# The Investment Paradox - when less is more

## Kurt Roosen, Senior Consultant, PDMS Consulting

## February 2003

The IT sector is well known for generating innovative new products and services. It is also an investors nightmare, combining the remote chance of a significant stake in the next Microsoft with a high probability of disillusionment and confusion. The problem is that investment in IT tends to be predicated on the fact that an idea should be the next big thing rather than simply a good team of people with a reasonable business plan in a measurable market. The truth is that most businesses in the IT sector, like any branch of engineering belong in the small to medium sized enterprise (SME) sector; they are never going to be global mega corporations just solid profitable efficient businesses which live within their means and understand their market niche.

To get a new business off the ground needs capital but too much is as bad as too little in that it creates an unreasonable expectation on the part of both investors and management of what can (and must) be achieved. Much investment in new businesses is made artificially more risky through the costs and time involved in raising more than is required. This problem isn't just restricted to IT but affects many smaller businesses irrespective of their market sector. Yet there are investors willing to invest private equity in new innovations, the difficulty for them is not only in identifying the investment opportunities but also a suitable investment method.

Looking at the different funding options currently available to companies, we see that several of them are beyond the practical reach of many companies whilst others may not appeal to the investor. Let's start with the Stock Market.

The Stock Market has always been a significant component in the engine of wealth growth, traditionally offering better returns than many other types of investment. Recently, however, there has been a chilling reminder that 'the price of shares may go down as well as up' first with the bursting of the Dotcom bubble, to be followed by the sapping of market confidence in the light of the corporate governance issues with Enron and then WorldCom. In light of this there has been a rush to more 'traditional' investment in the form of interest bearing deposits where slower growth is counterbalanced against increased security.

However, this is not such an interesting sanctuary as it has been in the past. It is common for interest rates and stock markets to continually operate in a see-saw motion passing each other in opposite directions. The trick actually becomes spotting the peak in one and the trough in the other and jumping from one type to another at the appropriate moment. In the current economic cycle this is not the case. Unusually, Stock Markets have fallen at a time when interest rates and inflation are also low. With traditional stocks exhibiting the volatility of 'Penny Shares' and interest bearing products just yielding higher than inflation where is a person to find the middle ground for at least some of their capital? Let's ponder on the fact that there are still a large number of companies and business potentials that exist outside the Stock Market - could Private Equity funding fill the current middle ground?

The most evident form of company investment is that provided by Venture Capitalists. Not really open to investment as part of a private portfolio of investments, these organisations obtain money from the Institutional Money Market to provide high risk, high return funding for initial start-up companies or refinancing of existing ones. The general rate of return on this is very high and the degree of control required can also be stifling to the developing business as it struggles to cope with the demands for accountability that would be expected from a listed company, but without the necessary resources to support that endeavour. Venture capital investment has a potential to create a self perpetuating loop of investment to support investment. If not managed carefully this can spiral into a real 'good money following bad' situation.

There are another couple of attributes that characterise the flavour of this type of investment. The first is scale. It is very difficult to arrange for risk capital for below one million pounds because the providing organisations themselves require high returns to fund their endeavours. This means that the 50% of companies that fall into the Small to Medium Enterprise (SME) category are not well served by this sector. The second factor is stated ambition. It is much easier for a company with an untested but expansive business development projection to gain funding than a business with a proven, if conservative, projection to do the same. The same generally applies to companies with existing track records but no record of outstanding growth. This type of funding is considered and classified high risk and high return and was really categorised by the Dotcom boom where projections, in some cases, were built wholly on potential rather than substance and they were bound to ultimately fail, the trick was to head for the cash generator of a Public Flotation and recover investments at that snapshot in time, before the proverbial 'busting of the bubble'.

At the other end of the scale are the 'Business Angels' or single private investors. In the most part investment opportunities are filtered through organisations that provide advice for start-up companies and create forums where companies requiring investment are introduced to potential investors. Although the information is formatted and presented to the business angel, they generally act as little more than a selling agent to gain the full amount of capital required generally in one go and their involvement ceases once that amount is found. From the perspective of the company that means that only one aspect of their development, the requirement for working capital, is covered without any sharing of risk. From the perspective of the investor the 'deal' still has to be struck between themselves and the company to meet requirements on both sides and this often involves a single investor taking all the risk. Looking at this in overview the requirements of the investor for middle ground risk/return profiles are not being met and the requirements of small business for handholding and active participation in their development, including shared risk is certainly falling short of the mark.

Current funding options do not appear to be meeting the needs of the SME's or their potential investors. What SME's with innovative ideas really need is an active development partner who will not only introduce them to investors willing to invest the traditionally smaller sums of money they require, but importantly, to provide business support to the new venture. In this way the 'Active Partner' will provide some of the benefit afforded by Venture Capitalists, but in a much less one-sided arrangement and with common objectives that are not solely related to Capital Investment Risk. Similarly, by grouping together a number of SME's with new business propositions and subdividing the investment into purchasable 'packets', investors would have access to a portfolio of investment opportunities allowing them to spread the investment risk in a similar manner to buying a range of different shares on the Stock Market. Surely we can't have stumbled across a reasonable balance to establish equitable risk and return? Now there's a thought...