensees and users, or by rights of parties other than the company. The company owners will usually have to guarantee that there are no disputes that may bring the company into litigation, including matters such as having all the licenses and permits that the company should have for carrying out its business. The company owners could also be required to state that they have ceded no powers, shares, future profits, commissions or royalties to a third party. Warranties vary from transaction to transaction, and reading the warranties in various contracts can give a person some insight into the concerns of the business angels before he enters into the agreement or of unfortunate problems encountered in earlier transactions. There are also warranties that business angels sometimes have to sign. These documents are not as large as the ones signed by the company. They may ask for warranties that the business angel is not bankrupt, has no civil actions pending against him and has appropriate insurance policies.

The agreement

The due diligence, assessments and comprehensive warranties are important phases in reaching the last stage of the agreement. But by its very nature the actual agreement is the meeting of minds, and the place where the equity investment components of people and capital collide.

The shareholders' agreement is the last act of faith between company owner and business angel, and is the rule book for the ensuing relationship. Throughout this book we have constantly emphasised the partnership aspect of equity investment. But partnership cannot exist properly unless both parties have their interests protected and their rights and responsibilities recognised. Lawyers are usually careful not to allow their opinions to impinge on the making of the deal, but when it comes to the drafting of the agreement their experience is paramount. While the clauses they insist on in some of these contracts can seem cynical and even pedantic, they are there for a reason. Remember, there are people who have invested in companies that did not even exist; there are company owners who have taken on a business angel only to watch their business stripped of its intellectual properties. The lawyers' rules for engagement in this arena are to treat every issue as if they are potentially dealing with a crook; and for every clause that protects the client, there must be a 'fallback'. The comprehensive warranty may seem an impressive document in itself but it acts only as a fallback to the main part of the document, the agreement.

While all agreements differ to suit the particular transaction, there are many issues common to this type of investment, and these must be covered somewhere in the agreement. The best time for discussing dispute-resolution mechanisms and fallback positions for impasses is when the optimism about the deal and the company's future is high. It is better to discuss these matters when the parties are positive and focused on common goals than when resentments or suspicions or cross-purposes have entered the relationship at a later date.

Below we outline the key points of a typical agreement used by business angels. To begin with, however, there are broader issues that both potential business angels and entrepreneurs seeking investors should understand before they find themselves in the lawyer's office.

The exit mechanism

The first issue to be considered is the exit procedure. Virtually every worthwhile lawyer will suggest his client consider the exit mechanism quite early in his assessment of the investments generally. In fact, many solicitors would advise their client not to enter into any contract for equity investment unless it has a built-in exit mechanism. This goes back to Chapter 2 where we discuss what business angels and entrepreneurs are looking for. The entrepreneur is looking for capital to grow his business to another level, where he hopes to be able to buy the investor out or sell the company to a larger company. The business angel, on the other hand, is usually looking for a capital gain that can be realised only on exiting the investment; to safeguard that primary objective he must build the exit into the contract as a central pillar.

The exit mechanism is usually spelled out in fine detail. And to cover the various contingencies that occur in the business world there are various specific procedures.

Of the many recognised styles of exit mechanism, one of the most popular is coloquially known as the 'sunset clause'. This puts a time imperative on the shareholders. The elapsing of the defined period will mark the business angel's exiting date from the trust or the company. As this date approaches, the shareholders (or unit-holders) must decide what they want to do. If there is no decision to stay in business in the current format, a sunset clause nominates the date which something must happen. This date can incur the previously discussed put/call option, where either the shareholders have to buy the angel out or the angel buys out the other shareholders. Alternatively, the sunset clause could trigger a trade sale.

The business angel, given the nature of his investment habits, may not be averse to exiting long before the agreed exit date comes around. The sunset clause in this case acts as a fallback; there are other clauses in the agreement that allow offers to be made from one shareholder to another at any time, in a set formula. This suits professional investors, because they only want a return on their money. The retiree business angel, who is in for the long haul or who wants a job, may not feel the need for such clauses.

Some agreements will have a clause that allows the original shareholders to buy the business angel out based on a pro-rata valuation of the shares when the company's profit reaches a certain point. This of course provides a powerful incentive for both entrepreneur and business angel to grow the company to the levels agreed on in the deal-making phase.

These are just samples of the ways an exit can be planned in an equity investment. Of most interest to the lawyers — and therefore of deep interest to the contracting parties — are the general fallbacks that must be provided in the agreement.

Dispute resolution

All agreements will be worded slightly differently but there are general principles that must be covered. One of these is the provision for mediation as a first resort of dispute resolution. Not all people can solve problems over a drink, especially when those problems involve money. So agreements on equity investment should have clauses to specify which route a dispute will take before it ends up in court. In this respect, solicitors go by the maxim that disputes should always be solved quickly, cheaply, easily, and without inflaming the original argument or creating long-term animosity. When disputes between small-business people end up in court as litigation, the costs, impact on the business and time wasted mean that both sides will lose.

Some agreements name professional mediation services staffed by former judges or qualified mediators; other contracts, especially if the mediation issued is concerned with valuations, may simply name 'the President of the Law Society of New South Wales' or 'the President of the Institute of Chartered Accountants' as the person who will appoint the final arbiter of the matter in dispute. There are also industry associations that provide dispute-resolution services.

Agreements should have reference to solving disputes and include lead times for their resolution; there is no point having alternative dispute resolutions built into the agreement if one party is able constantly to stall attempts to solve the problem. An agreement may also list the names of the lawyers, accountants, auditors and bankers who will be appointed to deal with their respective areas of work, unless the parties agree otherwise (thus ensuring these key services are agreed if there is any fracas; this at least stops a secondary argument about who the advisers will be.

In some of these agreements, the lawyers have written the ultimate fallback position for relationship breakdowns. This is often colourfully known as the 'Mexican standoff clause' and is a corporate variation on that line from early westerns, 'This town [company] ain't big enough for both of us'. The Mexican standoff can be invoked when the business relationship is essentially dead and the only real answer is for one of the parties to leave the company.

Under the Mexican standoff, one (or a group) of the shareholders can make an offer to buy out another shareholder or group of shareholders. If the offer is accepted, that ends the matter. Alternatively, the offer can be reversed: under the Mexican standoff clause the shareholder to whom the offer is made is entitled to require the offering party to sell their shares on the same basis and for the same price per share. In other words, you can force the other party's hand only with an offer that you would accept yourself. This is designed to ensure that, if the arrangement ends, at least it is done with an equitable division of the spoils. In fact, in practice this is not always the case as frequently one party is in a much stronger position to continue without the other or others than is another party, and this difference of position can be reflected in the value of the shares to each party.

The majority of the agreement will be concerned with the more mundane matters of control, duties, dealing with changes, where capital should be spent and who is employed.

These are important issues, but it is not for the lawyer to decide on the answers.

Control

In the case of control, business angels approach the matter differently. There are many reasons why a business angel would be concerned about how much control he had in the business. Most drastically he will be thinking of ways to recover his money should things get out of hand. At the very least, he will not want his money squandered on ill-advised expenditures.

When a business angel wants to be able to control the company he is buying into, there are various ways he can do it. He can insist that his shareholding is always equivalent to the rest of the shares held. In this way the single business angel may have three shares to make him equal to the other three shareholders. He will then have written into the agreement the right to cast the deciding vote. If he is only 50% of the Board, he may reserve the right to appoint an extra director at any stage, thereby maintaining effective control. Or he may have the right to make the casting vote.

Where a business angel is a minority shareholder, he may not have complete control as such, but there will be other corrective influences in the form of goals and hurdles. The investor's capital can be partially secured by having a unanimous Board vote (or a unanimous vote of shareholders) required for important decisions such as large expenditures and significant service contracts. This gives him the de facto power of veto.

Then, in the daily running of the company, who will be responsible for what, at what level and for what remuneration? This is all in the agreement, and the terms will differ from investment to investment. Once the business angel and the company owner have decided how they—the shareholders and directors—will be rewarded and for which duties, the investor will want clauses outlining separate service contracts with key personnel, executives and staff. As with the comprehensive warranty, the investor has the right to know who is doing which job and what they are being paid. This is not the case of a business angel seeking too much control: there is nothing in these contracts to stop the company employing more people or taking on new executives for new responsibilities. The point is that the contract offers the fallback position. This goes for other matters in the company such as insurance and acquisitions. The business angel may want the contract to stipulate that these must be ratified at Board level or by the shareholders themselves.

On the topic of accountability, it is often the case that the original owner of the company will want to remain as managing director; he feels it is his company and that he best knows the workings of the business. In this case—whether the angel is a majority or minority shareholder—the company owner continues in his leadership role while not necessarily having 'control' in terms of shareholder votes. In such a scenario, it is not uncommon for the business angel to accept the arrangement, so long as the continuing managing director meets agreed hurdles or performance benchmarks. This allows the business angel to relinquish absolute control yet leaves him the right to replace the managing director should the agreed performance figures not be met; the original company owner retains control over the business itself. These arrangements can be tricky and lead to disputes all of their own. If a managing director does not meet the agreed targets, is he completely to blame? What if there were an 'Act of God'? What percentage of the failure was his fault? The agreement should contain a fallback for this contingency. Lawyers usually favour a chartered accountant to adjudicate on the level of culpability relating to the managing director's own actions. Some joint shareholders work well like this; many do not.

The original company owner will usually go to some lengths to ensure that he does not lose too much control over 'his' company. His lawyer will insist on there being pre-emptive rights drafted into the shareholders' agreement. These rights mean one shareholder cannot offer his shareholding for sale without first offering them to the other shareholders. This concept is sometimes expanded with specific veto rights. The clause may say that even if the other shareholders do not want your shares, you cannot sell to certain specified parties (usually other companies and industries). Other clauses bind all shareholders to offer all business opportunities that come their way and are within the business of the company to the company first. Such a clause is overseen by broader provisions covering honesty, good faith, and the undertaking to share commercially relevant information that may come the way of the shareholders. This reflects the fact that the original company owner may not have the extensive business networks of the investor.

Dividend policy

Shareholders' agreements also frequently set out the agreed 'dividend policy'. This subject should be addressed in the agreement rather than be left to judgments on the run. Some business angels want capital growth, and the faster the better. They will be more interested in profits remaining in the business. Other directors may fully expect their dividend. But whatever dividend policy is listed in the shareholders' agreement, there must be a fallback as for every other issue.

Succession

The need for contingency planning to be built into the agreement is especially obvious in the provision for succession planning. Issues that the business angel needs to think over with his lawyer include the basic one: What if one of the key shareholders dies?

This can change the chemistry of the business relationship and potentially the course of the business. So it is important how the business angel and the company owner decide to deal with such an event in the agreement. Do the shares of the deceased shareholder pass to his family? In many agreements, the deceased shareholder's shares must be offered for sale to the other shareholders. A method of valuing the shares is agreed and company-held life insurance policies are often invoked to buy the shares from the shareholder's estate. But even this may not suit the angel or the other shareholders; the balance of power can be changed by a death, even where share allocations are kept numerically as before. Bear in mind that the business angel does not want to sell at any old time, he wants to sell at the very best time, and an untimely death may disturb these plans. Such problems arise also when a shareholder ceases to be a full-time employee of the company. Under some agreements this will not matter. Under other agreements only those working in the business can be shareholders in the business, and as soon as they leave their shares must be offered for sale to the other shareholders.

All the issues compound when the business angel has bought into a family business. As already discussed, succession in family businesses is a growing concern in Australia because there are no clear answers to potentially complicated problems. This is an area of particular concern to experienced business angels and their advisers.

Capital-raising

Concern also arises when a company decides it needs a round of capital-raising to achieve a certain goal. The contract should allow for occasional raising of capital from the shareholders/directors, but always allowing for the contingency where one of the shareholders does not have enough available capital to make a loan to the company. Sometimes there are provisions that the company can reallocate shares on the basis of who has lent money to the company and how much. There may also be a problem if one of the shareholders goes bankrupt. What happens to his shareholding? Potential business angels should think these matters through, and so should entrepreneurs looking for an equity investor, as at some stage a potential investor is going to query them on such matters.

It is worth considering these points before going into the lawyer's office and entering the final stage of equity investment. It is also worth noting, before we go through a sample agreement, that many lawyers and accountants prefer to structure these equity-invested companies as trading trusts. The way many trusts are structured (using a company as the trustee), they will have most of the characteristics of a company. But with trusts, it is usually easier to redeem units than it is to redeem shares in a company. In the world of equity investment, where share redemption and capital gain are prime concerns of the investor, the trust will frequently be the investment structure of choice.

The agreement frequently contains a number of annexures for copies of service agreements, a draft constitution of the company and, if loans are intended, perhaps a loan agreement or a deed of mortgage. A sample agreement for an equity investor buying into an established company is set out in the appendix.

If there is any doubt as to the ability of the business angel to focus the original shareholders' minds on the goals to be achieved (from the angel's perspective anyway), some of the clauses frequently used should dispel this doubt.

A clause may oblige the company to conduct its operations in such a way as to achieve market dominance in the distribution and sale of product X as quickly as practicable. The next clause may then require the company to expand its operations so as to establish wholesale outlets in X as soon as practicable. This may then be followed by an obligation to 'consider every commercially realistic opportunity to expand the operations of the company both vertically and horizontally in Australia and elsewhere'. Another specific objective clause frequently found in such agreements is an obligation for the company to be listed on the stock exchange by a specified date. However, objectives and goals are usually less specific in their wording.

Frequently used clauses demand that budgets for the company be approved by the Board and that new budgets must be prepared if there is a variation of more than an agreed percentage in certain aspects of the budget in the preceding trading quarter. Keeping a tight watch on budgets in this way is a familiar business angel method of keeping close control over the company's lifeblood.

Other examples of business angels hard at work in shaping agreements are specific clauses dealing with matters such as the appointment of key personnel, the appointment of national or interstate distributors, import and export arrangements, and employee relations. Agreements frequently require some or all of these to be approved by the Board and, in some instances, require unanimous approval of the Board or of shareholders.

From reading many shareholders' agreements you can see how fast business angels want their companies to grow; and you can see that they are locking the other shareholders into that ambition right from the beginning.

Other obligations that are frequently contained in shareholders' agreements include obligations for shareholders (or perhaps only a particular shareholder, possibly the angel) to advance certain loan moneys to the company within a specified period or in specified circumstances.

The extent of warranties given by existing shareholders to a new shareholder is always an interesting discussion point in finalising agreements such as these. Unless the venture is using a new company (where there are no 'skeletons in cupboards'), an investor will want certain warranties or guarantees from those who have been running the company until that time. It is not unusual for more time to be spent negotiating the warranties provisions than in negotiating all of the other provisions put together. It comes down to the extent of the protection the investor insists upon, how comfortable the existing shareholders are that nothing they have done could rebound on them, the extent of the due diligence (although many items simply cannot be discovered and have to be the subject of warranties) and the relative bargaining power and 'keenness' of each side to do the deal. Taxation and litigation issues are usually the areas of greatest concern, in each instance often because major problems can arise in the future without there being any indicator of them today.

With all of the clauses dealing with required objectives and targets, assuring the investor of certain levels of control or vitae and guaranteeing the existing 'health' of the company, it is reassuring to see towards the end of most agreements a clause whereby each of the parties undertakes to act towards each other in good faith.

7
Living together

Flatmates, spouses, school friends and army buddies can all testify to how hard it is to live in someone else's pocket. Now translate that difficulty to people with ambition, brains and ego and add the essential ingredient of money, and you have the highwire act that is equity investment.

The list of problems that can present themselves to the business angel and the original shareholders of the company is as long as the list of complaints any two people can have about one another. In an equity investment scenario, the stage is set for potential problems before the ink dries on the agreement and the money has changed hands. The angel is usually a business person with a particular strength or set of strengths and a track record of success. The company's original owners have been successful enough at what they do to attract an equity investor. Both sides therefore have strong views on how the smallest and most complex tasks are to be performed; if those views coincide at meaningful points, then well and good. If they do not then there are problems to be worked through.

It is encouraging to learn from equity investment experts we have spoken to that most properly executed equity investments are successes which make money for all the parties concerned. Still, there are enough complete disasters to suggest that equity investment is something not to be entered into lightly, and these failed ventures can usually be traced back to small personality clashes and differences which eventually climax in a breakdown of the business relationship. Those problems may even be traced back to laziness and acts of omission which return to haunt them later. The commonest problems are with duties and money. These can occur in many contexts but always come back to the same thing: there is a clash over who does what and there is no mechanism for deciding how significant expenditures are to be made.

But just as there are ways to 'manage' a marriage or a co-occupancy or a friendship, there are accepted ways to manage an equity investment relationship. As already discussed, not everyone can talk out their differences over a beer, especially when those differences have reached an impasse or have resulted in one of the parties having to 'pull rank' as per the terms of the agreement. The business angels and business owners we spoke to all emphasised that resorting to clauses of the agreement for very small problems was the very worst way to be partners in business. The agreement is a map and an outline for the equity-invested company; it is a safety-net only in the last resort, not the first instance. The best way to run a company with a business angel is to be sure you can live with the person before signing the agreement, then to do your best to live with them during the actual relationship. Behind this acceptance of the other's personality, there should be the same articles to be found in any company, stating who fulfils which role and what procedures are to be followed in major expenditures, large service contracts and significant financial commitments. Money and duties are usually secondary problems, which stem from primary personal problems.

We cannot give a sure-fire way to exist in a business partnership without tensions, arguments and breakdown, any more than anyone can write the fail-safe guide to happy marriage. However, there are broad issues which can be studied, resolved and integrated when it comes to the business angel and the company owners actually living together.

Rules for living together

Know your partners

This most basic of preconditions may be overlooked by angels too keen to invest in an interesting idea or by company owners desperate to get their hands on extra capital. But it is certainly worth more than just a cursory glance. Two people with much in common commercially can find themselves at odds on a personal level at an early stage if the one has not investigated the other. There is something intimate about equity investment, which requires a certain amount of give and take. If there is something not entirely compatible about your prospective partner—and you still want to go ahead—then at least know what the personality fault is so you can sidestep it, 'manage' it, or ensure that it is not a quirk that will affect the actual operations of the company or the growth of wealth.

In Chapter 5 we covered the topics of screening, getting to know you, and weighing up/the exit. It is in this phase that business angels and company owners should be disciplined in what it is they are looking for and what type of people they do not want to be in business with. Business partnerships do not iron out the small problems—they exacerbate them. This is one reason why so many experienced business angels employ the 'Asian way' of getting to know the owner of a prospective investment company over an extended period. One very experienced, very successful angel who spoke to us likes to take at least six months to get to know a potential partner. His particular bugbear is people who cannot have a disagreement without turning it into an argument. He will never go into business with someone he does not like. Another business angel prefers clarity of thinking in a person, and likes to spend several weeks ensuring that the potential partner can articulate complex ideas in simple sentences. He knows that what he dislikes most in people is an inability to get to the point.

These are just examples of aspects of personality that investors are looking for. Everyone has character traits they cannot stand and personality types they prefer to do business with. Before investing in a business, or taking on a business angel, at least know what you are looking for and what you are trying to avoid. Once you are in business with the angel or the entrepreneur, at least know who you are dealing with. The first rule for living together in equity investment is to know thy partner; even if you cannot find the perfect person, at least you will be prepared for their imperfections and have a strategy for dealing with them.

Duties

A ship is well run when everyone on board knows his duty and knows when to perform it. The best football teams have winning records because everyone on the team performs a task when the task is required. In equity investment, a small company is taking on a new person with money and expertise. A harmonious union is possible from the outset if all the shareholders of the new entity are quite clear on who is doing what and who is responsible. Experienced business angels are meticulous about duties and responsibilities because they usually have other companies they are working on, and they do not have the time or the inclination for misunderstandings, laziness and incompetence. These investors will make sure duties—marketing, finance, general management, distribution, production etc.—are written into the agreement and that the original shareholders understand exactly what those duties are. Less well organised angels may turn up for their monthly board meetings to be constantly disappointed by inaction and lack of completion of key tasks. What may rankle even more is another shareholder or key employee duplicating another's job, which not only wastes time but causes rifts.

In order to avoid the syndrome of 'now we have the money, everyone can relax' within the company, it is better to have duties stipulated in the agreement so that performance issues when living together are cut and dried. The second rule for living together is to have a written understanding of duties and who is performing them. This folds into the next rule.

Goals

Business angels say that an investor can get along with the original shareholders when everyone has their eye on the common goal rather than on each other. In an environment where each individual is working towards his own goal, which in turn contributes to the collective goal, powerful cultures of success can be nurtured. The canny business angel can use his 'outsider' status to breathe life and enthusiasm into a company's key personnel by focusing his partners on higher benchmarks than the day-to-day realities they may have been struggling with when in need of extra capital. Often the business angel is a person who has 'been there, done that' in the company's particular industry and has an ability to show people what they can achieve if they meet their goals. One angel told us that while the long-term goals could be established broadly in the agreement, he liked to create schedules of smaller goals at the first few board meetings. If the goals were set by all the shareholders, then monthly, six-monthly and yearly targets could energise the company in a way that bullying and arrogance never could. When a company started hitting its goals, it bred a new confidence which often bred more success.

Depending on what kind of exit strategy the angel has erected, there may also be an added incentive for everyone to achieve goals and targets: the entrepreneur can get the angel out of the business faster and the angel makes a faster turnaround on his investment. The third rule for living together is to have individual goals that are working towards a defined end. This also clarifies duties.

Employees

It is highly likely that a business angel will be more than happy with his new partner but will take a dislike to one or more of the company's employees. This is hardly unusual, and is actually one of the key reasons why an angel's lawyers or accountants will often investigate the company's employee provisions. Veteran angels know that there will be people working in a company who are not properly qualified for where they want to take the business. Angels should move on these problems sooner rather than later, and shareholders should be careful about where their loyalty ends and self-destruction starts. If the original shareholders have taken on a business angel, it is because this investor knows what he is doing and has a track record of success. Stopping him from doing his part by remaining loyal to an old retainer who cannot help the business may be detrimental to the whole company. Likewise, experienced business angels say that rooting out employees who may be personal friends of the original shareholders is never easy.

But when it has to be done it is better to mount a case whereby the original shareholders make the decision to terminate the person's employment, rather than letting the issue get to a point where it causes friction between the angel and the shareholders. Where the original shareholders will not terminate an employee, the angel might have the alternative position of giving the person a sideways promotion or, even better, putting the employee on a performance-driven contract. If the origninal shareholders have been arguing that the employee in question is a good operator, the contract solution will be hard to argue against. The fourth rule for living together is to make the hard decisions on employees early, for the sake of the business rather than on personal grounds.

Family

Where the company has a substantial family shareholding, even after the business angel has bought in, creating a good atmosphere for living together becomes the responsibility of the original shareholders. Because of the complicated loyalties and animosities that can develop in a family, the family members should have decided their goals and ambitions before the arrival of the business angel. It is too much to ask of an outsider that he commit capital to a company where the shareholders are still caught up in problems and arguments that have nothing to do with the business at hand.

Many experienced angels do not trust completely the dynamics of a family business, even though they may appreciate its stability. Many angels will not invest in family companies. Others, on entering family businesses, insist on preconditions that allow both parties to live together. These include clauses to stop non-executives or non-employees of the company taking positions on the Board; sometimes they go further and disallow non-executive shareholders. A simpler way for the business angel to ensure smooth sailing in a family company is to make sure he either has a majority voting bloc on the Board or owns at least 51% of the company. The fifth rule for living together is that the original shareholders should do everything in their power to make sure the company can run purely commercially with the business angel on board; the angel should make sure he has the ability to avoid family problems altogether by including appropriate clauses in the agreement.

Money

One of the reasons a business angel will conduct various levels of due diligence on prospective companies is to discover exactly how broke or cashed-up the company is. An angel is unlikely to throw $400 000 at a company that just happens to have a $400 000 tax problem. When the angel does invest, he is seen as the one with the money, which in itself can cause problems. Angels told us that they like to get to know their prospective partners so they can make sure they have their eyes on what is to be achieved rather than just the capital coming into the company in one big hit. One good way for both angels and owners to take their minds off the money, and therefore power imbalance, is to focus on what has to be done rather than what has happened with the bank balance. This goes back to 'duties' and 'goals'. One business person who attracted an angel said the relationship with the angel was always good because money was never put at the centre of the relationship; instead, the money had gone to boosting manufacturing and distribution capacity, while the angel performed his duties of opening up export markets in East Asian countries. Both parties did what they did best and money never became the issue.

In companies where the business angel's money becomes the major focus of the shareholders, all sorts of ancillary fights and disagreements can erupt over how much is being spent and who has the better company car. Other scenarios see complacency set in as soon as the angel's money is in the bank. Melbourne angel Colin Austin on at least two occasions found companies resting on their laurels as soon as he had invested his money. The sixth rule for living together is to focus on what has to be achieved rather than the money. This is a responsibility largely of the angel and the original owners.

The business

So much of this chapter relates directly back to the concept of knowing your prospective partners. This is especially pertinent in the simple-sounding yet prevalent issue of what it is that the company actually does, even in the best run, most professional and successful partnerships of business angel and small-business owner. Even without knowing that it is happening, a company that has been going in one direction under one set of owners can find itself in completely new territory under the influence of a strong-minded, success-oriented angel. One software/IT small company that was attempting to develop its own intellectual properties found itself — under its angel — doing product commercialisation work for other, smaller companies' properties. The strategy was enormously successful, as the angel was an expert at product commercialisation and at ensuring part-ownership of the IP, but the owners felt their company had been used to develop ideas which the angel had been aware of for some months before he invested in the company.

This issue crops up at different levels throughout the equity investment community. Both parties need to be clear and honest about what they want to achieve and their goals. Some of the problem can be solved before having to live together, but the remainder should be handled at monthly board meetings or strategy sessions. When the shareholders are setting their goals, that is the time to question where the company is going — not when the new strategy is a *fait accompli*. The eighth rule for living together is that success is not always desirable just because it is success; a company that is branching out or changing direction should be doing so by consensus. There should be no hidden agendas or unilateral actions in a partnership founded on equity investment.

Disputes

The dispute-resolution clauses in the agreement should only ever be seen as back-ups and a final resort should disputes grow out of control. Living together in business on a day-to-day and month-to-month basis requires small problems to be solved before they become big ones. Most of this is commonsense in theory but is often swept aside in practice. There is nothing wrong with disagreement in a company; it can be a sign of energy and commitment. But if a disagreement is not resolved, if one party becomes bloody-minded about getting their way, or if shareholders who should be having an opinion try to sidestep the issue, then disputes can quickly turn into fights. Where the business angel has bought into the company because of his financial power, he may end up either becoming the brunt of resentment and argumentative behaviour or he could find himself thrust into the role of peacemaker on an issue that was already stewing before he arrived.

Either way, board meetings were invented to deal with small fights and disagreements before they turned into big disputes. Extraordinary meetings of the Board can be used to vote down arguments while they are still small enough to handle with a smile. The ninth rule for living together is to tackle problems as they arise. It is advisable to keep goals and targets in writing, as these can often resolve disputes instantly and get people's minds back onto the job at hand.

Respect, honesty and good faith

They sound like old-fashioned concepts, but the more successful a business angel becomes the more these ideas become important to him. Some of the most successful and secretive business angels in Australia are multi-millionaires in their 50s and 60s who rely almost superstitiously on personal qualities of the people they invest in. In fact, the professional angels from Asia are famous for almost completely ignoring the business diagnostics of the prospective company for the first few meetings. These angels will usually have sourced the opportunity through the networks they trust and have a broad idea of what the company does and how much money it is making. What they are more interested in is the character of the person with whom they are going into business. They probe on matters to do with family, attitudes to do with society and broad inquiries that ascertain character. In this scenario, the method of living together in business is simple: invest in people you know and trust. And, most importantly, choose people you like.

VECCI's Bob Beaumont is not joking when he says the average business owner has about two minutes to impress a seasoned angel at a first meeting. This is because the good angels are interested in personal qualities and are highly sensitised to the people they do not want to be involved with. The final rule for living together is to behave as you want the other parties to behave towards you. Living together starts on the right track if both parties are respectful, honest and act in good faith.

8
Meet some entrepreneurs and business angels

All the generalisations in the world are inadequate to explain what business angels really are and how they behave. Following, therefore, is a sample of some of the entrepreneurs and business angels we spoke to during the writing of this book. In some cases their names have been withheld, but a trawl through their experiences will illustrate some of the points made in previous chapters.

The conservative angel: John

This chartered accountant, aged 63, wanted his name withheld. 'John' describes himself as a conservative. However, in his investment activities he has been a business angel for the better part of 40 years — a role he has embraced because taking equity in a small company is the 'most profitable and most satisfying' way of putting his money to work.

While he started as an angel in his early 20s, it was not until 1988 that he threw himself into equity investment as a serious and full-time concern. He has made 12 investments as an angel in the past eight years. He spoke to us on the understanding that he would not be required to provide detailed discussions of his major investments. It seems his years of accounting have given rise to strongly held views about confidentiality in business.

John was happy to discuss frankly the role of a business angel, and the important aspects of getting it right. In fact, he was the first to suggest that being a business angel is not the easiest — and not always the happiest — of investment techniques. His ideas are useful because his success rate has been high and these days he is well known enough in business angel circles that he is often approached for advice, and to form the backbone of investment syndicates where younger investors want a wiser head on board.

As an overall impression, John tells us that business angel activity is gaining attention in the media and among such professionals as accountants and lawyers because two phenomena have arisen at the same time: (i) men in their 50s are being given big golden handshakes as inducements to leave their companies; and (ii) people of this generation, who want their money to 'work', are not necessarily impressed with the stock market or property as viable investments. He says a lot of the people in their late 40s and early 50s grew up with Depression-era parents who hammered a mistrust of stock markets into their children. Now, as they grow older, they may look as if they are becoming cavalier with equity investment, but they are actually turning conservative and rejecting the potential horrors of the stock market.

In all the investments John has made, the 'people' aspects of the investment have been the most important. This can start with something as simple as whether you like and trust someone. He spends two to three months holding meetings with company owners before he invests. He wants to know about their lives, their families and their dreams: 'The personal chemistry has to be there; if it's not, you won't get anywhere'.

John will not proceed beyond the first 'date' unless he is convinced there is a basic sense of integrity in the company owner: 'Integrity is seen as an old-fashioned word these days. People say "Oh, that's the Asian way of doing business". Well, there was a time when it was the Australian way too'. There must be a frankness between himself and the entrepreneur if the deal is to proceed. He says that in business people must be able to have disagreements and even arguments without it spelling the end of the relationship.

Also, money is not the only or most important thing that a business angel has to offer:

> Our input on the management side is always more important than the money. Finding money is easy if the business is good. But usually when the business is not so good it's because they have the technical strengths but they are not so good at marketing or manufacturing. It's the specialist input they need as much as the money.

Consequently, he says the role of the business angel is usually to provide the objective, outsider's view of a business — to rearrange management structures, to develop strategies, to connect the company with important partners and associates and basically to push the business in a more organised, more 'corporatised' direction.

John says Australians are highly innovative, adaptable people. They invent more gadgets per capita than any other nationality. They also have the optimism and confidence to throw their life savings into developing their inventions. What these people do not have is a broader understanding of how their product will react with the outside world. Where will they make the product? How many will they make? Who will buy it, who will sell it, how will they distribute it and which countries will they export to? The business angel, according to John, is often the person who can see the answers to these questions, rather than just being the person with the money. Often, the business angel is the person 'who tells them to pull their horns in'.

John says he is typical of business angels: male, white, middle-aged and from a professional or business background. He operates in a network of similar types of investors. Sometimes they share the risk in a syndicate, sometimes not. In recent times he has joined VECCI's Business Finance Support Program to broaden his search for opportunities. But, like most experienced angels, he gets most of his leads and references from the network.

He is looking for 'blue-sky' opportunities in high-growth-potential industries (he is not interested in, for instance, garment manufacture). He does not want his money tied up for more than five years, so he is looking for a small company with a good idea but lacking in management, marketing, manufacturing or distribution expertise. In other words, he is looking for the company that can benefit very quickly from reorganisation, expertise and a good contact book. He will invest up to $200 000, he requires a seat on the Board and will spend at least half a day each week working on the company.

He looks for companies that can be developed to their next major stage. That could mean a trade sale, a merger with a bigger company, involvement of a venture capitalist or public listing. However it goes, he is looking for very large gains on his investment. 'The CGT should pale into insignificance', he says of the rewards for getting it right.

The entrepreneur turned business angel: Colin Austin

Colin Austin, aged 56, is an entrepreneur who became a business angel. The likable former Englishman built a company called Moldflow from nothing throughout the 1980s. It became the world leader in the computer-aided vacuum moulding of plastics. Moldflow set new benchmarks in precision and subsequently enjoyed great success in the car-manufacturing areas of the world, notably Germany, Japan and the USA.

In 1993 Colin received an offer too good to refuse, and sold the company. With the money he received on the sale, he could have basked on a Fijian beach for the rest of his life. But during his decade of building Moldflow to its exalted position in the plastics industries of the world, he had become aware of the ingenious inventions that existed in the backyards and garages of Australia.

With his new-found riches he set up an investment company which he called 'The Innovation Centre'. The company consisted of Colin, and its goal was to provide seed capital to people or companies with good ideas but little financial support. Most importantly, the Centre would provide international marketing support through the highest quality catalogues, CD-ROMs, videos and print campaigns. The marketing angle was important, he says, because many of the innovative companies were run by people from a technical/scientific background who knew nothing about marketing:

> Most of these companies didn't even know how to describe their proposition. They thought they would design something and the world would beat a path to their door. None of them had thought about the commercialisation stage of developing a product. They didn't know how to adapt their product to what the market wanted and then take it to that market.

His equity in the company would come in the form of owning royalties in the licensing arrangements for the products or 5% royalties on turnover. He would also be prepared to make loans available.

It did not work. After investigating more than 400 companies in the first year alone, he lost faith in his search: 'The world is full of nuts; thousands of would-be millionaires who have no idea of the commitment or tenacity involved in running a successful company'. He backed about 20 of these one-invention companies, each to differing degrees. They all could have made money, he says, but they did not:

> I'd come on the scene and I wouldn't have the technical skills. I'd suggest something but they'd resent my advice and they didn't want to change their product to what the market wanted; they thought the market should change to suit their great new invention.

He also encountered problems with some of the attitudes to his business angel funds: 'Many of these people would take a relaxed view once I was on board. It was..."Here's Colin

Austin with his millions from Moldflow — let's do dinner, let's go on holiday"'. The problem was that most inventors were inventing 'gizmos' rather than industrial applications. Another pitfall in investing in new inventions was the amount of time that could be wasted:

> It wasn't the whizbang ideas that were the problem — you'd know if they were wacky within 20 minutes. The problem was the ones which looked good, had good people and good ideas. You'd spend $10 000 just researching their products to realise that no-one wanted them.

From disappointing origins, Colin changed his investment emphasis from a scattered approach to a more integrated strategy, where he would invest in the development of various small companies with a single theme. He now has four companies in which he has taken 50% equity. All of these companies have innovative technologies under development and all of them are involved in irrigation, soil technologies and plant varieties. He is reluctant to give us the names of the companies, as they are at sensitive stages of development.

As an investment portfolio, he maintains that the individual companies were struggling as stand-alone entities. Colin hopes the critical mass of all four companies sharing a major investor will take each company further through strategic relationships and synergies. One of the big issues facing Australia in the next decade will be the damage to regions such as the Murray/Darling river basin. By gearing his companies towards major contracts with water boards, councils and environmental management authorities he believes the future could be very bright for soil/irrigation technology companies. Dairy farming also has irrigation and soil problems.

From the exit-strategy perspective of the business angel, Colin can look forward to either selling manufacturing licences to larger companies or selling out completely to larger competitors.

Along the way, he also invested in a truck-driver's air-conditioning unit which would sit in truckstops and be hooked into the truck window in much the way the speaker is hung at drive-in movies. Drivers could keep cool without having to leave their engines running. With Colin's investment (undisclosed) the company installed eight trial units in Mildura, but Colin withdrew when he saw that the money invested was not having the desired results. He now considers the investment 'written off'.

Another company had developed an electrolysis-based system for ridding women of cellulite. The inventors needed a cashed-up business angel to invest enough money to take the system offshore in search of a sale. 'You may ask: how do you stuff this up?', asks Colin now. They managed it. After an exhaustive trip to Paris it became apparent that frying cellulite was not exactly what the market was looking for. The company owner, instead of reworking the idea within established marketing principles, sold the licence for a pittance.

'He gave it away, then he walked away'. Colin had put just under $100 000 into developing and then trying to sell an idea that he believed could be franchised all over the world and eventually make tens of millions of dollars. Just another example, he says, of the lack of commercial sophistication he encounters too often.

These days Colin is happy with his four-company portfolio, which he will add to if there is a new technology that 'fits' his idea of integrated technologies. For now, he says the mission of the business angel is made difficult by inventors and innovators lacking either entrepreneurial adaptability or determination. He says most Australian inventors lack the determination to try and fail and try again. The thoroughness of an exhaustive marketing plan, with all of its research and data collection, is something still missing in most small and entrepreneurial companies. Some innovators, he fears, are simply not interested in the commercialisation of a product; it is easier for them to cast themselves as the childish inventor while letting the 'adults' do the backbreaking work of bringing a new product to market:

> I'm a bruised and skeptical angel. But if I saw the right idea tomorrow, I'd probably have another go.

The budding entrepreneur: Tim Carroll

Tim Carroll is a 33-year-old entrepreneur from Melbourne. During an extended ordeal in 1995 and '96, he pitched to some 40 business angels as he attempted to fund a database marketing concept that would tie Disney characters and products into a family club.

A successful and well-remunerated refugee from corporate Australia, Carroll had formed his own company, Frequency Marketing Pty Ltd, at the age of 29 in order to take advantage of the new software and applications in database marketing. His idea was to relaunch the Mousketeers Club of the 1950s with modern marketing techniques and technologies. It would be called the Disney Family Entertainment Club, and families would be able to join for $35.00. The membership would entitle families to a quarterly newsletter, videos, posters, and cheaper rates on subsequent videos and associated Disney products. The strength of such a system was that families could get cheaper Disney videos for their children and Frequency Marketing could build a valuable database of people who wanted to buy Disney products and could therefore be marketed to again and again.

The problem for Carroll was not initially Disney, which leapt at the chance to become a partner in the enterprise; by the end of 1993 Carroll's company had been made a licensee to Disney, with a royalty to pay on sold-through product. His problem was the capital required to set up the telemarketing and computer systems that comprise modern database marketing campaigns: 'I was looking for $200 000 and I spent 18 months searching for a business angel, although in those days I referred to him as "The Godfather"'.

From this point, until mid-1995, Tim Carroll became an almost full-time searcher and interviewer of business angels. He very nearly became a victim:

> First they spin you out to confuse you; I call it the Spin Cycle.
>
> They really want to leverage you with BS. It's all 'look

> at my wealth of experience, look at my white hair'. What they really want is to leverage their equity holding out to 80% or 90% so you're working for them.
>
> I found so many of them to be high on BS and very low on tangible 'let's do it'. It was a case of 'we will invest if we can run everything'.

The business angels he met were a merchant banker, an advertising executive, some multi-millionaires, small-business owners, former chairmen or executives of top-100 companies, and lots and lots of 'sharks'.

Carroll noticed something else as the months ticked past and the BS level rose: every time another business angel passed on the deal, he would alter his presentations and his business plan to suit the criticisms of the most recent investor, regardless of the next investor in line. He did not know it at the time but he was allowing these people to make him feel inadequate.

As this scenario developed, he found himself giving too much time to chasing investment and too little time to the business. Regardless of his efforts, when the Disney Family Entertainment Club was finally launched in August 1994 it was on the back of a $100 000 loan from Carroll's father and a $50 000 business loan from the National Australia Bank. His wife had left him by this stage. Still, the entrepreneur was looking for business angels, with the imperative now being to buy his father out of the business:

> All I could think about was getting the money back to my father, so I was looking for an investor for that reason. I was spending 40% of my time on the business and 60% on chasing money. And I still didn't have a contract with Disney.

In the first nine months of operation the Club made $450 000 in revenues. Although similar ideas for Disney had been tried in Italy and the UK only to fail, Carroll's was a success. There were 20 staff, a 4000-square-foot premises, and pending partnerships with some of Australia's largest retailers. Still no business angel would buy into the company.

In October 1995 Disney signed the contract with Frequency Marketing, and within three days Carroll had his business angels:

> Within three days of the contract, two angels put in $100 000. It was a one-hour meeting. I said, 'you can tell me all you want but the deal is 10% for $100 000'. My main priority was still to get my father out of it.
>
> But they said $60 000 now and $40 000 in the new financial year.
>
> They brought out the cheque book and once the money was under my nose I had to ring my accountant and ask what I should do with it. I didn't even know who it should be made out to.
>
> Carroll had his equity partners, but he also had new problems.

As soon as they were in, they wanted to control the company. They only had 10% but it was a vibrant, growing company and they couldn't keep their hands off it.

> One of the angels had been successful in franchised businesses. He was 60 and he said he wanted to be The Coach. I mean, Kevin Sheedy doesn't run onto the field.

Carroll clashed very early with 'The Coach', and had to explain that a 10% angel would not run the business. The other angel was an insurance executive.

Whatever the early problems, the company's fortunes took off between October 1995 and March 1996. They leased larger premises, the staff grew, there was a national television campaign and Nestlé had come on board as coalition partner, promising a whacking great cheque. By June 1996 Frequency Marketing was debt-free, with revenues of $1 million and running a 30% profit margin. The company was being courted by Warner Brothers, Mattel (Barbie) and the Turner Company for similar marketing campaigns for their product.

It was a dream come true, but it went sour for Tim Carroll, the investors and Frequency Marketing. Disney pulled out of renewing the licensing contract, three days before it was due to be signed on 1 July 1996. While this was happening, the investors were never far out of the picture. After all, they had a \$40 000 commitment to make in the 'new financial year'. That second round of funding was crucial; the Disney marketing operation had to be shut down while Frequency Marketing sued Disney for \$2 million, but there were other opportunities to go into business with Warner Brothers. However, when Carroll asked where the \$40 000 was, he was in for a shock:

> The one who owed the \$40 000 just refused to put the rest of the money in. We could have joined up with Warners but I couldn't get the money so we couldn't go on with it. It was that which forced the company into administration. The one who refused on the money just played on my good nature.
>
> The guy who called himself The Coach then resigned as a director without even telling anyone. These were people who came into my house and ate at my table.
>
> I had originally started the company for my daughter and here were these grey-haired men of experience. When the heat was on they just dropped the ball.

Tim Carroll went away, licked his wounds and came back tougher, smarter and with even more ideas. In his next enterprise, as the Australian management of a Seattle-based Internet commerce company, he will offer four blocks of equity at set prices and conditions. The angels will do it his way. Having been through one disappointment with equity investors he will take a different tack this time. The following is Tim Carroll's advice to an entrepreneur dealing with prospective business angels:

1. A deal's not a deal until the contract is signed. Anyone who tells you to trust them is a crook. If it's worth trusting, it's worth having in writing.
2. Always do a due diligence on the people doing due diligence on you. Due diligence is a two-way street. Just because someone's got a Rolls parked in front of a mansion doesn't mean they have money.

3. Ask for a $1000 deposit so you know they're serious. The money can be held in a trust account. Otherwise you are giving all the information and all of your time and they are giving nothing.
4. Tell them the process; control the process. It's your business so start acting like it's worth something. Before you give any plans or intellectual property or time away, create steps of action for the business angels. Make them actually *do* something as an act of good faith.
5. Get letters of intent (LOI); minimise the 'trust' factor.
6. Make sure any due diligence doesn't obligate you to sell equity. Some business angels sneak obligations into the due diligence process.
7. Confidentiality agreements are useless...but you should always have one.
8. Hold back the business plan, marketing plan, cash projections and intellectual property until talks progress and an act of faith has been cited; never furnish this information at the first meeting.
9. Set a time frame; if you can't get the money in a month, forget it. Tell the angel that negotiations will take 14 days in which time 'I will give this and you will give this'. Most angels will say 'No' but that just saves you time.
10. Ignore all promises; respond only to actions.

Highest on Carroll's 'must do' list for entrepreneurs is attitude. Angels, he says, are so accustomed to dealing with desperate people that they get used to the feeling of making someone feel stupid or unsuccessful in their presence. He advises people seeking equity finance to be very organised, very focused and

> never be afraid to tell one of these people to get stuffed. The only reason an angel is sitting down to talk with you is that he thinks you've got a good idea and he wants to make some money out of it. He's not doing you a favour, so stop treating him like he's a god.

Business angel set to fly: Ross McDonald

Ross McDonald is a 29-year-old chartered accountant who excelled at university and then in the professional world. But while still at university a decade ago he became interested in the idea of informal equity investment along with his friends. It was not until he and two others — an airline pilot and a marketing guru — were in their late 20s, earning good salaries, that the concept of investing in a small company again emerged as a serious proposition:

> My colleagues and I were on good money and we were as educated as we could be. We couldn't really leave our work because of the opportunity costs but we decided we could use the skills we had been trained with to work on a business where the owner hadn't had the time to stick his nose in the books; someone who hadn't been able to stand back and look at his business objectively.

Early in the search, the airline pilot took a job overseas, and the syndicate was down to the chartered accountant and the marketing guru:

> We were looking for the best of both worlds. We would keep our careers during the week, but in the evenings and the weekends we would have a business to work on. Both of us were more interested in more work than going out to a pub or something.

McDonald says the idea of buying into a company, fine-tuning it into a real success and then selling out again had come from some of the case studies and assignments during university of small companies going under for certain reasons:

> It is apparent to anyone who has studied small businesses that no-one is good at everything. That's why large corporations have divisions of experts.
>
> In small business, the value of partnerships and different skills working together cannot be underestimated. If you can't buy those skills then you have to find them another way.

When McDonald and his colleague first started looking for opportunities, they encountered not only mistrust between entrepreneurs and potential investors but also suspicions from accountants and lawyers. At this early stage, he says, both of them realised that a new approach would be needed; although they had up to $100 000 to invest, they would not invest capital because that was the subject that got people off on the wrong foot; it also saw the doubting accountants and solicitors becoming involved. Instead, they would earn their equity holding through devoting time and expertise to the business. They would not demand any regular payments, but neither would they do any paying of their own.

The syndicate's first investment was in a Melbourne organic fruit and vegetable wholesaler. McDonald says the small company had a great idea and had a virtual monopoly on the supply of organic vegetables to metropolitan Melbourne. However, the business was operating on very tight profit margins and the bank debt had blown out. The bank in question had refused to lend more money or extend the overdraft.

McDonald and his partner met with suspicion at first, especially from the company's lawyer who was very protective of the troubled business. So the business angels ended up taking a 30% stake in the business, but on an option basis; if McDonald's syndicate could turn the business around through their expertise, the company owners would have the choice of either paying them consulting fees or signing over the 30% holding in the company:

> We produced reports and marketing plans, fixed the people who were mainly the problem and the profits turned around. They got out of trouble and we wanted to be in the company — we saw the potential.
>
> But their lawyer got stuck on the control issues. We took the money in the end: $12000 for consulting fees. We'd taken them to a level where they were organised and no longer in trouble, so they didn't need us. They didn't want to take the next leap of growth.

The second company McDonald's syndicate looked at wanted all their angel expertise without giving up anything:

> People are very protective about their businesses. Some only want to hear what they want to hear. In the second company, I ended up saying 'Do this, or you'll bleed. Get a partnership with a milling company'.
>
> But they probably won't because it's too much trouble for them.

McDonald said the personality issues in looking for equity investment opportunities were more important than either he or his partner had ever envisaged. Both business angels and entrepreneurs had to learn to see things through the other's eyes or nothing would ever be achieved. From McDonald's point of view, what entrepreneurs have to start doing is seeing their business in terms of business issues such as management and marketing:

> Most of the companies we look at have pretty bad management. Many of the owners have never been in a structured environment where they have to perform to an objective benchmark, so they often don't see the woods for the trees.
>
> Successful small companies have the product and the vision, the understanding, coordination and communication. And they know how to bring in the experts when the business needs it, just like Bill Gates.

He says many small-company owners confuse an emotional attachment to their business with doing what is best; sometimes when they think they are protecting the company they are actually stopping it from growing. Along with mistrust of outsiders and overly protective attitudes, there were also many small-business owners who exaggerated or lied about their businesses in order to attract business angels: 'We're still out there looking. Sometimes though the companies aren't what they claim to be'.

On the other hand, he is quite aware that business angels have to make an act of faith and be open to the companies. Arrogance, he has found, makes most companies withdraw from negotiations immediately: 'At the organic wholesaler, they had seen five business angels before us and sent them packing; they just didn't like the attitude'.

The future for successful business angels, he predicts, lies in showing what they can do for a company, rather than just throwing their money and weight around:

> Debt is not so hard to find. What these companies really need is expertise in finance, marketing and management. It's not just about putting capital to work but skills and experience.
>
> Entrepreneurs should ask what the business angel is bringing to the table. It should be more than money and it must be in the contract.

His syndicate will 'look at' about half the proposals they receive and will actually talk on the phone with a third of that half:

> Now we're looking at a company which needs its overdraft knocked down and a few things done. We will throw an initial $40 000 in but really our input will be tweaking the company.

The invention's search for an angel

For commercial reasons, 'Peter' wanted his name withheld. He is a 48-year-old former marketing manager who designed a better system of display for retail. He had initially created the display idea for a client in early 1994, at which point he realised it was an intellectual property worth marketing as his own. But having no funds behind him, and with the client refusing to put up any development money, Peter took six months to make a prototype:

> I couldn't attract any investors and the banks were hopeless. One bank manager told me I was trading insolvently and basically threw me out of his office.

To make the first display systems and to have a model of his idea he taught himself model-making and rudimentary tool-making. The prototype was finished in June 1995, at which point the client was interested. In fact, the client was so interested that he showed the system to a large retailing chain in order to get clearance for the concept, which is where the story becomes troubling.

As many small-business people know, the embrace of a large corporation is as likely to crush you as protect you. In Peter's case the retail chain wanted the displays, not only for Peter's client but for all of the client's competitors too; the retail chain was taking over:

> This happens all the time; essentially, the idea gets hijacked without being hijacked. They wanted the idea but they wouldn't help with financing, the development or with tooling.
>
> At the same time I couldn't get an investor because the retail chain wouldn't place an order, and you can't attract investors cold if all you can say is 'This large company might make an order if they like our first production run'. The chain store won't place an order until they see the first production run and are happy with it.

For the next year and a half Peter worked the phones, met the angels, took the rejections, went broke and got divorced. By the end of 1996 he was becoming depressed as his idea — so close to success — was no further advanced. In the midst of his despondency his accountant advised him to seek bankruptcy, so Peter fired him:

> It's very hard to find an investor who's right. You have to get all the criteria right just to get his interest; then you have to get him to part with his money. I learned that it's best to target your angel and then chase him down.

Peter was not new to the innovation game. In the late 1980s he had devised a soluble fibre formula for use by diabetics and weight-watchers. He had sold the patent on the formula to a pharmaceutical company. Unfortunately, most of the deal rested on royalties from sales, and when Wallace got into financial trouble the expected rivers of gold failed to flow.

This time, he had landed the big client with a multimillion-dollar annual budget for displays, but he was stuck in limbo and not impressing the business angels who were steered his way:

> I was being approached by investors with big superannuation money; it wasn't really there to invest, they wanted no-risk projects. One fellow kept me talking for three months then asked me for bricks and mortar.

One group of three investors courted Peter for six months. They drew up heads of agreements, contracts, letters of intent and even wrote to Peter's bank advising that they were paying out his overdraft in order that Peter might take out a loan and reach settlement with his former wife. One of the business angels was even going to work in the company with Peter:

> On the Monday he was supposed to start, the person who was going to work alongside me turned up at 10 o'clock and said 'The deal's off, we've changed our minds'.
>
> That's what it's like being an entrepreneur.

On the advice of a mentor, he changed his presentation from a rambling half-hour monologue on his trials and tribulations to a two-page pitch which ignored his history and concentrated on the product and its prospects. Also on advice, he went through the *Yellow Pages* looking for a manufacturer which would be a business angel but, instead of supplying pure capital, would supply a resource as well — in this case, tooling. He found a factory on the first page:

> They were keen on the idea; they could see how it would make money. But they had just bought another factory in another city and they didn't have the time or money to get involved. Then a friend of mine tipped in $100 000. I went back to the factory, showed them the money, and said I wanted them as a resource anyway.

The manufacturer has now provided the infrastructure, factory space and tooling for the first runs of the displays. By now Peter will have made the first production runs for his displays and the verdict will have come down from the corporation:

> The big thing I learned from all this I learned right at the end of the process: you must train yourself to stand outside your project and see it as others would see it. Otherwise, you'll become a prisoner of your own idea.
>
> The others who see it are going to be business angels who have had a lot of success in business and they are very rational and able to find a thousand reasons why your idea won't work. That can be soul-destroying but you must accept it.
>
> My current deal may still fall through.

Angel and match-maker: Brian Meltzer

Brian Meltzer is a merchant banker who has a unique view-point on business angels and the way they operate: not only is he a business angel himself, but he runs a discreet matching service for well-organised small firms and cashed-up equity investors.

Aged in his 40s, Meltzer currently has a portfolio of five equity investments, which he admits are showing a bias towards companies involved in business services. His investee companies include telecommunications, human resources, marketing services, software and printing. He prefers to take a majority position in a company, a decision he reaches by measuring entry price against expected performance. He also does his own due diligence:

> There are a whole range of equity deals out there; some insist on 51% or more while others are prepared to take minority positions. Some investors want to be active participants and then others are happy to have their money in and just turn up for the monthly meetings.
>
> Me? I'm active and I prefer a majority position, although I do take a minority position for the right deal.

Meltzer brings more than money to the table: he brings skills in strategy, decision making, financial structuring, marketing and his network contacts. He also expects the company owner(s) to be receptive to his expertise and skills:

> Normally I'd only invest where I thought they were open to contributions and willing to listen. Where there seems to be an entrenched culture, then I would assess very closely the people.

He is also interested in being pitched a business venture rather than simply an idea:

> One of my big turn-offs is the company owner who enthuses solely about a product or invention. A lot of these things are fantastic inventions and people bring them in and spend an hour telling me how good they are. And I say 'You don't have to convince me — I accept it'.
>
> I want to see if they can turn a good idea into a good income-generating business. They lose me if they don't have a story, if they don't have a marketing plan. I like to be involved in a business, not products.

Meltzer admits that he likes to get the people and the business as right as they can be before he invests because there are no guarantees of returns on investment in the business angel game. He has been known to invest in a company where he did not personally like the owner, but usually, he says, he does not invest if he does not like the people involved.

Similarly, his rules on what an investment should return are broad rather than specific:

> There's no certain return benchmarks; with some investments you'd be happy if you could get 15% on your money. Other deals you'd only take if you could double your investment.

Likewise, the parameters for exit are dependent on circumstances:

> If you have a minority holding in a company then the exit is very important and liquidity is very important. When you have a minority share you have to ask yourself if you can list or if there's a ready market for your holding.
>
> If you have a majority holding you don't really care: you might even keep the company long term for a nice income stream.

He defends his focus on taking majority positions as something the business owner needs and therefore the necessary lure for a business angel to commit his money:

> A business owner will accept the investor's majority holding when he is extremely capital-constrained. They realise a small piece of a growing pie is better than 100% of nothing. They've gone as far as possible.
>
> As an investor you have to consider exit issues: how marketable is a share in that company when it's a minority share? Maybe you could get out with a trade sale or get the other shareholders to buy you out in a put option. But that doesn't always happen.

He says his experience as an investor has shown him that, while Australians are innovative and have a lot of energy for new projects, most small companies lack business skills, especially in management and marketing.

Other angels come to him looking for investments, as do small companies looking for an investor. Most of the leads have originated from inside his network or from the networks that overlap his. Meltzer keeps his matches to a minimum and introduces people only where he is fairly certain the meeting will result in a deal:

> Capital-constrained companies know that I can find them an equity investor. I also have a very good network of wealthy investors looking for opportunities.

He says the business angels and entrepreneurs who approach him want a completely confidential service:

> Some of the investors are on BRW's top-200 list. They don't want their financials advertised up and down Collins Street. They don't see why they should have to lift their skirts.

He says he is secretive about his matching service because business angels themselves are secretive. He does not even have a shopfront, preferring to operate out of the offices of a leading Melbourne law firm.

The marketing entrepreneur: Tony Course

Tony Course is the 39-year-old owner of a small marketing company called Loyalty Magic Pty Ltd. About two years ago his small company developed advanced computer software which could run customer-loyalty programs. When hitched up to the customer database files and the accounting systems, the software triggers follow-ups, offers and promotions to certain customers.

While the software was world class and a winner in various computer show product awards, Course could not get the capital he needed to push his software onto the world stage. Software moves so quickly and intellectual property is so prone to being surpassed that he felt the need to get Loyalty Magic wide brand recognition as soon as possible:

> The banks were just hopeless. They just had no interest or understanding. Around the beginning of 1996, we got into a long negotiation with a business angel but he didn't turn out.
>
> What we had was a good product, a good set of clients, but no money and no contacts. We joined the VECCI matching service and the first business angel invested in us. We were very lucky.

Course prefers not to disclose how much money the investor put in, but he does tell us that the angel settled for a minority shareholding. What the angel brings to the company, says Course, is something money cannot buy:

> We needed his money, but it wasn't until he was on board that we realised how much we needed his contacts. It's a different world; he knows the right people for every situation. People we would work at for a month just to be told we couldn't meet with them, our angel opens them up in a few minutes.

In one instance, Loyalty Magic was working on getting the AFL clubs interested in the benefits of the customer-loyalty software:

> We had been sending the letters, trying to get to meet someone, but we were getting nowhere; all our approaches were being delegated downwards and nothing was happening.
>
> Our investor turned around and got us a meeting with David Smorgon, the president of Footscray Football Club.

The investment must already have sparked off bigger ideas for the business angel because he has entered into talks with Australia Post about a joint venture with the software. In order to make a go of the Australia Post opportunity, Loyalty Magic will need another capital infusion to gear up to the next plateau. The business angel has solved that problem by having several other angels from his network on standby to syndicate further equity investment:

> We would never have got anywhere near a deal with Australia Post without the investor. And he has other investors ready to put more money in. It's amazing how fast things move when you have the money *and* the right person.

Course feels very comfortable with equity investment as a form of capital-raising: 'They take a risk and so do you. You take the same risk'.

Appendix 1
A sample shareholders' agreement

The sample shareholders' agreement is based on the following scenario.

The business angel is investing in an existing company, Widgets Pty Limited, which has its plant and offices at 22 Smith Street, Brookvale in Sydney, Australia.

There are two existing shareholders in Widgets, each holding 50 ordinary shares, purchased for one dollar each when the company first began business. Each of the existing shareholders owns his shares in his own name. One of the existing shareholders looks after the general operations (he is the managing director) and the other looks after the technical and production side of the business. Each of the existing shareholders is a director of the company.

The company has a July to June financial year, and accounts have been prepared up to 30 June, 1998. These accounts form the basis of the business angel's assessment of the financial aspects of the company.

The business angel will buy a 50% shareholding in the company for the sum of $50 000 and, in addition, will lend the company a further $150 000 over a period of three years on commercial terms. The business angel will have the right to appoint two directors (but for now, only he will become a director). He will acquire his shareholding by subscribing for additional (new) shares, rather than purchasing shares from either of the existing shareholders. The business angel is an experienced businessman and has many 'contacts' that could be very useful to the company.

The existing shareholders and the business angel agree that all key decisions must be approved by either the Board or by the shareholders themselves. The business angel requires each of the existing shareholders to enter into a service agreement with the company in an approved form, setting out agreed entitlements and obligations, including restraints on them competing with the company after they cease to be employed by the company. The business angel is to become a director of the company and the chairman of the Board.

Shareholder 2 is technically brilliant and, at least at present, is vital to the Company. He is to be insured under a keyman insurance policy for $200 000.

Because of the relatively small sum involved, the business angel has had only a brief due diligence carried out and requires comprehensive warranties from the existing shareholders.

The company manufactures and sells widgets, under the name Widgets Australia, pursuant to a patent that is owned by the company; and all parties agree that the company will confine itself to doing this unless they all agree to the contrary. All parties agree that the company will either become listed on a stock exchange or be sold to a competitor within five years; so have set an agreed 'sunset' clause for that time.

The company owns no real estate of its own and leases its business premises. The lease of those premises contains a clause that obliges the company to obtain consent from the landlord if there is a 50% or more change in the shareholding of the company.

Additional points about the sample agreement

In the sample shareholders' agreement

- the company has been added as a party so it is formally aware of the arrangements among its shareholders;
- schedules have been used as it is easier to substitute information and terms into a schedule than into the main body of the agreement;
- words inside square brackets are examples only (to suit the described scenario) and should not be taken as being a necessary or normal arrangement;
- angle brackets are prompts where further information is required.
- 'Constitution' is the new term for what was previously known as the memorandum and articles of association.

New issue v. buying existing shares

Watch the capital gains tax implication of purchasing from an existing shareholder. Sometimes it is better to have the business angel acquire new shares issued by the company; but this does change the 'calculations' somewhat because the money paid for the new shares goes to the company rather than to the existing shareholders.

Parties

If either existing shareholder or the business angel holds, or intends to hold, his shares through a company or a trust, it is usually necessary to add the individuals controlling those entities as additional parties, in order to get the full force and effect of their promises.

* * *

THIS AGREEMENT is made on the day of 199< >.

BETWEEN **<EXISTING SHAREHOLDER 1>** of <ADDRESS>, [New South Wales] (**"Shareholder 1"**);

AND: **<EXISTING SHAREHOLDER 2>** of <ADDRESS>, [New South Wales] (**"Shareholder 2"**);

AND: **<BUSINESS ANGEL>** of <ADDRESS>, [New South Wales] (**"Shareholder 3"**);

AND: **WIDGETS PTY LIMITED** A.C.N. <> <ADDRESS>, [New South Wales] (the **"Company"**).

WHEREAS:

A. The Company has a paid up capital as set out in Schedule One.

B. The names of the registered holders of all of the issued and allotted shares in the capital of the Company are set out in Schedule Two, and each of such registered holders is the beneficial owner of the number of shares there set out opposite his name.

C. Shareholder 1, Shareholder 2 and Shareholder 3 are to become the beneficial owners of all of the issued shares in the capital of the Company.

D. Shareholder 1, Shareholder 2 and Shareholder 3 have entered into this agreement to regulate their relationship as shareholders of the Company and to set out their agreement in regard to the management, control and future ownership of the Company.

E. The Company has joined in this Agreement to take notice of the provisions contained in it and, as far as it is permitted by law, to conduct its business and affairs in the manner contemplated by such provisions.

IT IS AGREED that, in consideration of the mutual promises herein given and received:

1. DEFINITIONS AND INTERPRETATION

1.1 Definitions. In this Agreement, and in any instrument created pursuant to or in accordance with it, unless the context otherwise indicates or requires:
"Accounts" means the balance sheet and the profit and loss account of the Company for the period ended on the Accounts Date, true copies of which are attached to this Agreement;
"Accounts Date" means [30 June, 1998];
"Agreed Rate" means [two (2) percentage points above the overdraft rate charged by the Company's bankers from time to time];
"Business" means the [widget manufacturing] business presently carried on by the Company and any other business approved by the Board;
"Board" means the board of directors of the Company from time to time and includes any committee of that board;
"Completion" means completion of the matters set out in clause 3 and clause 4;
"Loans" means any money loaned to the Company by a Shareholder, or an associate of a Shareholder, pursuant to clause 7;
"Shareholders" means Shareholder 1, Shareholder 2 and Shareholder 3 for as long as they respectively hold shares in the capital of the Company;
"Tax" means income tax (including capital gains tax), franking deficit tax, pay-as-you-earn remittances, prescribed payments, withholding tax (including deductions pursuant to the royalty withholding obligation), fringe benefits tax, customs duty, sales tax, payroll tax, land tax, stamp duty, financial institutions duty, debits tax, municipal rates and all other taxes, charges, imposts, duties and levies and any penalties, interest, fines or other costs relating thereto; and
"Tax Act" means any legislation of a federal, state or territory of Australia imposing a Tax.

1.2 Interpretation. [Various rules of interpretation]

2. CONDITIONS PRECEDENT

2.1 This agreement, and the obligations of the parties under it, are subject to the following conditions (the "Conditions"):
(a) each of Shareholder 1 and Shareholder 2 entering into a service agreement with the Company for a period of not less than [five (5)] years in a form approved by all Shareholders;
(b) Shareholders 3 being issued all of the shares referred to in clause 3;
(c) Shareholder 3 being appointed a director of the Company;
(d) if so required under the terms of its lease, the Company obtaining

consent in writing from the lessor of its business premises to Shareholder 3 becoming a shareholder in the Company; and

(e) this Agreement being signed by all of the parties to it.

2.2 The parties will take all steps necessary, and will use their best endeavours, to ensure that the Conditions are fulfilled at the earliest practicable date and, in any event, within [one (1) month of the date of this Agreement].

2.3 If, notwithstanding due compliance by each party with its obligations under clause 2.2, the Conditions are not satisfied [within one (1) month of the date of Agreement], unless all Shareholders in their absolute discretion waive any outstanding Conditions, this Agreement may be rescinded by any party. If this Agreement is rescinded pursuant to this clause:

(a) the rescission will be a rescission from the beginning of the Agreement and each party will use its best endeavours to put each party back in the position it was in before the signing of this Agreement;

(b) any moneys paid by any pursuant to this Agreement will be refunded; and

(c) no party will be liable to pay any sum for damages, costs or expenses to any other party.

3. OBLIGATIONS OF SHAREHOLDER 3

As soon as is practicable, Shareholder 3 will:

(a) apply for the issue and allotment to him of shares in the capital of the Company, in the number and for the amount set out opposite his name in Schedule Three; and

(b) give written consent to the Company, in a form reasonably required by the Company, of his preparedness to act as a director of the Company.

4. OBLIGATIONS OF OTHER PARTIES

As soon as is practicable:

(a) Shareholder 1 and Shareholder 2 will cause a meeting of the Board to be held at which:

  (i) the Board will resolve that the application for shares referred to in clause 3(a) will, subject to payment of the relevant amount set out in Schedule Three, be issued and allotted to Shareholder 3; and that a share certificate for those shares be issued to Shareholder 3 after such allotment; and

  (ii) subject to receipt of the appropriate form of consent to act, Shareholder 3 is appointed a director of the Company;

(b) the Company will enter into a service agreement with each of Shareholder 1 and Shareholder 2 in a form approved by all Shareholders; and

(c) the Company will, if so required under the terms of its lease, obtain written consent from the lessor of its business premises to the change of shareholding in the Company envisaged by this Agreement.

5. OPERATIONS OF THE COMPANY

5.1 The business of the Company will be confined to the manufacture of [widgets] and related activities and to such other activities as all Shareholders from time to time agree in writing.

5.2 The Shareholders will, in their respective capacities as a shareholder or a director of the Company, or in any other capacity whatever, use their best endeavours to ensure that the affairs and operations of the Company are conducted in a vigorous, efficient and profitable manner and in accordance with good business practice in all respects.

5.3 The Shareholders will ensure that, unless they all agree in writing 'to the contrary', the affairs of the Company are conducted by the Board in a manner consistent with, and so as to achieve, the following:

(a) the Board will consist of not less than [three (3)], and not more than [four (4)], directors of whom [one (1)] will be appointed by Shareholder 1, [one (1)] will be appointed by Shareholder 2 and up to [two (2)] will be appointed by Shareholder 3;

(b) meetings of the Board will be held at least [monthly];

(c) a quorum of the Board will be [two (2)] directors of whom at least [one (1) will be a nominee of Shareholder 1 or Shareholder 2 and at least one (1) will be a nominee of Shareholder 3];

(d) each director will have (1) vote;

(e) the following matters in relation to the Company must be submitted to the Board for approval:
   - (i) determination of the dividend and the declaration of dividends;
   - (ii) distributor, agency, licensing and similar agreements;
   - (iii) service contracts for key employees;
   - (iv) remuneration packages for all directors, officers and other key employees;
   - (v) insurance policies including "keyman" policies;
   - (vi) annual and monthly budgets;
   - (vii) new ventures or projects or any changes or proposed changes in the existing business of the company;
   - (viii) significant acquisition or disposal of assets;
   - (ix) charging or encumbering assets; and
   - (x) assumption of liabilities including borrowings, leases, guarantees and other material contractual obligation and liabilities;

(f) [detailed monthly budgets] of the Company will be submitted by the [Managing Director] to the Board for approval, and an annual budget of the Company will be submitted to the Board for approval prior to each annual general meeting of the Company. If the Board does not approve any such budget, the Board will require a new budget to be prepared and submitted for approval without delay;

(g) the [Managing Director] will prepare and submit to the Board a monthly report relating to the performance of the Company and to such other matters as the Board may reasonably direct from time to time;

(h) except as provided in this Agreement, the Company will not issue any share(s) in the Company to any person;

(i) except as provided in this Agreement, the Company will not borrow, lend, give guarantees or grant any security or surety otherwise than in accordance with its approved budgets;

(j) the Board will recommend, and the Company will declare, dividends in respect of the issued shares in the Company in amounts each year of income being in aggregate not less than [fifty per cent (50%) of the after tax profit of the Company] in respect of that year of income;

(k) the Company will effect and maintain a "keyman" insurance policy on the life of the person(s), and in the amount(s), set out in Part A of Schedule Six, and naming the Company as the beneficiary; and

(l) any proposed alteration in the capital structure of the Company will require the approval of all Shareholders.

[NOTE: THIS IS MERELY A SAMPLE LIST OF COMMON REQUIREMENTS AND INDIVIDUAL REQUIREMENTS SHOULD BE ADDED OR DELETED AS APPLICABLE TO THE PARTICULAR TRANSACTION]

5.4 Each Shareholder will promptly and fully disclose to the others all information learned, obtained or produced by him in relation to the affairs of the Company which is material to the Company, including any infringement (or any threatened or likely infringement) or any intellectual or other property or other protected rights relating to the products, services or assets of the Company.

5.5 The day to day management of the business and affairs of the Company will be the responsibility of the [Managing Director] who will consult with, and obtain the agreement of, the Board in respect of all matters of commercial significance concerning the affairs of the Company.

5.6 Unless otherwise agreed by all Shareholders:

(a) the chairman of the Board will be the person described as such in Schedule Four;

(b) the [initial] Managing Director, directors and secretary of the Company will be the persons described as such in Schedule Four;

(c) the registered office of the Company will be the office described as such in Schedule Four; and

(d) the [solicitors, accountants, auditors and bankers] for the Company will each be the firm or company described as such in Schedule Five.

5.7 The Shareholders will:
(a) provide the Company with the benefit of their business and technical expertise to develop and further the business of the Company; and
(b) provide the Company with (or assist the Company, at the cost of the Company, to procure) such financial, marketing and other advice, information and assistance as may reasonably be requested by the Company from time to time;

PROVIDED THAT, except as set out in this Agreement, no Shareholder will be obliged to provide services, personnel (other than its appointed directors), facilities, equipment or other property or rights other than for fair and reasonable remuneration.

5.8 Shareholder 1 will be responsible for the [day to day operations of the Company and the Business, reporting to the Board].

5.9 Shareholder 2 will be responsible for the [technical operations of the Business, reporting to the Managing Director].

5.10 Shareholder 3 will:
(a) pay to the Company the sum of money set out against his name in Schedule Three;
(b) as soon as practicable after the Conditions have been (as applicable) met or waived, advance to the Company the sum of [one hundred and fifty thousand dollars ($150,000.00)] on the following bases:
    (i) the advance will be secured by a first registered fixed and floating charge over all of the assets of the Company;
    (ii) the advance will carry interest at the Agreed Rate;
    (iii) the term of the advance will be [three (3) years], with the principal sum to be reduced by the amount of fifty thousand dollars ($50,000.00) each twelve (12) months; and
    (iv) the provisions of clause 7 will not apply to this advance;
(c) provide commercial contacts, on a regular and on-going basis, to contribute to the sales and profits of the Company; and
(d) be responsible for the raising of additional capital for expenditure or development by the Company, in accordance with budgets approved by the Board.

6. RIGHTS AND RESTRICTIONS RELATING TO SHARES

6.1 Except as provided in this Agreement, no shares in the Company may be transferred unless and until the rights of pre-emption set out in clauses 6.4 to 6.13 (inclusive) have been exhausted.

6.2 In addition to the requirements set out in clause 6.1, any Shareholder who wishes to transfer his shares in the Company to any person who is not a party to this Agreement must, as a condition of such transfer, require that prior to such transfer being completed each transferee enters into an agreement with all other parties to this Agreement on the same terms and conditions as those contained in this Agreement.

6.3 No Shareholder may mortgage, charge or otherwise encumber his shareholding interest, or any other interest, in the Company or the Business without the prior written consent of all Shareholders.

6.4 Every Shareholder who is proposing to sell or otherwise dispose of or transfer any shares in the capital of the Company (the **"Vendor"** and the **"Vendor Sale Shares"** respectively) must give written notice (a **"Transfer Notice"**) to the Board of his intention, specifying the number and class of the Vendor Sale Shares and the price the Vendor fixes as the fair value of the Vendor Sale Shares.

[Clauses 6.5-6.12 set out the procedure to have the Vendor Sale Shares valued, if necessary, and for the existing shareholders to have right of first refusal to purchase the shares.]

6.13

(a) If there is a Change in Control of a Shareholder (being a corporation), unless all of the other Shareholders otherwise agree in writing, that Shareholder will be deemed to have given a Transfer Notice to the Board pursuant to clause 6.4 that it desires to transfer the whole of the shares held by it at the price determined by the Valuer in accordance with clause 6.5 or clause 6.6, and the provisions of clauses 6.4 to 6.11 (inclusive) will thereafter apply.

(b) For the purpose of this clause a **"Change in Control"** of a Shareholder means the acquisition by any person or corporation, either alone or together with any associate of that person or corporation, of a relevant interest (within the meaning of that term in the Corporations Law) in more than fifty per cent (50%) of the issued voting capital of that Shareholder.

6.14 If any Shareholder:

(a) being an individual, becomes or is made bankrupt, makes any assignment of his estate for the benefit of creditors or otherwise takes advantage of any law for the time being in force relating to insolvent debtors, or permits his shares to be levied upon any execution or other legal process; or

(b) being a corporation, is dissolved or goes into liquidation (whether voluntary or otherwise), except for the purpose of amalgamation or reconstruction, or an administrator, receiver or receiver and managed is appointed to such Shareholder or the whole (or any part) of its undertaking or assets;

(c) transfers, creates or grants (or attempts to transfer, create or grant) voluntarily or by operation of law any shares or any interest (legal or equitable) therein other than in accordance with the provisions of this clause 6; or

(d) being an individual, ceases (for any reason other than his death) to be an employee of the Company;

then, in any case to which paragraph (c) applies, such transfer, creation or grant will be deemed to be void and, in every other case, that Shareholder (or its trustee in bankruptcy or liquidator, as the case may be) will be deemed to have forthwith thereupon given a Transfer Notice to the Board that he desires to transfer the whole of the shares held or formerly held (as the case may be) by the Shareholder at the price determined by the Valuer in accordance with clause 6.5 or 6.6, and clauses 6.4 to 6.12 (inclusive) will thereafter apply.

7. LOANS

7.1 If the Company requires further funds for working capital or otherwise and the Board considers that such further funds should be raised from the Shareholders then, with the prior written consent of all Shareholders, the Shareholders will contribute (or procure the contribution from an associate of) such further funds in proportion (after making allowance for the amount, if any, of their existing Loans to the Company) to their respective shareholdings in the Company on the basis provided in this Agreement.

7.2 Unless all Shareholders otherwise agree in writing, the following details will apply in relation to the Loans:

(a) subject to paragraph (c), the term of each of the Loans will be [twelve (12) months] from the date it is advanced; and

(b) interest on a Loan will be calculated from the date of each Loan advance and will be payable on that Loan (or on so much of it as is from time to time outstanding) at the Agreed Rate. Interest will accrue from day to day and will be payable [three (3) monthly in arrears]; and

(c) if the Company commits an Event of Default (as set out in clause 8.1), each Loan (or so much of it as is then outstanding), together with accrued interest to that time, will be immediately payable.

7.3 The Shareholders may charge (and recover as a debt due from the Company) interest at the Agreed Rate on any instalment of principal or interest of their respective Loan(s) not paid on the due date for payment, from that due date until the same is paid to or recovered by them in full.

7.4 The Shareholders will be entitled (but not obliged) to apply all money received by them from the Company in relation to their respective Loan(s) towards outstanding interest before applying any such money in reduction of the outstanding principal of such Loan(s).

7.5 For as long as any part of a Loan has not been repaid, the Company:
(a) may not repay (or offer to repay) the whole or any part of any one (1) or more of the Loans without offering to repay the whole or the same proportionate part of each of the Loans; and
(b) will not repay (or offer to repay) the whole or any part of the Loans unless there are sufficient funds from which, consistent with the obligations of the Company under this Agreement and any applicable law, the Company is able to make such repayments and redemptions.

7.6 The Company will have the right, at any time and from time to time, to make payments of [one thousand dollars ($1,000.00)] or a multiple thereof in reduction of the principal amount of the Loans or to repay the whole of the Loans (or the outstanding balance thereof) PROVIDED THAT the Company may not reduce or offer to reduce the principal amount of any one (1) or more of the Loans without offering to reduce the same proportionate amount of each of the Loans.

8. EVENTS OF DEFAULT

8.1 Each of the following events or circumstances is, for the purposes of this Agreement, an Event of Default:

[Various events, including breaches of this agreement, breaches of warranties and insolvency actions against the party]

and the party in default is called the **"Defaulting Party".**

8.2 If an Event of Default occurs then, at any time thereafter, any Shareholder (unless he is the Defaulting Party) may declare his Loan(s) due and payable; and all other moneys due and owing by the Company to the Shareholders (whether actually or contingently) will become immediately due and payable (together with interest at the Agreed Rate) on the date of that declaration (the **"Due Date"**).

8.3 Notwithstanding that a declaration may have been made under clause 8.2, interest will continue to accrue and be payable after the Due Date on any money owing under this Agreement, in the same manner as it would have accrued and been payable if no such declaration had been made.

9. RESTRICTIONS ON OPERATIONS OF SHAREHOLDERS

9.1 No Shareholder may during the term of this Agreement, except to the extent permitted by this Agreement, undertake or participate in any venture or activity which is the same as or competitive with the operations of the company without first offering in writing participation in that venture or activity to the Company on a basis no less favourable to the Company than is available to the offering Shareholder. That Shareholder may undertake or participate in such venture or activity only if, pursuant to a resolution of the Board, the Company declines the offer of participation.

9.2 For the purposes of clause 9.1 a Shareholder will be deemed to undertake or participate in a venture or activity if that Shareholder (or a related body corporate or associate) directly or indirectly, alone or in conjunction with another or others, carries on or conducts, or is engaged, concerned or interested in, any such venture or activity, whether as principal, agent, director, shareholder or employee of any other such person or as debenture holder or holder of any other security.

9.3 If the Company undertakes to carry out or conduct a venture or activity of a kind referred to in clause 9.1, each Shareholder will (as far as possible) ensure and procure that the Company does all things reasonably necessary to comply with its obligations in connection with that venture or activity.

10. CONFIDENTIAL INFORMATION

10.1 The parties will not disclose or use, or permit to be disclosed or used, other than for the purpose of the business of the Company, any confidential information of the Company or any confidential information supplied by any Shareholder to the Company except:

(a) in the case of confidential information supplied by a party, with the consent of that party;
(b) in the case of confidential information of the Company, with the consent of all Shareholders;
(c) in respect of information which has become public knowledge other than as a result of unauthorised disclosure by any of the parties; or
(d) information disclosed by any party to its auditors or its accounting or legal advisers, or required by law to be disclosed to any person.

10.2 Each party will use its best endeavours to ensure that those of its employees, agents and contractors who are at any time in possession of such confidential information do not disclose or use it (or permit the disclosure or use of it) for any purpose other than in the course of their duties.

11. WARRANTIES

11.1 **Warranties.**

(a) (**Terms**): Each of Shareholder 1 and Shareholder 2 covenants, warrants, represents and undertakes to and with each of Shareholder 3 and the Company in the terms set out in Part A of Schedule Ten, it being al term of this Agreement that each of such covenants, warranties, representations and undertakings is true and correct in every respect.

(b) (**Construed Separately**): Each covenant, warranty, representation and undertaking in Schedule Nine is to be construed separately, with the meaning of each to be in no way limited by reference to any other clause or paragraph other than the disclosures in Part B of that Schedule.

11.2 **Indemnity.**

(a) (**By Vendors**): Subject to clause 11.4, Shareholder 1 and Shareholder 2 indemnify and hold each of Shareholder 3 and the Company harmless against all losses, claims, costs, demands, liabilities and expenses which may be suffered, sustained or incurred by Shareholder 3 as a result of, or in respect of, breach by either or both of Shareholder 1 and Shareholder 2 of any of the covenants, warranties or representations on their part contained in this Agreement.

(b) (**Claims**): Any claim for indemnity by Shareholder 3 or the Company against either or both of Shareholder 1 and Shareholder 2, and any acknowledgment or admission of liability by either or both of Share- holder 1 and Shareholder 2, must be in accordance with the Notices clause of this Agreement.

12. TERM AND TERMINATION

12.1 Subject to any provision requiring or permitting earlier termination, this Agreement will continue for an initial term of [five (5)] years from its date; and prior to the conclusion of that initial term the Shareholders will meet to determine whether the term should be extended.

12.2 If all Shareholders do not agree to extension, the Shareholder(s) not wanting an extension will be deemed to have given a Transfer Notice pursuant to clause 6.4.

12.3 If all Shareholders agree to an extension, but do not agree on the term of that extension, this Agreement will be extended for the shortest period nominated by a Shareholder.

12.4 Clauses 12.2 and 12.3 will be capable of successive operation in respect of further extensions of the term of this Agreement.

12.5 At the expiration of the term (or any extension as provided in clause 12.3), unless the rights of pre-emption which arise as a consequence of clause 12.2 are exercised the Shareholders will, without delay, cause the business of the company to be sold and the Company to be wound up and, for the purposes of such winding up, will:

(a) cause the Company to transfer and assign (or re-transfer and re-assign) all property of any nature to the person entitled to it in accordance with this Agreement or any other agreement or arrangement;

(b) sell and dispose of the assets and undertaking of the Company (either by way of public auction or public contract) for such price or prices as can reasonably be obtained for such assets;

(c) do all things necessary to enforce payment of, and receive all moneys due to, the Company;

(d) pay and satisfy all the debts of, and moneys due by, the Company; and

(e) take all steps necessary for the purpose of liquidating the Company.

12.6 The Shareholders may at any time determine (by unanimous vote) that the Business should be wound up and, upon such determination being made, the provisions of clause 12.5 will apply.

13. COMPLIANCE BY COMPANY

Where, under this Agreement, the Company is expressed to be under any kind of obligation, in addition to the Company being under that obligation, each of the Shareholders will be bound to do all on his part possible and necessary (whether as a director or a shareholder of the Company or of a Shareholder, or otherwise) to ensure that the Company duly and perfectly complies with such obligation.

14. PARAMOUNTCY

The provisions of this Agreement will prevail over any inconsistent provision in the Constitution of the company.

15. FURTHER ACTION

[Each party will do all things necessary to give effect to the intentions of the parties as envisaged by this Agreement.]

16. GOOD FAITH

[Each party will act promptly, reasonably and in good faith...]

17. VOTING

Unless stated to the contrary in this Agreement, decisions of the Shareholders will be on the basis of a simple majority with each Shareholder having one (1) vote for each voting share held by him.

18. DISPUTE RESOLUTION

If a dispute arises out of, or relates to, this Agreement (including the breach, termination, validity or subject matter of it) the parties will endeavour to settle the dispute by mediation administered by a mutually acceptable mediator. If the parties are unable to agree as to a suitable mediator, the mediation will be administered by [mediator's name].

19. PUBLICITY

No public announcement or communication relating to the negotiations of the parties or the subject matter or terms of this Agreement may be made or authorised by, or on behalf of, any party without the prior written consent of the other parties.

20. NOTICES

...

21. STAMP DUTY AND COSTS

The costs and expenses of and incidental to the preparation and execution of this Agreement, and any stamp duty payable on this Agreement, will be paid by the Company.

22. CONSENT

Where this Agreement provides that any particular transaction or matter requires the consent, approval or agreement of any party that consent, approval or agreement may be given subject to such terms and conditions as that party may impose and any breach of such terms and conditions by any person will be deemed to be a breach of the terms of this Agreement.

23. SEVERABILITY

...

24. FORCE MAJEURE

...

25. ALTERATION

Except as stated in this Agreement the terms of this Agreement can be amended only in writing, signed by the parties.

26. ENTIRE AGREEMENT

...

27. WAIVER

...

28. TIME OR INDULGENCE

...

29. NOT A PARTNERSHIP

...

30. ASSIGNMENT

No party may assign any of its rights, benefits or obligations under this Agreement without the written consent of the other parties.

31. NO REPRESENTATIONS

Each party has entered into this Agreement without relying on any representation by any other party or any person purporting to represent any other party.

32. MERGER

...

33. GOVERNING LAW AND JURISDICTION

...

34. COUNTERPARTS

..

Schedule One

(Issued Capital of the Company)

[Fifty dollars ($50.00)] comprising [fifty (50) ordinary] shares.

Schedule Two

(Shareholdings in the Company)

Shareholder 1: [twenty five (25) ordinary] shares.
Shareholder 2: [twenty five (25) ordinary] shares.

Schedule Three

(Shares to be Applied For)

Applicant	No. of Shares	Amount to be Paid
Shareholder 3	[50 ordinary] shares	[$50,000.00]

Schedule Four

(Officers and Registered Office)

Chairman:	[Shareholder 3]
Managing Director:	[Shareholder 1]
Directors:	[Shareholder 1, Shareholder 2 and Shareholder 3]
Secretary:	[Shareholder 2]
Public Officer:	[Shareholder 2]
Registered Office:	[22 Smith St, Brookvale]

Schedule Five

(Solicitors, Accountants, Auditors and Bankers)

Solicitors:	<>
Accountants:	<>
Auditors:	<>
Bankers:	<>

Schedule Six

Part A — Keyman Policies (Insurance Policies)

Insured	Amount
[Shareholder 2]	[$200,000.00]

Part B — Other Insurance
[Set out details]

Schedule Seven
(Intellectual Property)

Patent
Patent No. <> dealing with the manufacture of widgets.
Business Name
The Company carries on business under the business name "Widgets Australia" registered in New South Wales and Victoria.

Schedule Eight
Employees
[Set out details of all employees of the company]

Schedule Nine
Warranties

Part A - Warranties
Shareholder 1 and Shareholder 2 covenant, warrant, represent and undertake to Shareholder 3 and the Company that, other than as disclosed in Part B of this Schedule:

1. Share Capital and Shareholders

(a) The shares described in Schedule Two and Schedule Three comprise the entire issued share capital of the Company at the date of this Agreement.
(b) All issued shares are fully paid up and have been duly issued and allotted.
(c) No person has any right or option to subscribe for, or to otherwise acquire, any further shares in the Company.
(d) There are no outstanding options, contracts, calls, first refusals, commitments, rights or demands of any kind relating to the issued or unissued capital of the Company.
(e) The Company is not under any obligation to allot any shares to any person or persons, or to otherwise alter the structure of any part of its unissued share capital, and no option exists (nor is the Company under any obligation to give any option) over any part of its unissued share capital, nor has the Company offered to do any of the foregoing.
(f) Each of Shareholder 1 and Shareholder 2 is the registered holder and beneficial owner of the shares shown against his name in Schedule Two.
(g) All issued shares in the capital of the Company are free of any encumbrance.
(h) Shareholder 1 and Shareholder 2 each has the power to enter into and

perform this Agreement, and has obtained all necessary consents to enable him to do so.

(i) The entry into, and performance of, this Agreement by Shareholder 1, Shareholder 2 and the Company does not constitute a breach of any obligation (including any statutory, contractual or fiduciary obligation), or default under any agreement or undertaking, by which any of them is bound.

(j) Neither Shareholder 1 nor Shareholder 2:
   (i) (if any individual) has been made bankrupt, and no bankruptcy petition has been presented, or is threatened or is expected to be presented, against either of them; or
   (ii) (being a company) has gone into liquidation or passed any resolution for winding up, no petition for winding up has been presented against either of them, and no receiver or receiver and manager of the undertaking or assets (or any part thereof) of either of them has been appointed or is threatened or expected to be appointed.

2. Company.

The Company:

(a) is accurately described in this Agreement;

(b) is duly incorporated;

(c) has full corporate power to own and carry on the Business as now conducted;

(d) has done everything necessary to do business lawfully in all jurisdictions in which the Business is carried on;

(e) has no subsidiaries (within the meaning of that term in the Corporations Law); and

(f) has not gone into liquidation or passed any resolution for winding up; no petition for winding up has been presented against the Company; no receiver or receiver and manager of the undertaking or assets (or any part thereof) of the Company has been appointed or is threatened or expected to be appointed; and there are no unsatisfied judgments or arbitral awards outstanding against the Company.

3. Accounts.

The Accounts:

(a) disclose a true and fair view of the state of the affairs, financial position and assets and liabilities of the Company as at the Accounts Date and the income, expenses and results of the operations of the Company for the period ended on that date;

(b) include in the balance sheet sufficient reserves and provisions for Tax to cover all Tax liabilities (whether or not assessed and whether actual, contingent, deferred or otherwise) of the Company up to the Accounts Date;

(c) contain adequate provisions for all other liabilities (whether actual, contingent, deferred or otherwise) of the Company as at the Accounts Date; and
(d) have been prepared:
  (i) in accordance with the Corporations Law and applicable accounting standards;
  (ii) in the manner described in the notes to them and the accompanying auditor's opinion; and
  (iii) on a consistent basis with the audited accounts for the prior financial year.

4. Period Since Accounts Date.
(a) There has not since the Accounts Date been:
  (i) any material adverse change to the financial condition, or in the trading operations, of the Company from that shown in the Accounts;
  (ii) any material change in the nature, amount, valuation or basis of valuation of the assets or in the nature or amount of any liabilities of the Company;
  (iii) any borrowings, other than as in the Accounts or in accordance with existing overdraft facilities from its bankers; or
  (iv) any dividend declared or other distribution made (except as may be contemplated by this Agreement).
(b) There has not arisen since the Accounts Date any item, transaction or event of a material or unusual nature likely to affect substantially the operations or results or state of affairs of the Company.
(c) Since the Accounts Date:
  (i) the Company has carried on the Business in the ordinary regular and normal course;
  (ii) no material asset has been acquired or disposed of;
  (iii) no liability has been incurred except in the ordinary course of business;
  (iv) no contingent liability has been incurred by the Company; and
  (v) the Company has used all reasonable endeavours to preserve the goodwill of the Business.
(d) None of the debts shown in the Accounts has been released or settled for an amount less than that reflected for such debts in the Accounts and, to the best of the knowledge and belief of Shareholder 1 and Shareholder 2, all such debts owing to, and accounts receivable by, the Company are good and collectable in the amount disclosed in the Accounts (other than for any allowance in the Accounts for doubtful debts); and to the best of the knowledge and belief of Shareholder 1 and Shareholder 2 no such accounts receivable are (or will be) subject

to any counterclaim or set-off other than in respect of money payable by persons also shown as creditors of the Company in the amounts shown in the Accounts (as such amounts may have been affected by transactions in the ordinary course of business since the Accounts Date).

5. Commitments.

5.1

(a) The Company is not directly or indirectly obliged in any way to guarantee, assume or provide funds to satisfy any obligation of any person, and has not given a letter of comfort to any person.
(b) The Company is not party to any agreement or arrangement under the terms of which any other party, by reason or any change in the beneficial ownership of shares in the Company or in the management or control of the Company, becomes entitled to terminate such agreement or arrangement earlier than it would, except for such change, have been liable to be terminated, or require the adoption of terms less favourable to the Company than those subsisting in the absence of the change.
(c) The issue of the shares to Shareholder 3 in accordance with this Agreement does not, and will not, constitute a breach of any obligation (including any statutory, contractual of fiduciary obligation), or default under any agreement or undertaking, by which the Company is bound.
(d) There are no outstanding commitments of the Company for capital expenditure other than replacements and normal purchases of plant and equipment in the ordinary course of business.
(e) There are no foreign exchange contracts binding the Company, and there are no foreign exchange exposures of the Company.
(f) The Company is not party to any agreement in terms of which it is (or will be) bound to share its profits or pay any royalties (except to the extent to which it may in the ordinary course of business calculate and pay commissions to salesmen).

5.2 To the best of the knowledge and belief of Shareholder 1 and Shareholder 2:

(a) every material contract, instrument or other commitment to which the Company is a party is valid and binding according to its terms and, without prejudice to any other warranty, no party thereto is in material default under the terms thereof;
(b) the Company is not a party to any contract or commitment entered into which:
    (i) is outside the ordinary course of its business;
    (ii) even if entered into in the ordinary course of business, involves (or is likely to involve) obligations or liabilities which, by reason of

their magnitude or nature, ought reasonably to be made known to an intending new shareholder in the Company;

(iii) is not at arm's length or not on normal commercial terms; or

(iv) is long term, substantial and/or onerous;

(c) no offer, tender, quotation or the like given or made by the Company is capable of giving rise to a contract merely by any unilateral act of a third party, other than in the ordinary course of business; and

(d) no customer or supplier of the Company has ceased or reduced (or has indicated an intention to cease or reduce) trading with the Company as a result of a further person or company becoming a shareholder in the Company.

6. Business.

6.1

(a) The Company is the legal and beneficial owner of all of the assets used in the Business, and such assets are free of any encumbrance.

(b) The Company holds all statutory licences, consents, authorisations and permits necessary for the proper carrying on of the Business and the use of its business premises and they are each valid and subsisting. There is no fact, matter or circumstance known to either of Shareholder 1 or Shareholder 2 that might prejudice the continuance or renewal of any such licence, consent, authorisation or permit.

(c) The Company:

(i) will not at Completion hold (or have agreed to acquire or take up) any shares in the capital of any company, apart from investments in the ordinary course of business;

(ii) is not a member of any partnership, joint venture or unincorporated association;

(iii) is not a trustee or manager of any trust estate or fund; and

(iv) does not have a permanent establishment (as that expression is defined in the Tax Act) outside Australia.

(d) No powers of attorney given by the Company in favour of any person are in force.

(e) The accounts, books, ledgers, financial and other records of the Company:

(i) have been fully and properly maintained and contain due records of all matters required by any relevant legislation to be entered therein, and there has not been removed there from any material records or information;

(ii) contain or reflect no material inaccuracies or discrepancies;

(iii) give and reflect a true and fair view of the trading transactions, or the financial and contractual position, of the Company and of its assets and liabilities; and

(iv) are in the possession of the Company.

(f) Shareholder 1 and Shareholder 2 will not permit the name of the Company to be changed before Completion and have not permitted (and will not permit before Completion) the Company to consent to the adoption by any other person or company of a name similar to its name.

(g) The Constitution of the Company produced to Shareholder 3 is a true and correct copy of that document and will remain so until (and as at) Completion.

(h) All directors and the secretary of the Company have been duly appointed in accordance with the Corporations Law.

6.2 To the best of the knowledge and belief of Shareholder 1 and Shareholder 2:

(a) the business of the Company is conducted in accordance with all applicable laws, does not contravene any laws, and no allegation of any contravention of any laws by the Company is known to them;

(b) the Company has complied in all respects with:
    (i) all instruments to which it is a party or by which it is bound; and
    (ii) all legal requirements and all judgments, orders, injunctions and requirements of any court, commission, board or other governmental, semi-governmental, municipal or administrative body or competent authority;

    and there has not occurred any event which, with the effluxion of time or the giving of notice, would constitute a material breach or default thereof;

(c) all plant, equipment and vehicles owned by the Company are in good order and repair except for fair wear and tear;

(d) all stamp duties and other taxes for which the Company is primarily liable in respect of every deed, agreement or other document to which the Company is or has been a party have been duly paid or adequately provided for and no such deed, agreement or other document, the time for stamping of which has expired, is unstamped or insufficiently stamped; and

(e) the assets of the Company are:
    (i) fully paid for;
    (ii) in the possession of the Company;
    (iii) used solely for the purposes of the Business;
    (iv) the only assets used in the Business; and
    (v) not the subject of any finance lease, hire purchase agreement, operating lease, rental agreement or any other agreements for the purchase on deferred terms.

7. Property Leases and Premises.

7.1

(a) The premises situated at [22 Smith Street, Brookvale] (the "Premises") are the only real property owned or leased by the Company.

(b) The lease of the Premises is valid and binding on the parties and enforceable in accordance with its terms.

(c) A true copy of the lease of the Premises has been provided to Shareholder 3 prior to the date of this Agreement, and there are no material terms of such lease other than as set out therein.

(d) Shareholder 1 and Shareholder 2 have disclosed to Shareholder 3, prior to the date of this Agreement, full and correct details of all commitments (whether legally binding or otherwise) of the Company to take leases of any premises.

(e) There is no current material dispute relating to the Premises or their use.

(f) No notice has been received by the Company from any statutory, legal or public authority requiring any work to be done, or any money to be expended, on the Premises; and the Company has received no notice (and is not aware of any pending notice) of proposed resumption, compulsory acquisition or any other matter affecting the Premises.

7.2 To the best of the knowledge and belief of Shareholder 1 and Shareholder 2:

(a) the Company has properly performed and observed the covenants of its lease of the Premises;

(b) the Company has made all payments required by the lease of the Premises and has complied with all other material terms of such lease; and

(c) the lease of the Premises is valid and binding on the parties and enforceable in accordance with its terms.

8. Environmental Compliance.

8.1

(a) There is no adverse agreement or consent order to which the Company is a party in relation to any environmental matter.

(b) There have been no orders issued which have not been fully complied with and cleared, investigations conducted or other proceedings taken or threatened by any governmental body or other regulatory authority or threatened in writing by any person under any applicable environmental laws and regulations with respect to the Business.

(c) The Company has not received any written communications which have not been fully complied with and cleared concerning alleged violations of environmental legislation or claims with respect to environmental matters with respect to the Business.

(d) All permits required under any applicable environmental laws and regulations to own and operate the Business have been obtained by the Company and are in good standing.
(e) No claim has been made in respect of the use or operation of the Premises by any adjoining land owner or other party.

8.2 To the best of the knowledge and belief of Shareholder 1 and Shareholder 2:
(a) there is no environmental contamination to the Premises (including contamination of the atmosphere, air, soil, sub-soil, ground water or surface waters within or adjacent to the Premises);
(b) no hazardous materials, and no other materials intended for use in, or generated by, the Business have been or are used, stored, treated or otherwise disposed of by the Company in violation of applicable existing environmental laws and regulations;
(c) any hazardous materials removed from, or emitted by the Company at, the Premises were and are documented, transported and disposed of in compliance with all applicable existing laws and regulations;
(d) no materials, including effluence leachate, emissions or hazardous materials generated on or emitted from the Premises, have caused (or will cause in whole or in part) any environmental contamination; and
(e) the conduct of the Business does not constitute a nuisance.

9. Intellectual Property and Other Rights.
(a) Schedule Eight accurately describes:
 (i) all registered and unregistered business names and trade marks;
 (ii) all registered patents and designs;
 (iii) all applications for registration of trade marks, patents and designs which are owned or used by the Company in connection with the Business; and
 (iv) all licenses used by the Company in connection with the Business; (together in this Schedule the **"Intellectual Property"**).
(b) The Company:
 (i) has all necessary right, title and interest in and to the Intellectual Property;
 (ii) has not on-licensed any of the Intellectual Property; and
 (iii) has not assigned or disposed of any right, title or interest in the Intellectual Property.
(c) The Intellectual Property is:
 (i) legally and beneficially vested in the Company;
 (ii) not being presently infringed, and is not the subject of any dispute, litigation or expungent application (whether threatened or other- wise); and
 (iii) not subject to any licence or authority in favour of any third party;

(d) Neither the Intellectual Property, nor the Company's use of the Intellectual Property, infringes against the intellectual property rights of any other person.
(e) Neither Shareholder 1 nor Shareholder 2 is aware of any conflicting use by any other person of any Intellectual Property owned or used by the Company.

10. Litigation.
(a) The Company is not engaged in any prosecution, litigation or arbitration proceedings.
(b) There are not legal proceedings pending or threatened by or against the Company, and there are no facts or disputes which might give rise to any such proceedings.

11. Insurance.

11.1
(a) Part B of Schedule Six accurately describes all contracts of insurance and indemnity in force in respect of the Business, property and assets of the Company.
(b) Each of the contracts of insurance and indemnity is in force and there is no fact or circumstance known to Shareholder 1 or Shareholder 2 which would lead to any of them being prejudiced. None of the contracts of insurance and indemnity will be terminated or cease to have effect as a result of the transactions contemplated by this Agreement.
(c) The assets of the Company are adequately insured in respect of the risk to which they are subject (including loss or damage by fire, theft, storm and tempest) in such amounts as accord with sound business principles and such insurances will not expire prior to Completion.
(d) The Company is adequately insured against public liability, product liability, loss of profits and all other risks in such amounts as accord with sound business principles, and such insurances will not expire prior to Completion.
(e) The Company is adequately insured against workers' compensation liability.
(f) All premiums in respect of the insurances referred to in clause 11(a) of this Schedule will have been paid prior to Completion.

11.2 To the best of the knowledge and belief of Shareholder 1 and Shareholder 2:
(a) there are no claims outstanding, pending, threatened or capable of arising against the Company in respect of any incident, accident or injury which are not fully covered by insurance;
(b) all claims against the Company which are notifiable by the Company under its insurances have been notified; and

(c) all claims which have been notified under the Company's insurances are all fully covered by those insurances.

12. Taxation.

(a) The Company has duly complied with all obligations imposed by, and the provisions of, the Tax Act.

(b) The Company has filed all returns under the Tax Act for all previous years, together with any applicable certificates, notices, declarations and any other lodgements. All such returns were correct and on a proper basis, and no dispute exists in relation to any of them; and there are no facts or circumstances which might give rise thereto.

(c) All Tax for all prior income and franking years, which has been assessed or imposed or which is deemed to have been assessed or imposed or which is lawfully assessable or payable by or upon the Company, has been duly assessed and paid.

(d) In relation to the Company, all credits and debits to any franking account maintained by the Company have been duly and properly recorded in accordance with the Tax Act, giving rise to a franking account balance in conformity with the Tax Act, and there are no existing or pending statutory franking debits in relation to dividend streaming arrangements, share buy-back purchases or otherwise.

(e) Adequate provision has been made by the Company for any Tax on the Company which the Company is aware is payable or may become payable but which is unpaid.

(f) All copies of any information, notice, computation or return submitted by the Company in respect of any Tax which have been supplied by Shareholder 1 and Shareholder 2 or their advisers are true and complete copies of the originals.

(g) The Company is not aware of any pending or threatened Tax audit.

13. Filings.

To the best of the knowledge and belief of Shareholder 1 and Shareholder 2, the Company has filed all annual returns, resolutions, returns and documents as and where required to be filed or registered under the Corporations Law or its predecessor, the Companies Code; all such returns and forms were accurate in all material respects; and the Company is not liable to be struck off the register of companies.

14. Staff and Superannuation.

14.1

(a) Schedule Nine contains full and correct details of:

   (i) the employees of the Company and the employment conditions of all employees of the Company; and

   (ii) all contracts of service, or for services, and all letters of appointment in respect of any employees of, or consultants to, the Company which cannot be terminated on less than two (2) months notice.

(b) Each of the contracts entered into by the Company with employees or consultants is enforceable against the parties to it and there is no party in breach of, or in default under, any such contract.

(c) Since the Accounts Date, the Company has not paid any bonuses or increases in salary (other than normal increases to employees in the ordinary course of business or as imposed by industrial awards) or otherwise altered the remuneration, emoluments or benefits or other conditions of employment of any officers or employees of the Company.

(d) Since the Accounts Date, the Company has not paid any remuneration or fees to its directors other than normal remuneration to executive directors.

(e) The Company has complied with all applicable industrial awards and agreements and all statutory requirements, in respect of its employees.

(f) The Company has complied, and until Completion will continue to comply, with all of its superannuation commitments.

(g) Unless required by legislation to do so, the Company will not increase its superannuation commitments between the date of this Agreement and Completion, without the written consent of Shareholder 3.

(h) The transactions contemplated by this Agreement will not cause any increase in the superannuation commitment of the Company.

(i) The Company has duly made all necessary payments on behalf of employees and other persons in order to avoid incurring any liability to pay the superannuation guarantee charge under the Superannuation Guarantee Charge Act 1992.

14.2 To the best of the knowledge and belief of Shareholder 1 and Shareholder 2, the Company has complied with its obligations under each agreement, statute, industrial award or code of conduct in respect of the employees of the Company.

<u>Part B - Disclosures</u>

[Set out any information at variance to the warranties in Part A]