

Informal Venture Capital in Australia

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*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 a sheep on 'thirds', with a loan from a Sydney capitalist who would take a third of the profit (A. Shaw, *The Story of Australia* (1954)).*
(quoted in Abernethy and Heidtman 1999).

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 (Abernethy and Heidtman 1999).

There are various sources of the supply of venture capital for small firms. One of these is informal venture capital supplied by private individuals called 'business angels'. This appendix is an overview of informal venture capital in Australia, the profile of business angels and the development of services to bring angels and small firms together.

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Informal Venture Capital in Australia

Formal venture capital (FVC) is provided by enterprises (often called funds) which formally screen and select small investee companies with the potential for high growth and high financial returns within a five to seven year period. Funds are siphoned from investors (financial institutions such as superannuation funds, non financial institutions, and private individuals) by the venture capital entity to investee companies.

Informal venture capital (IVC) has been defined by the Industry Commission (1997) as:

Equity investment by a person (business angel) in a small or medium-sized business, where the investment is not made through any intermediary such as a managed investment fund. As an equity partner the investor shares the profits and the risk of business failure, as do venture capital firms which provide equity to businesses. The investment usually involves direct contact between the investor and the initial owners, at least initially for the investor to assess the business and decide whether or not to invest. The investor may also have a continuing involvement with the business.

Researchers have tended to exclude from the definition of IVC, funds supplied by owners, family, relations, friends and other people closely associated with the small firm. In other words, IVC has been regarded as supplied by external investors to the firm.

The suppliers of IVC have been called 'business angels' (BAs). The business angel was originally a cash rich investor, the strange bedfellow of entrepreneur and philanthropist to the arts. The 'business angel' was the last minute saviour of Broadway and West End stage productions that had run into financial difficulties before the opening night. The following definition is a generally accepted one around the world:

An individual who invests equity capital directly into a business, usually a small or medium-sized business. These investors often also work in some capacity with the business, alongside the original owners, and often become a director of the company. However, neither of these features is considered essential for an investor to be classed as a business angel. Business angels may provide loan finance and other assistance in addition to equity investment (Industry Commission 1997).

Beginning with the MIC impetus from 1983 (see Chapter 3) there has been a significant growth by the end of the 1990s in the supply of FVC funds and the number and variety of venture capital firms. This has been accompanied by professional and media commentary and the collection of data by the Australian Venture Capital Association Ltd. (AVCAL) and more recently by the ABS (2001).

Information, publicity and data regarding IVC was almost non-existent prior to 1995. Only after the release of two government commissioned studies, *Financing Growth* (1995) and the *Investment Readiness Study* (1997), IVC and BAs gained some prominence. About the same time Hindle and Wenban (1999) completed an exploratory survey of the profile of BAs and their investment interests in Australia.

As with FVC, the Australian market for IVC is younger and smaller than in countries such as the UK and the US (Industry Commission 1997). Because of its informal and private nature there are few generally accepted and accurate statistics regarding the size of this market. Hindle and Rushworth (2000) in the *Global Entrepreneurship Monitor (GEM) Australia 2000* survey (refer Chapter 1) claimed that Australia ranked 10th among 21 surveyed countries in terms of BAs as a per cent of national population.

In August 1996 the *Industry Commission* (1997) included extra questions concerning IVC in the quarterly survey of the *Yellow Pages Small Business Index* completed by 1,208 small business operators throughout Australia with 1 – 19 employees. The focus was on investment from people not previously associated with the firm, and who were neither family members, nor close friends before the investment was made.

It was found that 1.7% of the businesses had received equity investment from a BA at some time in the previous few years. The number of firms with more than 19 employees with such investment would not have been zero, but the number would have been small. **(1)** By extrapolating to the overall small business population with employees, the researchers established that 6,800 small firms received angel funds ie. roughly 1.9% of small employing firms.

The average investment size was \$150,000 giving a ballpark estimate of total informal equity investment as \$1b. **(2)** A 'guesstimate' placed the average number of investments per angel at two or three, implying that 2,300 – 3,400 people in Australia had invested as a BA in at least one business.

Total informal equity investment of around \$1b. at that time was small compared to UK and US experience where total IVC was claimed to be a multiple of total FVC of around two in the UK and around six to eight in the US. Also, it seems likely that at least five times as many SMEs received BA equity in Australia as received equity from FVC firms. **(3)**.

Two federal government commissioned studies have provided an important impetus to IVC in Australia and these are now discussed.

Financing Growth (1995)

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

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

- 1 The "vast majority of SMEs (had) no aspirations for significant growth". Probably only about 10% of small firms "aspire, plan and achieve growth (to) provide the essential dynamism of the SME sector".
- 2 Most growth firms seeking equity are not 'investment ready' ie. they fail to meet fundamental requirements to be attractive to external investors.
- 3 Despite the difficulties small firms have in obtaining investment capital, there is no shortage of capital in Australia. However, major difficulties lie in the efficiency of the market's allocation processes and the ability to deal with the risk, uncertainty, high cost and regulatory impediments incurred when investing in small business.

- 4 High search, information and transaction costs, and risks and uncertainty, are inherent characteristics of the small firm capital market that constrain the flow of capital to small firms.
- 5 Corporation Law prospectus requirements and other regulations act as major constraints and impediments in the already difficult search process that emerging growth firms must undertake in order to obtain equity.
- 6 There is virtually no information on the current and potential role of Australian private investors in small business.
- 7 A gap exists in the supply of equity finance in Australia for amounts approximately between \$0.5 and \$2m. This is above the typical upper threshold of most potential business angels and below the typical minimum investment threshold of many venture capital firms. Little is known about the magnitude and significance of this gap and the extent to which amounts of less than \$0.5 million are actually serviced by business angels.

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

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

In addition, gazelles need to meet other minimum criteria to be attractive to investors including the following.

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

The recommendations of the *Financing Growth* inquiry included (pp. 1-5):

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

The National Investment Council reported that even among the Australian gazelles that were seeking external equity, not many understood what was needed to attract external equity investment. From the interviews and research undertaken, it was found that SME owners were either not willing to, or did not know how to, meet the requirements of external investors. Therefore, it suggested that the "concept of investment ready needs to be clarified and tailored to reflect the requirements of different stages growth and difference classes of investors". The Federal Government took up the recommendation and commissioned the *Investment Readiness Study* (1997).

Investment Readiness Study (1997)

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

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

- That small business owner-managers lack an understanding of external equity as an alternative financing source,
- that investment readiness was a complex issue involving subjective evaluation by the equity investor and a ‘mind set’ change process by the small business owner-manager, and
- that most small firms do not possess the attributes to meet the requirements of venture capital investors and BAs.

Following consultation with investor groups the IRS confirmed an equity gap between \$0.5m. and \$2.5m., illustrated in Figure 1.

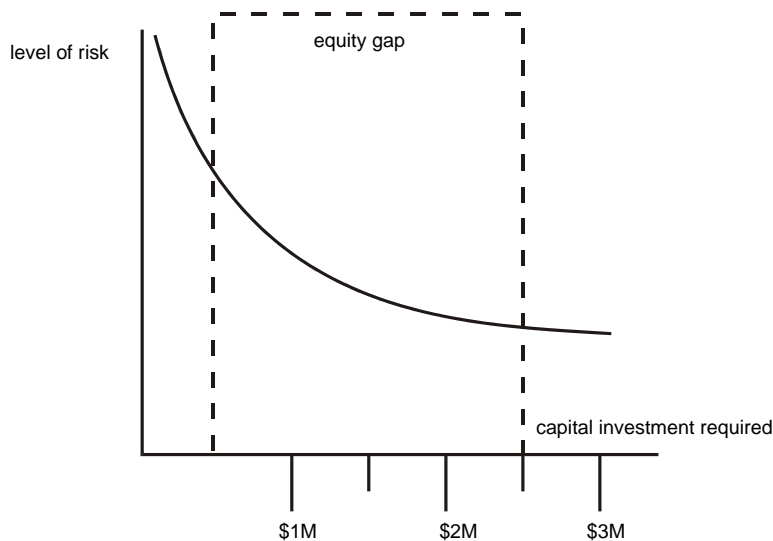


Figure 1 perceived equity finance gap

source: Ernst & Young and Centre for Innovation and Enterprise, *Investment Readiness Study* (Canberra: AGPS April 1997), p. 11. Commonwealth of Australia copyright reproduced by permission.

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

known about the size and significance of this gap.

A return on equity of 25 - 30% p.a. over 3 - 5 years was required by a venture capitalist or BA who invests in a minority position in the ordinary shares of an unlisted later stage SME. At that time about 8% p.a. could be returned from treasury bonds, and 15% p.a. from blue chip listed shares, so that a further risk premium of 10 - 15% p.a. was needed to compensate for the high risk, lack of marketability and minority position of investing in a small company. For early stage ventures a return of 40 - 50% p.a. may be required - see Figure 2. Therefore, "SMEs who are between the debt parameters and have not yet reached the equity investor parameters of return on investment, present a problem for the SME sector" (Ernst & Young et al 1997).

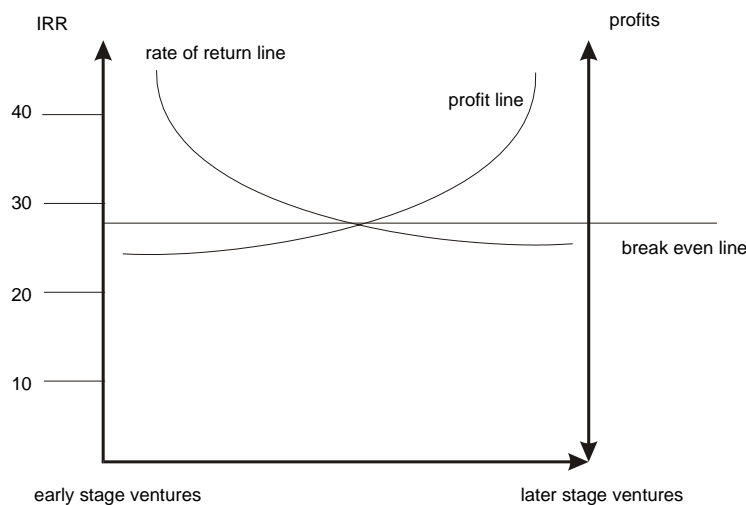


Figure 2 ratio of risk of return

source: Ernst & Young and Centre for Innovation and Enterprise, *Investment Readiness Study* (Canberra: AGPS April 1997), p. 38. Commonwealth of Australia copyright; reproduced by permission.

As part of its investment readiness, the small firm has to ensure that it can professionally present a proposal that can satisfy financial and non financial considerations of a venture capitalist or BA. It needs to possess the necessary qualities to develop a relationship with the investor, including a sufficient level of trust and comfort to enable an amicable partnership (Ernst & Young et al, Nicholas 1999).

Getting ready for investment

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

- **Investment parameters.** *These represent the established investment guidelines and focus of the investor, which may include, for example, a focus on large manufacturers or management buyouts over \$5m.*
- **Growth opportunity.** *This represents the evaluation of the external factors impacting on the investment potential such as market opportunity, product innovativeness and competitiveness, external influences and the capital growth return potential.*

- **Internal capabilities.** *This represents the capabilities of management and the internal operations and controls present in the business to achieve the identified growth potential (Ernst & Young et. al 1997).*

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

Venture capital investors (venture capital funds, superannuation funds, **business angels**, PDFs, banks and companies) were surveyed and their investment ready criteria summarised. These criteria apply to small firms at different stages of their life cycle and to different types of small firms. Three matrices have been prepared as follows:

Matrix 1. SME stages of development.

Attributes of the owner-manager, attributes of the business, and critical issues are identified for the five stages of development of a small business – start up, early development, stability, growth/expansion, and resource maturity. For example, for the early development stage:

Personal attributes.

Maintains direct responsibility for all aspects of the business. Focus on cash management.

Business attributes.

Break even cashflow is a priority. Supervision of small staff direct with owner. Simple systems focused on cash planning. Early customer base secured.

Critical issues.

Focus on reaching early sales and cost targets. Owner's decision to persevere.

Matrix 2. SME equity providers.

Individual equity providers are listed who are prepared to invest in SMEs at the respective stages of development. For example, for the early development stage:

Business angels.

VECCI - Business Angels Program. Australian Business Ltd.

Early stage venture capitalists.

ATG. Obelisk Capital Pty. Ltd.

Corporate investors.

Siemens Ltd. Telstra Ltd.

Matrix 3. Investment decision criteria by investor group.

The criteria adopted by equity providers are listed in five sections. For example, for the early development stage:

Investor parameters.

Risk and return. Industry sector matches investor's focus. Investor satisfaction on ownership level. Capital growth potential. Exit mechanism. Sufficient turnover.

Market factors.

Potential market growth. Sustainable competitive advantage. High barriers to entry sustainable.

Personal characteristics.

Trust, comfort and fit with investor. Good track record of CEO. Previous experience in industry. Persistence, energy, sense of proportion. Segregation of business and personal affairs.

Skill and competence level of management. Owner's financial commitment. Provision of personal fulfilment for investor.

Financial factors.

Capital expansion requirements understood. Sustainable profitability.
 Annual budgets and cashflows used. Monthly management information available.
 Business valuation undertaken pre-funding. Financial accounts audited.
 Effective tax benefits available.

Organisational factors.

Intellectual property is protected. Business plans completed and in use. Appropriate entry structure in place. Business not dependant on owner. Effective use of external adviser.
 External board member. Business had stable track record.

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

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

Ernst & Young et al. (1997) indicated that government had an important role in the education process that is needed for both businesses and investors. Equally important are business and industry bodies, and advisers such as accountants and angel matching service managers who are in constant contact with the small business sector.

The Victorian Government was the first to initiate and subsidise an 'Investor Readiness Program' which steered small firms to business angels or formal venture capitalists, and in September 1997 it opened an Investment Readiness web site.

The web site highlighted the benefits of the program to small business proprietors:

- *a clear picture of your business and its prospects*
- *a sound understanding of the advantages and disadvantages of introducing an equity partner to your business*
- *an understanding of investors and their requirements*
- *a better understanding of alternative financing options*
- *a structured plan to help you source and secure the right investment for your business*
- *access to other programs designed to improve your company's performance.*

The small companies which could best benefit from the product included those which:

- *have the potential for high growth and profitability*
- *are export focussed*
- *have an annual turnover between \$1m and \$60m*
- *will require non debt finance to grow*
- *are innovative and R & D oriented*
- *have a strong management team.*

There is little doubt that the *IRS* (and the earlier *Financing Growth* study) raised the issue in Australia of the necessity for small firms to change their 'mind set' towards becoming investor ready, and then to subsequently pursue a BA, or FVC firms for larger sums (Moodie May 61997, Beer May 18 1999).

The attributes of BAs in Australia are now discussed.

Business Angels in Australia

Only one specific study of BAs in Australia has been completed to date. Hindle and Wenban (1999) investigated three research questions:

1. Who are Australia's business angels?
2. How do they behave?
3. What are their investment criteria?

The study was conducted by survey questionnaires and the authors employed the snowball technique, which resulted in a convenience sample of 36 BAs. Wenban, who was a BA himself, used his personal network to locate seven other BAs. In turn, these introduced other BAs and so on. In addition, the NSW Chamber of Manufactures helped to distribute the questionnaires to BAs via its own network. Most of the data was collected in the later half of 1995, and "quality control checks and attempts at depth interviews took place in early 1996" (Hindle & Wenban 1999).

Drawing from Hindle and Wenban, the *IRS* and the *Financing Growth* study, and Australian professional and media commentators, a 'typical' Australian BA could have the general characteristics and investment profile summarised in Tables 1 and 2.

Table 1: Australian Business Angel General Characteristics

BA characteristics	Comments
1. <u>A male in his 50s, although anecdotal evidence suggests that a growing number of BAs are younger men in their 30s, making their fortune through involvement in information technology</u> (Hindle & Wenban 1999; Neales 1992; Clayton 1998; Lawson 1999).	In terms of BA's general characteristics, this seems to be the only significant difference between Australian BAs and BAs from overseas. Australian BAs appear to be younger than an average overseas BA. This could be because Australian BAs were slightly better at accumulating wealth than their foreign counterparts.

<p>2. <u>Successful in business or professional practice</u> (National Investment Council 1995; Hindle & Wenban 1999; Clayton 1998, 2000; Cochrane 2000).</p>	<p>Similar to overseas.</p>
<p>3. <u>Well-off (both in terms of income and net worth) but mostly not in the “super-rich” category</u> - having income and net worth greater than \$500,000 and \$7.5 million, respectively. Have a mean income of \$180,000 per annum and a net worth of \$2 million (Hindle & Wenban 1999).</p>	<p>Similar to overseas.</p>
<p>4. <u>Well educated as they are likely to have a tertiary qualification in business or engineering</u> (National Investment Council 1995; Industry Commission 1997; Robertson 1995).</p>	<p>Similar to overseas.</p>
<p>5. <u>Would generally prefer to keep a low profile</u> (Hindle & Wenban 1999; Moodie 1997; Yelland 2000). (4)</p>	<p>Majority of overseas BAs tends to guard their privacy.</p>

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Table 2: Australian Business Angel Investment Profile

Investment Profile	Comments
1. <u>Use a wide variety of methods in locating VC investment opportunities from friends, business associates and matching services, with the former two being the more common sources of information</u> (Industry Commission 1997; Lee 2000; Robertson 2000).	Similar to overseas.
2. <u>Relatively infrequent investor</u> (Industry Commission 1997). Hindle and Wenban showed that in 1994 the 36 BAs surveyed made about one investment each, although each received about three investment proposals that year.	Similar to overseas and could be even more infrequent than overseas BAs.
3. <u>Besides looking at the business proposal and cash-flow, the BA would also consider: (1) the personality type of the owner-managers and their ability to communicate, their integrity and other intangibles (e.g. quality of management) (2) growth potential of the market (3) the uniqueness of the product or service (4) structure of the deal and nature of competition</u> (Hindle & Wenban 1999).	Quite similar to overseas BAs, with the most important factor relating to the characteristics of the owner-manager.

<p>4. <u>Besides providing the required funds, would also invest time, extensive management skills and expertise, and networks to mentor promising enterprises</u> (Industry Commission 1997; Neales 1992; Clayton 1998; Moodie 1999; Baker 2000; Cochrane 2000).</p>	<p>Similar to overseas.</p> <p>However, Australians generally will only be involved on a part-time and strategic basis rather than in a day-to-day capacity (Neales 1992; Robertson 1995a; Clayton 2000).</p>
<p>5. <u>Does not expect a return from the investment in the first three years, which imply that the Australian BA may not be as patient as BAs from other countries such as Japan, who are willing to wait up to seven years</u> (Hindle & Wenban 1999; Lawson 1999; Lee 2000; Needham 2000).</p>	<p>It seems that the Australian BA may be less patient than overseas BAs.</p>
<p>6. <u>The exit route “had generally received considerable thought before the deal was entered into, but ... often the timing and manner of exit were not specified in any written agreement”. “A common feeling [is] that the preferred method of exit would depend on the outcome” of the venture. This includes company share buy-back schemes and MBIs</u> (Industry Commission 1997, p.45-46).</p>	<p>Similar to overseas.</p>
<p>7. <u>Tend to invest close to home</u> (Lee 2000; Robertson 2000).</p>	<p>Similar to overseas.</p>

<p>8. <u>Would generally not want a controlling role</u> (Walters 1999; Clayton 2000)</p>	<p>Similar to overseas.</p>
<p>9. <u>Will invest in any business that has a product or service that is new or superior to what is in the market</u> (Walters 1999, , 2000).</p>	<p>Similar to overseas. However, more Australians seem to invest in earlier development stages than FVC firms (National Investment Council 1995; Lee 2000).</p>
<p>10. <u>Most will invest up to 14% of their capital in VC type of investments</u> (National Investment Council 1995; Sunday Herald Sun 1999). <u>This implies that the BAs are prepared to invest only a small proportion of their disposable wealth in IVC investments</u> (Hindle & Wenban 1999; Robertson 1995; Abernethy & Heidtman 1999; Tucker 1999).</p> <p>Although the investment range is generally from \$20,000 to \$500,000 (Industry Commission 1997; Hindle & Wenban 1999; Mitchell 1994c; Lawson 1996; Butler 1999; Lowe 1999), the average</p>	<p>Similar to overseas</p>

<p>transaction size is about \$150,000 (Industry Commission 1997; Hindle & Wenban 1999; Moodie 1997). However, it seems that more recently the average has risen closer to \$250,000 (Walters Jan 28 2000).</p>	
<p>11. <u>Invest mainly for financial gains, such as capital appreciation</u> (Industry Commission 1997; Hindle & Wenban 1999).</p> <p>However, other commentators have found that many BAs do have other motivations such as satisfaction from being involved in the development of a young business (Industry Commission 1997; Clayton 1998, 2000; Moodie 1999).</p>	<p>Similar to overseas, though Hindle and Wenban (1999) suggest that Australian BAs are relatively more profit orientated.</p>
<p>12. <u>Is seeking a return of at least 20% and to double their capital in three years</u> (Hindle & Wenban 1999; Lawson 1999; Sunday Herald Sun 1999). <u>This seem to be about the same or lower than the average rates required by FVC firms</u></p>	<p>Seems similar to overseas, but needs further investigation.</p>
<p>13. <u>As BAs often desire to play an active role, they tend to prefer to invest in ventures that they are familiar with</u> (Industry Commission 1997; Neales 1992; Robertson 1995; Moodie 1997) and often had some prior relationship with the investee (Hindle & Rushworth 2000).</p>	<p>Similar to overseas.</p>

Although the majority of Australian BAs are well educated, researchers (Hindle & Rushworth 1999; Hindle & Wenban 1999) suggest that there are two distinct groups in terms of level of education – (1) no more than high school (2) University and above. In addition, BAs who are more educated tend to be young ‘high-flying professionals’, while the less educated BAs tend to be older.

The main difference between BAs from Australia and those from countries such as Singapore, the US and UK, appears to be that they tend to be more risk-averse (Abernethy 1996, Walters March 30 1998, August 2000, Howarth 2000). This could be due to the fact that the Australian venture capital markets, both formal and informal, are much younger than markets in the UK and US (Gome 1999, Walters March 1 1999, Bennett July 26 2000). Being less experienced, the Australian BA could be more tentative. It could also be due to cultural differences as Australians investors are generally seen as more conservative than elsewhere (see Chapter 1).

Researchers such as Harrison and Mason (1999), and Reitan and Sorheim (2000) have suggested that BAs in different countries have more common features than differences. This has proven correct according to Tables 1 and 2. Nevertheless researchers emphasis that many BAs defy categorisation because of their own rules of behaviour and networks within an informal sector of the market (Lee March 13 2000).

We now turn to an analysis of the services which seek to match BAs and investee firms.

Matching Services

Traditionally, the IVC market worldwide has been described as a “giant game of hide-and-seek with everyone blindfolded” (Gaston 1989). According to the *Financing Growth* study (1995) the effectiveness of the IVC market in Australia was “severely hampered by information inefficiency”. The major sources of such inefficiency are “the invisibility of business angels and the high search costs of angels for businesses and businesses for angels” (Harrison and Mason 1996).

There is little doubt that individual angels and business owners have been able to match their interests for centuries using informal methods such as trade fairs, exhibitions and private and business networks. In the modern economy there is a need for formal matching services to bring the two parties together and these can comprise investment forums, on-line data bases, computer matching and publications. According to Mason and Harrison (1996) matching services are still in an experimental stage and no single best blueprint has yet emerged.

The matching service concept is relatively new in Australia. It would seem that organised matching services in Australia mainly emerged from around the mid-1990s. The development of the services is tabulated in Table 3.

Table 3: Development of Matching Services in Australia

Time Period	Developments
Pre-1990s	Matching efforts conducted on an informal basis.
1990 – 1994	First full-fledged matching services and programs established in Australian states – <i>Business Angels Pty. Ltd.</i> (1992 – Melbourne), <i>Corporation Builders Pty. Ltd.</i> (1994 – Queensland), <i>Ideas and the Investor</i> (1993 – 1999 Adelaide), and Business Finance Support Program (1994 - Melbourne) – renamed <i>Business Angels Service</i> in 1998.

1995	<p><i>Equity Match (Perth)</i>, <i>Australian Business Angels (ABA)</i> (NSW), <i>BizEquity Ltd</i> (Qld),</p> <p><i>The Venture Capital Market Place</i> (Sydney), and <i>Australian Equity Business Exchange (AEBE) Ltd.</i> (1995-1998 Perth) were established.</p>
1996 onwards	<ul style="list-style-type: none"> • <i>Equity Portfolio (1996-1998 Melbourne)</i> opened. • In 1998, the Corporations Law was altered to allow business enterprises (under certain conditions) to canvass up to \$5 million, without producing a prospectus. • <i>Australian Equity Association (1997-1998 Melbourne)</i> started and the ASX launched the <i>Enterprise Market (E.M)</i> (1997-2000 Sydney) on the Internet. • In 1998 <i>E-match</i> (Perth) opened on the Internet and <i>North Coast Business Angels (NCBA)</i> opened at Coff's Harbour. • In 1999 five services were established: <i>Burton and Associates</i> (NSW), <i>TiNSHED Aust. P/L</i> (NSW), <i>BSX Equity Matching Service (BSX)</i> (Victoria), <i>NetEquity P/L</i> (Perth), <i>East Coast Angels P/L</i> (Sydney). • In 2000 <i>ePark</i> (Sydney) opened.

Two early private matching services were the Melbourne *Business Angels Pty. Ltd.* established by Christine Kaine in 1992, and the Queensland based *Corporation Builders Pty. Ltd* in 1994.

In 1994, the Australian Chamber of Commerce and Industry proposed that a capital raising initiative be included in the Australian Federal Government's industry statement. Subsequently, as part of its White Paper commitment to provide funding for "business equity information services", the government provided financial support to the State Chambers of Commerce for angel schemes to be established in each state. This was to bridge "the equity funding gap for small, unlisted firms" and "to encourage investment in small business" (Gome May 16 1994).

The Chambers of Commerce and Industry in South Australia and Victoria established two matching services. The *Ideas and the Investor* scheme (5) became fully operational in 1993 in South Australia and brought SMEs with mostly technological ideas and products to the attention of BAs. The Business Finance Support Program was a computer matching service

developed in 1994 in Melbourne, but in 1998 it became the *Business Angels Service* (operated by the Victorian Employers' Chamber of Commerce and Industry (VECCI))

The federal government also provided support and funding to *Business Angels Pty. Ltd.*, *Corporation Builders Pty. Ltd.*, and the Australian Business Angels Program, a BA meeting program – established in 1995 (by the Australian Business Chamber, and associated with Australian Business Ltd.) to be later called *Australian Business Angels (ABA)*.

In 1995, more matching services were established including *Equity Match*, *BizEquity Ltd.*, *Australian Equity Business Exchange (AEBE) Ltd.*, and *The Venture Capital Market Place*. These, and *Australian Business Angels (ABA)*, were for-profit enterprises, with a nation-wide focus and with some international links. Only *BizEquity* had a preference for certain states and operated strictly within Australia. As for operational structure, all five utilised more than one matching method, with computer matching and on-line database via the Internet being the most common method. Besides providing matching services, all five enterprises had other investment related services that aimed to increase the proportion of introductions that were converted into successful matches. The most common service was to provide 'investment readiness' education after 1997.

In 1996 the *Equity Portfolio* opened from Melbourne. Also, employer bodies and banking and accounting bodies teamed up in 1997 to start a non-profit service based in Melbourne called the *Australian Equity Association (AEA)*. Initially, matching facilities were provided but from 1998 it changed its name to the Private Capital Council and confined itself to assisting in networking among its members **(6)**.

The earliest matching services were restricted by legislation. They had to be cautious in using advertisements to promote their services as these could constitute a public offer, involving expensive requirements and constraints of the Australian Securities Commission (ASC). Consequently, according to several commentators, only small firms with access "to an 'old boys network' of wealthy friends could hope to find an angel" (Gome February 3 1997, 1999).

In January 1998, the ASC granted relief from the prospectus and advertising provisions of the Corporations law. ASC Class Order 97/2329 allowed registered introduction agencies to now bring investors and companies together by publicising opportunities, without the necessity of a fund raising Disclosure Document (prospectus) as long as the deal was worth less than \$5m. There was somewhat of a "a rash of matching services [tried] opening their doors, including one run by the Australian Stock Exchange (called *Enterprise Market (E.M.)*) and hopes ran high" (Walters April 20 2000)

Enterprise Market (E.M)

In 1997 the ASX indicated that it was interested in revisiting the idea of a capital raising structure for small firms. Unlike the second boards that collapsed in the late 1980s, exchanges could be centered on a bulletin board concept to provide a platform for small unlisted businesses to raise funds and for BAs to sell their equity – a similar concept to the service provided by matching services.

This led to the establishment of the *Enterprise Market (E.M.)* in 1997 with the stated aim of becoming the largest matching service in Australia via the Internet. Computer matching took place between buyers (angels) and sellers (small firms) via an on-line data base. An important facility was provision for the sale of unlisted shares.

The E.M however never achieved its critical mass. Although it had predicted that 1,000 firms would join the service in its first year only 50 firms had registered by March 1999 and only 250 signed on indicating serious interest during three years of operation. A number of reasons have been suggested for the failure:

1. "The main problem was finding companies to register on the site companies balked at the registration fees, which started at \$1,000 for companies looking for \$200,000" (Walters February 2001).
2. The Australian Securities and Investments Commission rules prevented the ASX from taking equities in companies in lieu of fees, or from charging success fees.
3. The E.M web site was complicated and expensive to run. About \$6m was expended in total for the E.M.
4. "Louise Convy, founder of the advocacy group Entrepreneurs Only, says bad management killed Enterprise Market staff ignored problemsthere was no follow-up service." (Walters February 2001).
5. " too expensive, too cumbersome and not user-friendly" (Gome April 23 1999).

From 2000 the E.M ceased direct matching and repositioned itself towards networking and to act as an infrastructure to integrate all the matching services in Australia. This has also proven to be unsuccessful and the E.M closed abruptly in February 2001.

In 1998, *E-match* (Perth) opened using the Internet and *North Coast Business Angels (NCBA)* opened in Coff's Harbour. Then a further six services quickly followed, reflecting changes in the Corporations law regarding the canvassing for funds. It is also likely that the increase was due to the 'dot-com' explosion and increased interest of investors and entrepreneurs in new start-ups, especially in the US but also in Australia. Perhaps also this was an indication of some maturity of the matching service industry. According to Walters (2000a), services were no longer competing head-to-head for deals, but were tending to find their own niches and make alliances – partly due to the repositioning of the *E.M.*

Burton and Associates (Sydney), established in 1995 as an advisory agency, became a matching service in 1999. *TiNSHED* (NSW), *BSX Equity Matching Service (BSX)* (Victoria), *NetEquity* (Perth), *East Coast Angels* (Sydney) all opened in 1999, and *ePark* (Sydney) opened in 2000.

TiNSHED was a new form of angel syndicate for Australia. A number of wealthy business angels (including millionaires like James Packer and John Singleton) pooled resources to establish their own matching service and to locate and formally screen potential investments. Each angel was free to solicit business plans from SMEs and the final investment decision lay with each individual BA. Similarly, *East Coast Angels* comprised members who paid fees of \$3,960 each per year which gave them the right to invest in deals found by the group's executive director.

Developments in the late 1990s included the use of 'success fees' to raise revenue, equity stakes and the formation of alliances.

It has been said that "there is no money to be made from private equity matchmaking" (Lawson July 5 1996). However new services such as *Burton and Associates* and *TiNSHED* adopted a success fees approach which spread to other services. Instead of charging up-front fees, the services took a percentage of the funds raised by small investees from BAs. For example, following new opportunities brought about by the 'dot.com' boom in the biotechnology, information technology and telecommunications sectors *Burton & Associates* decided to change direction in April 1999, from advisory work to matchmaking. Unlike other matching services at the time, it charged a success fee of up to 5% of the amount raised, and took up to 2% of that as equity. If no capital was raised, there were no fees.

Instead of charging fees *TiNSHED* helped companies prepare for investment and find BA funds in exchange for an equity stake in the firm equivalent to a 10% success fee. *ePark* also took equity in exchange for preparation and matching help.

Late in the 1990s alliances developed in the IVC sector allowing the expansion of operations and reduction of duplication and fragmentation. For example, in 1999 *North Coast Business Angels* made a deal with *Australian Business Angels* to help promote selected businesses

seeking funds from each other's databases. The businesses did not pay extra for the co-promotion, and the two matchmakers split success fees if a match was made. In Queensland *First Tuesday* was formed in 2000 to provide a network for formal venture capital firms, BAs, technology entrepreneurs and professional advisers. The network, which originated in London, had branches in 40 cities throughout the world.

Overview

As may have been anticipated from overseas experience, especially in the UK, the early services in Australia tended to start with enthusiasm but with false expectations. Many services thought that if they could obtain a modest proportion of potential clients they would make profits. However, "their expectations [were] soon dashed, [as] they found out that the sector can be categorised in many ways – for example, size, industry, age of business, age of owner and stage of growth". They were unable to meet the expectations of a substantial proportion of the market, simply because they were unprepared and lacked the resources to cater to the wide variety of needs of different types of clients (Gome July 6 1998, April 23 1999).

Since the mid-1990s, it was reported that many of the matching services were plagued by SMEs that took too long to become investment ready. Although they were eager for equity investment they seemed unaware of the need to restructure their operations and were apprehensive about losing control of their businesses. Even when prepared to change, many of the firms had insufficient funds or were unwilling to pay for the assistance they needed to become investment ready. As many matching services were desperate to register deals, they tended to absorb the costs (Walters October 1 1998, April 20 2000).

Matching services in general found it essential to put great efforts into helping gazelles to become investment ready. For instance, some matching services, like *Corporation Builders Pty. Ltd.*, specialised in educating SMEs on how to be investment ready through seminars conducted in every state. Others like *E-match* and *Business Angels Pty. Ltd.*, developed investment-ready preparation packages that guided small firms and their business advisers through the process of becoming investment ready. Some matching services complained that if they had more resources they could have assisted a lot more firms to become investment ready (Walters March 30 1998).

There was early rivalry between the matching services "the entry of the *E.M* made things worse, although it gave added respect to the struggling market and provided an exit strategy for investors" (Gome April 23 1999). Rivalry resulted in an unhealthy type of competition as "greed and shortsightedness" made the matching services unwilling to share and learn from each other. As each went their own way the entire market was unable to move forward as quickly as if there were a unified approach.

Before the *E.M.* became operational in 1997, Australian matching services tended to lag in utilising the Internet to match investor and investee parties. Following *E.M.*'s lead, existing and new matching services started to go onto the Internet.

The rationale for utilising the Internet was to encourage more investors (particularly those BAs who were afraid to be publicly identified) to consider investing in SMEs - BAs would not need to meet the SMEs face-to-face. Also, matching services could "overcome the geographic problems and reach the diverse business sector efficiently and cheaply" (Fish April 29 1997). On the other hand, at least one commentator was wary of the trend as the evidence then seemed to show that personal one-to-one preparation had a higher success rate in matching SMEs with BAs and overseas research had shown that the Internet was not popular among IVC participants (Abernethy November 18 1997). Based on the results by 1999, it seemed that providing matching services through the Internet had not been as effective as predicted (Walters November 12 1999).

As a result of emerging problems matching services became under immense pressure with some closing eg. *Ideas and the Investor, Australian Equity Business Exchange, Australian*

Equity Association, Equity Match, North Coast Business Angels, Equity Portfolio and importantly the highly touted *E.M.* It was also reported in 1998 that potential services “after doing research and realising they(would) not be profitable ... (did) not even open their doors” (Gome April 23 1999).

By the late 1990s, commentators claimed that matching services overall tended to have mediocre results, given the amount of time and money invested in them. Basically many “participants do not understand how to play the game, and businesses come to the process as a last resort financial advisers, accountants, solicitors do not have sufficient understanding of the process to wisely advise their clients when and how to consider the option” of seeking business angel funds (Kaine December 1 1998, Robertson October 20 1998).

In many senses the organised matching service game is as much blindfolded as the informal search by small firms for BAs and the search by BAs for investments. Information regarding the size, extent of activity and success of services has been very limited. The public has to rely upon limited data on the web sites of the services, media commentators and the annual *Australian Venture Capital Guide* (Pollitecon Publications, NSW).

The latter guide published in 2000 (covering to the September quarter 1999) included a précis of 14 matching services current at the time, including *E.M.* Only four indicated figures for “total capital available”: *Australian Business Angels* \$200m., *Netequity* \$5m., *E-match* \$170m. and *Business Angels Service* \$150m.

Only five services supplied details of the true success indicators, ‘marriages’ (completed matches):

- *E.M.* 15 matches worth \$21m.
- *Netequity* 4 matches worth \$1.35m.
- *Business Angels Service* 94 matches for \$42m. **(7)**
- *Equity Match* \$45m.
- *North Coast Business Angels* 4 matches for \$1.52m. for 1998-1999.

The total of these marriages is far from the \$1b. suggested in 1997 by the *Industry Commission*, suggesting that most matches occur informally outside the formal matching services. **(8)**

Conclusion

In this overview we have discussed the first pilot study of business angels in Australia and no doubt this will lead to further research. Reasonable research by the Industry Commission (1997) has indicated that informal equity capital supplied by BAs in Australia by late 1996 was about \$1b.

As shown in Table 3, we are aware of 20 formal matching services which started from 1992 to bring together BAs and small business owner-managers. Of these, six have closed and six are quite young, having started after 1998. Information regarding the success or otherwise of the services has been meagre, with a number of commentators claiming that overall they have achieved mediocre results given the time and money expended in them.

The rise and fall of the matching services has been affected by a number of key events.

1. The *Financing Growth* study (1995) and the *IRS* (1997) highlighted the small business equity gap of amounts of less than \$0.5m. that needed to be filled by BAs, and also the necessity for small growing firms to become investment ready.
2. From 1994 to 1997 the federal government has provided funds for organisations to initiate and expand matching services.

3. Corporation law was amended in 1998 to allow the canvassing of up to \$5m. in equity without the necessity of a formal prospectus.
4. World wide interest in private equity from the mid 1990s, and the dot com share price explosion in the US led to an interest by investors in venture capital in Australia, including IVC. Innovations in methods of providing BA funds to small firms were initiated in the late 1990s by enterprises such as *TINSHED* and *East Coast Angels*.
5. The crash in the US dot com share market in early 2001, the US economic downturn and aftermaths of the September 2001 terrorist attack in New York have reduced the upsurge in all forms of venture capital activity, but probably only temporarily.

The IVC market in Australia has now received some limited research and some media exposure. The matching services component of the market is in its infancy but may well develop to be of material value to gazelle firms and budding entrepreneurs in Australia.

NOTES

1. This is true because some 85% of all private sector businesses in Australia have less than 20 employees. Also, larger businesses are less likely to seek funds from a BA than from financial institutions such as banks (*Industry Commission 1997*).
2. More recently the average may have risen closer to \$250,000 (Walters January 28 2000).
3. The authors relied upon data from the *Australian Venture Capital Guide 1996* for investments by venture capital firms. However this data includes a greater proportion of later stage deals and management buy-outs and buy-ins than overseas, and also deals for some rather large firms. This gives support to the belief that Australian BAs are playing a very important role in financing small firms in Australia.
4. Overseas research has shown a minority group of BAs that act more like FVC firms and are quite open about their investment activities (Lumme, Mason and Suomi 1998). Similarly, recent services such as *TINSHED* have shown such characteristics in Australia (Butler July 28 1999).
5. This scheme was started in Adelaide in 1989 by Rod McInnes an Adelaide finance broker, who published a newsletter (in the SA Employers' Chamber of Commerce and Industry magazine) listing small firms needing BA funding. Actual matching was left to potential BA readers and only in 1993 was the scheme more fully developed to provide matching services (Gleeson 1995). Subsequently the scheme was taken over by the University of South Australia but closed down, probably in 1999.
6. Initially AEA took over the matching service function of the *Business Angels Service* operated by the VECCI. But in 1998 when it repositioned itself it returned the matching service to the VECCI (McConnell November 5 1999).
7. According to Walters (April 20 2000) the *Business Angels Service* had 14 marriages in 1999.
8. It seems reasonable to believe that had the other nine services achieved successful marriages they would have made a point of publicising this.

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