PREM 19/2953

Confidential Filing

Venture Capital

ECONOMIC POLICY

Attached Folder: "The Genghis Khan Guide to Business" & Cash Flow Forecasting.

June 1981

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~23. 6. 81~~							
~~30. 6. 81~~							
~~13. 7. 81~~							
~~3. 8. 81.~~							
~~22.8.81~~							
~~1. 9. 81~~							
~~13.6.83~~							
~~21 6 83~~							
~~29.9.83~~							
~~19.1.84.~~							
~~5.3.84~~							
~~19.3.84~~							
~~14 3 85~~							
~~10.11.85~~							
~~20.2.86~~							
~~12.1.87~~							
~~29.1.87~~							
~~14.2.90~~							
~~19.2.90~~							
15.5.90							

CLOSED.

PREM 19/2953

1. BP
2. CF

CABINET OFFICE

70 Whitehall London SW1A 2AS Telephone 071-270 0101

From the Secretary of the Cabinet and Head of the Home Civil Service
Sir Robin Butler KCB CVO

Ref. A090/1251 24 May 1990

Dear Geoffrey,

Many thanks for your letter of 15 May about Business in the Community's proposals for regional venture capital funds. With your agreement and Peter Gregson's, I have spoken to Sir Hector Laing and have said those promoting this scheme should address themselves to you. I added, however, that this did not mean that the objections in principle to a Government financial contribution would be easily overcome.

I am copying this letter Peter Middleton, Peter Gregson and Andrew Turnbull.

Yours ever,

Robin

Sir Geoffrey Holland KCB
Department of Employment

14may.bic.hl

cc [illegible]

1. [illegible]
CCF

Department of Employment
Caxton House, Tothill Street, London SW1H 9NF

Telephone 071-273 3000/01-273 5826
Telex 915564 Fax 071-273 5821/5517

Permanent Secretary
Sir Geoffrey Holland KCB

Sir Robin Butler, KCB, CVO
Cabinet Office
70 Whitehall
LONDON SW1

15 May 1990

Dear Robin

BiC Proposals for Regional Venture Capital Funds

Will request if required

I am replying directly to Sonia Phippard's letter of 27 April to Tony Medawar, as requested by Tony.

I can say straight away that the proposal by the Midland Bank to make available a number of regional funds for small equity investments is very much to be commended. There is undoubtedly a 'gap' in equity finance for amounts of the size envisaged, £5-50,000, although the level of demand and the size of the potential market is simply not known, as the Target Team remark in their draft report. I should add incidentally that the remarks about the Loan Guarantee Scheme in the draft report are not accurate and Sir Peter Gregson was briefed to say so. This does not however affect the case for considering the provision of equity finance.

As regards the background of the proposal, Tony Medawar has already pointed out that it was not put forward at the final meeting of the Target Team whose report merely set out the Team's belief that Business in the Community should continue to seek private and public sector sponsors for small development capital funds. Since that time BiC officials, Peter Quine and David Grayson, have from time to time made brief mention to one or two officials here that funds were in prospect and that in due course a Government contribution might be sought but they asked specifically for the information to be treated in strictest confidence.

Very recently David Grayson gave an indication of the scale of funding he had in mind. My officials expressed some surprise at the scale involved and that, in conjunction with DTI's earlier rejection of a very similar proposal from the British Venture Capital Association, is no doubt the reason why Sir Hector decided to approach you directly.

Quite separately however the Midland Bank have kept Tim Eggar, as Small Firms Minister, in the picture. They mentioned a proposal to him in a letter set last October. They mentioned that that proposal had been put first to the Committee of London and Scottish Banks but that Midland were proposing going it alone following rejection by the Committee. They did however specifically ask Mr Eggar to treat the information in confidence both from BiC and 'on the grounds of competition'.

Midland wrote again on 5 April this year to update Mr Eggar with the news that they were nearing completion of their plans and were proposing to contact DE officials to explain to them in greater detail and also to explore the prospects for a Government contribution. Mr Eggar replied on 9 May that officials here were looking forward to discussing the scheme when Midland were ready but his letter was overtaken when he met Ian Mullen of Midland Bank at an Association of British Factors dinner on the evening of 9 May.

Mr McMeekin of Midland has now written direct to Mr Eggar enclosing a copy of the BiC proposal. He also mentioned that Sir Hector Laing was to dine with the Prime Minister on the evening of 8 May and that the subject would probably arise. Andrew Turnbull's letter of 9 May however sets out what happened and I now await an approach.

In summary therefore we have up to now been kept rather vaguely in the picture (thought every contact has been informal). No written proposal has yet been put to this Department nor have we been asked to react to a specific request for funds. Naturally a request of this nature would require detailed consideration, in due course involving the Treasury, and the final decision would need to be taken by Ministers. We are ready to meet BiC but clearly we would need a good deal more information than has been provided so far.

A number of immediate questions arise including those of displacement, additionality, the question of equity participation, and the check and balances that would be needed to justify contributing public money in the manner suggested. But over and above all that there is the primary question about the appropriateness of Government funding for this kind of proposal.

Midland, who tried initially to get backing from the Committee of London and Scottish Banks, have made no secret of the fact that there is a competitive element and to some extent at least a long term investment for the future although we do appreciate the Target Team's arguments about the difficulty of making a commercial case for the provision of equity funds on this scale.

Nevertheless we do know of at least one other very large company which is on the point of launching a very similar equity fund as a contribution to community regeneration but which is not seeking any public sector contribution and which has found a way to set up the fund commercially.

My conclusion is that there must clearly be a serious question mark over a contribution from the taxpayer to a venture of this nature funded largely from by one particular bank. I think it reasonable for you to point this out to Sir Hector if by any chance he approaches you again. I fully agree with the advice in your minute of 8 May to Andrew Turnbull. Meantime, I myself await developments here. I rather suspect the next step will be a request from Sir Hector Laing for a meeting and I am inclined to think that, if that request materialises, Tim Eggar should see him.

I am copying this letter to Sir Peter Middleton, to Sir Peter Gregson and to Andrew Turnbull.

Yours ever,

Eion

CEB1/8

PRIME MINISTER 19 February 1990

CITY SHORT-TERMISM AND UK INDUSTRIAL PERFORMANCE

A LACK OF EVIDENCE

The Treasury paper of 14 February demonstrates that there is very little evidence of any link between inadequate long-term investment by UK companies and the short-term attitudes of some of the financial institutions.

A GAP BETWEEN MANAGERS AND SHAREHOLDERS

The paper does, however, recognise that pension funds in particular do have short-term attitudes created by the competitive need to deliver good short-term portfolio performance.

The management of UK companies often hold this view of the City and although it does not seem to influence the companies' decision-making, it does create the climate of suspicion and antipathy in which loose talk of "short-termism" flourishes.

The root of all this lies in the fact that the trustees of pension funds in general have no wish to use their position as important shareholders to discuss issues of common interest with the Boards of companies. So there is often felt to be a wide gap between the managers and the owners of a business.

TAKE-OVERS

The threat of take-over is certainly a powerful stimulus to management and shareholders do in practice rely on that as their ultimate protection. However, the gap between managers and shareholders becomes critical when a bid is actually made. There is little evidence to show that hostile take-overs are generally a success and in many cases shareholders would be better advised not to sell out but to change the management themselves - which they are rarely organised to do so.

To make take-overs more difficult will simply weaken the most potent pressure on management but that is not the same thing as saying that every hostile take-over is necessarily a good thing. Major shareholders could, when necessary, exert their own pressure for management change, which might well be in their interest and in that of the industrial performance of the UK. This is not a matter for government but there is a case for urging the institutions to reconsider their position on this issue. It cannot be healthy that only 11% of shareholders cast their votes at annual general meetings when directors are elected.

CONCLUSION

If 'short termism' is really a problem created by a lack of communication between managers of companies and their shareholders, is it necessary to promote structural change in response?

Section 49 of the Treasury paper looks at the ways in which non-executive directors could be used to link companies and major shareholders. You may wish to ask Mr Major if he sees greater institutional involvement of this sort as being desirable in itself - do we actually want them to acquire greater direct influence?

A better way of improving the relationship between the 'City' and industry might be to encourage the pension fund industry to re-assess its attitude towards short-term portfolio performance and high turnover of shares.

Howell Harris Hughes

HOWELL HARRIS HUGHES

47. Increasing the number and role of independent non-executive directors is widely seen as a means of providing both effective pressure on management short of takeover and a reliable channel of communications to large shareholders. The Bank of England, the clearing banks, the CBI, the Stock Exchange and other bodies have sponsored a campaign by PRONED (Promotion of Non-Executive Directors), which included the circulation to all listed companies of a Code of Recommended Practice. This called for each Board to have strong, independent non-executive directors to number at least three and to be one-third of the board with a controlling majority on audit and directors' remunerations' committees. Their main task should be to help the board provide the company with effective leadership, to ensure the continuing effectiveness of executive directors and management and to ensure financial probity. The code makes the obvious point that such directors need support from the chairman and relevant information in good time. It is, important, however, that the non-executive director should not be in the pocket of the full time management.

48. Surveys in 1983, 1985 and 1988 of the Times 1000 companies show that the number of non-executive directors as a percentage of the total board has increased from 33 to 36 per cent, but that the momentum slowed in the last three years. 44 per cent of companies had fewer than three non-executive directors. There has, however, been a marked shift towards more 'independent' non-executive directors - 75 per cent in 1988 of them against 65 per cent in 1985 had not served as an executive or had a professional relationship with the company.

49. Possibilities for encouraging non-executive directors further include:

(a) persuading companies to consult major institutional shareholders about non-executive directors. The institutions would not wish to see their own employees on the board, but their involvement might lead to non-executive directors being more widely seen as an appropriate channel for shareholder concern;

(b) in principle major institutions might share out the lead role in applying shareholder pressure through a non-executive director on companies in whom they all had an interest. However, despite attempts to encourage a move in this direction, the Bank say that there is insufficient consensus at present to make this workable;

(c) encouraging or requiring institutional shareholders to exercise their voting rights, or at least consult the beneficial owners, particularly in the election of directors. At present, only some 11 per cent of proxies are exercised. In the USA the Department of Labour argues that the trustees of certain funds are obliged to vote their shares after considering the best way of protecting beneficiaries' long term interests. The same may be true here. There is a risk that in practice institutions would exercise their voting rights passively, and follow the company management's own recommendations with little questioning. But this area may deserve further work;

(d) formally requiring, either through Stock Exchange listing requirements or company law, a set number of non-executive directors on boards of listed companies over a certain size. However, the Government has opposed backbench amendments to this effect to Companies Bills, arguing that companies themselves should determine the most effective management and supervisory structure.

50. The Bank will continue to encourage more non-executive directors but, short of compulsion as in (d) above, progress is likely to be slow.

Making Banks More Important

51. Critics of short termism in the UK point to the beneficial long term involvement of the banks in Germany and Japan as an alternative model. Hostile takeovers are practically unknown and

MR GRAY 14 February 1990

SHORT-TERMISM

The Prime Minister has asked the Treasury to comment on the issue of "short-termism".

She may be interested to note an article in the February edition of the Bank of England quarterly bulletin on the development of venture capital funds. I enclose an extract which discusses "short-termism" on the part of pension funds and insurance companies.

In this instance, "short-termism" has a clear definition. It is often used more losely but I think it is fair to say that the pressures for short-term portfolio performance often underlie what is said. Where venture capital is required, those pressures may inhibit really long-term commitment; where shareholdings in quoted companies are the issue, those pressures deter pension fund managers and trustees from establishing relationships with the management of companies which would remove the climate of suspicion which frequently exists nowadays. Those relationships would not remove the deterrent effect of potential take-over where the assets of a company did not perform but they would do something to recreate the necessary link between owners and managers which has been weakened by the rapid growth of institutional ownership.

Howell Harris Hughes

HOWELL HARRIS HUGHES

Increasing signs of short termism?

UK pension funds and insurance companies have been considered ideal investors in venture capital funds because of their long-term horizons. However, institutional fund managers have increasingly come under pressure to demonstrate better than average short-run returns, including those from their venture capital investments. Venture capitalists are responding to these pressures in a number of ways. First, they have increased information flows to investors by providing, at least once a year, reports on the progress of funds, in particular what interim rates of return have been achieved and what final returns might be expected. Although such estimates are accepted as tentative, some indication of progress is considered to be better than none. Second, venture capitalists have increased their investments in buy-outs, attracted by the promise of quicker exits than those offered by traditional forms of venture capital investments. Third, an increasing number of new venture capital funds incorporate pre-set performance targets, which can stipulate minimum returns to investors and require capital repayment on realisation of individual investments. Fourth, the fee structures, charged to the fund's investors, are changing in response to institutional pressure. Front-end fees (up to 2% of total funds committed) are gradually being eliminated. There are indications that the size and basis of annual management fees are being increasingly examined.

There are mixed views within the industry about these developments. Many venture capitalists are concerned, for example, that too much will be read into estimates of interim returns and that this will lead to even greater short termism on the part of investors. The other developments mentioned above may, in part, be indications of greater investor experience and increased competition among venture capitalists for institutional capital as much as a reflection of increasing short termism. There is a general worry among venture capitalists that shortening investment horizons will especially damage those venture capital organisations genuinely involved in long-term, high-risk investments which need patient money.

chex.ps/jg2/30 **CONFIDENTIAL**

E CCBIUP.

c/fu

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

14 February 1990

P R C Gray Esq
Private Secretary to
Prime Minister
10 Downing Street
LONDON
SW1

Dear Paul

I attach a paper by Treasury officials on City Short Termism and UK Industrial Performance, which was prompted by the Chancellor's discussion with the Prime Minister on 17 January. Although the Chancellor has not been able to consider the subject closely himself, he thought it would be helpful for the Prime Minister to see it (or at least the four page summary at the front) before the dinner arranged by the Governor tomorrow. As you will see, the paper reflects exchanges with DTI officials and the Bank, but it has not been agreed with them. (The timetable for completing the paper had to be compressed a little to meet the deadline of the dinner and one or two detailed corrections may be necessary later.)

The paper concludes that the case that "City short termism" has been a major cause of inadequate long term spending by companies has not been established, and that the Government's main contribution is to provide an environment of stable low inflation, permitting the high profitability which has recently led to increased long term spending by companies. But it discusses some modest options which might be helpful, though none of them would produce rapid or dramatic results.

I am sending copies of this letter and the enclosed paper to the private secretary of Mr Ridley and the Governor.

Yours
JG.

JOHN GIEVE
Principal Private Secretary

CONFIDENTIAL

CITY SHORT TERMISM AND UK INDUSTRIAL PERFORMANCE

SUMMARY AND CONCLUSIONS

Introduction

The attached paper discusses the thesis that "City short termism" is a major cause of inadequate expenditure by industrial companies on research and development (R&D), training and other aspects of innovation (most of which are current costs and so reduce reported profits) and on fixed capital investment. These in turn lead to weaknesses in the UK's industrial performance compared with our strongest international competitors, Germany and Japan.

Evidence

2. There are indeed major structural differences in the financial environment in which industrial companies operate in the UK compared with Germany and Japan. Key differences are the greater importance of the Stock Exchange, publicly quoted shares, and the non-bank financial institutions which hold most shares here, compared with the influence of the banks in Germany and Japan; and the greater openness to hostile takeovers here and in the USA, whereas such takeovers are almost unknown in Germany and Japan. UK arrangements, however, have advantages (market pressures for efficiency and mobility of capital towards more profitable firms).

3. On the other hand survey evidence from industrialists, perhaps surprisingly, does not support the idea that City pressures are the main constraint on long term expenditure. One reason may be that the companies likely to be most affected by City pressures are those whose current performance is not strong but which have plans for improving it in, say, five years time that are not sufficiently credible to investors; sharp discontinuities of this sort may be relatively rare.

4. Concerns about the UK's performance relative to Germany and Japan, and often the USA as well, have been prevalent for many decades and certainly started well before the proportion of shares held by financial institutions or the size of company vulnerable to takeover bids reached their present levels. At the same time

it is clear that City short termism has not prevented the considerable improvement in the UK's absolute and relative performance during the 1980s (see para 27 and Annex B).

5. The paper concludes that the case for City short termism as a major cause of industrial weakness is not established and has been exaggerated. This conclusion need not conflict with a belief that the UK's industrial performance and industrial competitiveness need further improvement or that higher company spending on innovation is needed to achieve it. The main weakness could lie in industrial management itself and its own short term attitudes which can exist independently of City pressures; and in deep seated influences like the education system, the quality, qualifications and management style of senior executives, as well as in macro economic policy and performance in the UK over many decades.

<u>Measures taken or proposed</u>

6. Part IV of the paper discusses a range of measures which are relevant to perceived City short termism.

7. These include better communication by companies of their long term plans to shareholders, more dialogue between companies and their pension funds about guidelines for investment in equities of other companies and about how to vote shares, eg on directors and takeovers; and tax changes to penalise high turnover of portfolios or to reward patience. All these are designed to affect the behaviour of institutional shareholders.

8. Increasing the number and role of non-executive directors independent of full time managements has been widely backed, as a way of maintaining pressure on companies for strong performance, short of a takeover, and of improving communication. After a period of progress, this seems to have faltered.

9. Individual shareholder ownership has been tripled by Government action. It is not clear whether or how far individual shareholders are less short termist than institutions. But they are likely to be, if only because of inertia and higher transaction costs.

10. Some critics want to protect management from shareholders through more frequent intervention by the competition authorities to prevent takeovers, for example, of firms with high R&D spending. (See the Labour party's recent "Technology and Training in the New Industrial Age".)

11. Several of the proposals in paras 7-9 are sensible. But as things stand, there is unlikely to be very rapid or extensive change - certainly not enough to satisfy those who exaggerate the causal role of City short termism.

<u>The Role of Government</u>

12. The most important contribution of Government to improving industrial performance is to provide business with a stable, low inflation environment in which it is easier to make long term plans and less risky to take the long view; and in which it should be possible for recent levels of profitability, innovation expenditure and fixed investment to be further improved.

13. Many of the Government's existing policies will also contribute over the long term:

(a) promoting supply side changes, non-intervention in the affairs of individual companies, and continuing to refer takeover bids, other than those caught by the new EC regulation, to the Monopolies Commission mainly on competition grounds;

(b) reducing public expenditure on near market civil R&D, while continuing to support the science base and reducing defence R&D so as to free resources for company expenditure (though the planned reduction has been somewhat slowed down to allow for developing the European Fighter Aircraft and the Challenger 2 tank);

(c) improving value for money from public expenditure on training and stimulating more company expenditure through the Training and Enterprise Councils (TECs).

14. The Government's role in changing shareholder and company behaviour on lines discussed in Part IV of the paper is much more limited, except through wider individual share ownership, and seeking to identify tax changes that are helpful in this context, practicable and defensible. There are however some modest options which may be worth exploring:

(a) the Governement can help improve communication with shareholders through speeches and by supporting disclosure requirements, as with the accounting standard on R&D which will begin to bit this year. This approach could at a later stage be extended to training: if that was thought desirable, Ministers could seek to stimulate early work by the accountants on the problems of definition;

(b) the Government has resisted legislation to require non-executive directors when backbenchers have proposed it. But the Stock Exchange might be invited to consider whether it would be desirable to imitate the requirements of American exchanges, at least for larger listed companies;

(c) Ministers can of course refer in speeches to the need for innovation expenditure by companies to be based on long term judgements; to the evidence that active management of portfolios by fund managers does not yield higher net returns; and to the case for companies to discuss with the trustees of their pension funds investment guidelines, the criteria for judging fund managers, and arrangements for deciding how their shares should be voted, eg on the apppointment of directors and takeovers. They could also discuss these and similar options with the CBI during the presidency of Sir Brian Corby, the Chairman of the Pru.

14 February 1990

CONFIDENTIAL

CITY "SHORT TERMISM" AND THE UK'S INDUSTRIAL PERFORMANCE

I INTRODUCTION

This paper focuses on the argument that City "short termism" - a convenient shorthand which is spelt out later - is a major cause of inadequate company expenditure on R&D, training and innovation generally, as well as on fixed assets and that this leads to weaknesses in the UK's industrial performance, compared with its strongest competitors like Germany and Japan. After setting out the argument, the paper discusses the evidence for it and some relevant measures that have been proposed or might be explored.

2. Some of the evidence and measures are also relevant to the related but different question of the prevalence of short termism among industrial managers and its effect on the UK's international competitiveness, irrespective of the relative importance of the City as a cause. But the paper does not directly address that.

3. The conclusion points to some ways in which the Government can help. But the levers it has for affecting shareholder behaviour are limited, structural differences between countries are difficult to alter, and the reasons why we do not match Germany or Japan are deep seated. The paper does not offer new measures capable of quickly raising the UK's industrial performance to their level.

4. The paper has benefitted from comments and contributions from DTI officials and the Bank of England but is not agreed with them.

II CITY SHORT TERMISM : THE ARGUMENT

5. There are several strands to the argument about City short termism and its damaging effects on companies and the economy:

a. the investment of UK personal savings is dominated by large non-bank institutions. It is argued that the investment decisions of these institutions are taken by (highly competitive) fund managers, who need to show high short term (often annual or quarterly) returns (even though they typically have very long term objectives);

b. share prices are vulnerable to rapid downward movement should sentiment change;

c. a high proportion of UK companies by value are quoted on the stock market, or have readily tradeable shares;

d. UK companies are open to hostile takeover if their share price drops; and many such takeovers occur;

e. company managers must therefore concentrate their efforts on ensuring that their share price is kept high. This means maximising short term earnings;

f. by implication, this is at the expense of investment in R&D, training and fixed assets and hence of longer term earnings.

6. The same complaint is also made in the US. The two Anglo-Saxon countries, on the one hand, are contrasted with Germany and Japan, on the other: the position on most of the points in paragraph 5 (a)-(f) are asserted to be worse in the former two countries than in the latter. These criticisms are common but they are typically made most forcibly by managers of companies whose short term performance is not strong.*

7. The subject arouses strong feeling and has provoked much discussion and analysis in recent years, as the references in this paper show. But it remains intractable in terms of evidence on the causal importance of City short termism; and, even if the argument were regarded as inherently unprovable but broadly correct, of identifying practical and desirable remedies.

---

* A 1987 DTI study of the performance of 7 companies whose chairmen had made representations both for and against openness to takeovers, showed that those advocating greater protection had the worse company performance. A recent update shows no change in their comparative positions. However, the study was not detailed and the correlation could be due to other factors, such as company size.

III EVIDENCE

8. Evidence involving international comparisons and claims about causation is unlikely to be conclusive. But ideally the thesis about City short termism should be supported by evidence not only that the factual points in para 5(a)-(f) apply to the UK and either do not apply or apply to a smaller extent to Germany and the Japan; but also that these cause the differences in industrial performance, though here we have to make do with surveys of the views of participants in industrial decisions, the reactions of stock markets to information about innovation expenditure, and the timing of changes at the finance end and in industrial performance.

<u>Differences between the UK and Germany or Japan</u>

9. Some of the necessary evidence is undoubtedly there, though it is not sufficient on its own. There are major structural differences between the capital markets of the UK and Germany and Japan, as well as many important social and legislative differences.

10. Institutional investments follow a different pattern in Germany. A large volume of German personal savings is channelled into savings banks (whereas in the UK, equivalent savings would tend to go to the building societies). The German commercial banks borrow from the savings banks, and channel the monies into industry.

11. The relationship between banks and industrial companies is much closer in Germany than in the UK. Depending on their size, companies have one or more "Hausbank", ie a principal bank which is closely involved in the company's financial affairs. The bank will hold a considerable amount of collateral, in the case of smaller companies, and/or proxy voting rights on behalf of shareholders and seats on the company's supervisory board, in the case of larger companies. The bank will also influence company behaviour through providing investment and corporate finance advice.

12. Another difference lies in the arrangements for funding occupational pensions. German companies typically carry a large part of their pension liability on their balance sheet. This means that they have a very significant additional source of internal finance. It also means that pension funds are much less important in terms of institutional investment in Germany than they are in the UK.

13. The position in Japan is much closer to Germany than to the UK. Many companies, including many of the larger ones are protected by a complex system of inter-locking shareholdings. The companies build up relations with institutional investors in pursuit of long standing mutual shareholdings. There is a pre-eminent emphasis on retained capital as a source of investment, with very low dividend levels by Anglo-Saxon standards. This, in turn, reduces the pressures on companies to meet short term returns.

14. In the UK by contrast the proportion of shares in the hands of non-bank financial institutions is exceptionally high at 68 per cent of market capitalisation, though even in the USA the institutional proportion now seems to have passed 50 per cent.

15. Moreover in the UK a far larger proportion of economic activity is represented by companies whose shares are traded on the Stock Exchange.

16. Germany has approximately 2 million small companies, and only 2,200 public companies. Of these, only some 470 are listed on the official stock exchanges. Trading in equities is on a far smaller scale to that in the UK. The commercial banks control a high proportion of shares, which they either own or hold on deposit for investors, whose proxy rights they exercise. The market capitalisation of shares is higher in proportion to GDP in the UK than in any major country in Europe or North America (see table 1, Annex A) though the proportion for Japan is even higher.

17. In the UK, as in the USA, there is a great deal of takeover activity. UK companies seem to spend more on takeovers here and elsewhere, proportionately, than any other country's. Intervention by the UK authorities is largely confined to cases which threaten to weaken competition. More important, there are very few barriers to hostile takeovers erected by private sector arrangements. In Germany and Japan hostile takeovers are virtually unknown.

18. These differences are by no means all disadvantageous to the UK. For example within Germany the dominant banks are criticised for conservatism and ignorance which means that some good but risky projects are not financed and many poor projects are financed. In cases where there is inadequate pressure for good performance, the absence of a threat from hostile bidders removes an important discipline. Nevertheless the differences exist and they broadly fit the description of City short termism in para 5.

<u>The City as a major cause of inadequate industrial expenditure</u>

19. The evidence is far from clear on whether concentration by the City on short term profits has an adverse effect on decisions affecting industry's long term profitability. A DTI paper (sent to No 10 on 10 February 1987) concluded that although the UK spending on R&D did not match Germany's or Japan's, the available evidence fell short of what would be needed to support the "myopia" hypothesis. The available evidence is mainly of two sorts: analysis of the effect of the markets on R&D spending and surveys of industrialists.

20. R&D spending is viewed as a crucial test of the short term hypothesis because, unlike fixed investment, it is shown in the accounts as a cost which reduces current profits (because returns are generally several years distant and very uncertain). A study for the US Stock Exchange Commission looked at the relationship there between the R&D spend, institutional ownership and share price movements. In each case, the actual relationship was the opposite of what would be expected were short termism true. Companies with larger proportions of shares held by institutions spend more proportionately on R&D, contradicting the short termist

expectation that institutions would use their greater influence to maximise short term profits by reducing R&D. Share prices appeared to react positively to announcements of increased R&D spending, rather than negatively as short termism would suggest. A similar study has not been undertaken in the UK.

21. On the other hand, there is evidence from one study+ - although contradicted by other studies - that the stock market 'over-values' current dividends relative to future dividends, which would tend to support a short termist view. But this finding applied to the stock market as a whole and not just to institutional shareholders.

22. Anecdotal evidence was provided by a survey for the CBI City/ Industry Task Force in 1987 which asked companies what were the constraints preventing them from taking long term strategic investment decisions. The responses listed the cost of capital or fear of an inadequate rate of return as the most significant. Although 80 per cent of the firms surveyed had been involved in takeover activity in the last three years (either as bidder or target), none considered the fear of takeover a major constraint. Over three-quarters of firms thought pressure from financial institutions was not a significant constraint. A follow up survey in 1988 showed some worsening of attitudes but little significant change.

23. A 1988 survey by the DTI of 25 firms similarly concluded that, despite a general belief that short term attitudes were dominant in the City, this did not significantly constrain R&D expenditure. The main determinant of R&D expenditure was past and future profitability. Industrialists in the survey attached importance to good communications to overcome City short sightedness and supported formal disclosure of R&D expenditure in company accounts to allow the City to take account of it; this is to come into effect this year.

\+ by Wadwhani and Nickel

24. Other anecdotal evidence points to the failure of some takeover bids (eg Dixons/Woolworth and BRT/Pilkington), despite a considerable premium on the current share price, as examples of the City refusing to be guided only by short term profits.

25. There is therefore little hard evidence for a causal link between short term attitudes in the City and reduced long term investment in industry. Indeed, perhaps surprisingly, there is a good deal of evidence, including the opinions of industrialists themselves, which is at odds with the thesis that short term financial horizons are a significant constraint.

26. Whatever the truth, it is clear that short termism has not prevented the significantly improved performance of British industry in the 1980s, compared both with its own past and with other countries. Annex B gives details.

27. But the major points are:

(a) the fall in the UK's share of manufactured exports, compared not only with Germany and Japan but also France and Italy, was halted;

(b) the productivity gap in manufacturing compared with France and Germany was narrowed;

(c) a substantial increase in industry-financed expenditure on R&D performed in industry accompanied the restoration of return on capital in ICCs to 1960s levels. Annex B, table 3 shows that UK industry spent considerably less proportionately than Japan and Germany in 1987, almost the same as the USA and more than France and Italy. But between 1983 and 1987, UK industry's spending on R&D increased by an annual average of 8.7 per cent in real terms, equal to Japan and significantly more rapidly than in USA, France and Sweden. There was also an improvement in companies expenditure on training;

(d) over the 1980s business investment in the UK (including former nationalised industries both before and after privatisation) rose at an annual average of 5 per cent or twice as fast as GDP as a whole. In the last three years business investment has risen to a record share of GDP rising by 10¾, 17½ and 10½ per cent respectively. It is normal cyclical behaviour for UK business investment to be slowed and falling back from these exceptional levels in 1990. Annex B, table 4 gives international comparisons (on a slightly different definition). These suggest that of G7 countries only Japan showed a faster growth of investment in 1980-88;

(e) throughout the period the notable success of chemicals (including pharmaceuticals) and oil companies, which depend on long term decisions, has continued.

28. Some of these improvements were from a low level and were partly cyclical. They do not raise the UK to German or Japanese levels; and it remains possible that City short termism in some sense inhibited an even greater improvement. Nonetheless the timing of various changes discussed casts doubt on the causal role of City short termism. Concerns that the UK was falling behind other countries including Germany and Japan have been expressed for many decades. The improvements in para 27 have occurred over a period in which the institutions' holdings reached their current record levels and the size of individual bids reached new heights.

Conclusion to Part III

29. The evidence suggests that critics have exaggerated the causal role of the City in weakening the UK's industrial performance compared with Germany and Japan. This conclusion is, however, compatible with believing that further improvements in the UK's industrial performance are desirable and that higher company spending on R&D and training is needed to achieve it.

IV MEASURES ALEADY TAKEN AND FURTHER POTENTIAL OPTIONS

30. Various measures have been taken or proposed which are designed wholly or partly to deal with City short termism by improving the financial environment of industrial companies. These include:

(a) ways of changing the behaviour of institutional shareholders, eg better communication by management and more disclosure; dialogue between management and trustees of their pension funds about decisions on use of votes; or tax changes;

(b) promoting wider or deeper individual share ownership;

(c) increasing the pressure for good performance by companies, short of a takeover, by appointing more independent non-executive directors or by making the role of British banks more like that of German banks;

(d) protecting management from shareholders through more blocking of takeovers in certain circumstances, eg when R&D spending is 'high'.

31. Several of these measures are desirable for other reasons irrespective of the importance of the City as a cause of weakness in industrial performance. The main difficulty with those changes that are practicable and desirable is that their scale and effect may be modest and that the Government does not have many levers for making them more extensive. 30(d) can be seen as the prescription of those who see 30(a)-(c) as inadequate to the perceived problems of City short termism.

<u>Improved Communication between management, shareholders and other financiers</u>

32. This was a central recommendation of the CBI's City/Industry Task Force in 1987. A year later a CBI follow up survey showed that:

> "Although the majority ... have not changed the amount of information disclosed to shareholders ..., a significant minority of large firms ... now reveal more in their annual reports and individual presentations".

This improvement was modest. Since then the Bank of England believe that improvements have continued, though this is time consuming for top management and more difficult for medium size than for large companies.

33. The CBI Task Force recommended companies to include a statement about their innovative activities in their annual reports. It would be natural for this to include the information about R&D expenditure which will have to be disclosed during 1990 as the new accounting standard becomes effective. It applies to accounts for periods beginning 1 January 1989. This will bring the UK closer to practice in the USA where comparative tables of R&D expenditure are regularly compiled from information in accounts.

34. At a later stage a similar disclosure requirement might be extended to training. There would, however, be obvious problems of definition and it would be worth considering whether work to see if these could be resolved could usefully start now.

Discussion between management and pension fund trustees

35. The CBI Task Force recommended more dialogue between a company and the trustees of its pension fund and in particular that it should cover arrangements for deciding how votes of the shareholders' pension funds are cast, particularly on contentious issues. The Task Force also suggested that investment managers might be encouraged to get more information on companies' policies on innovation; R&D, and training.

36. The CBI's 1988 follow up questionnaire showed that only 10 per cent of all respondents discussed the use of pension fund voting rights in third companies. One-third of respondents had no regular discussions with trustees.

37. In principle there need be no conflict between the responsibilities of pension fund trustees for the interests of beneficiaries and decisions by companies in which they hold shares which maximise profits and returns to shareholders over the long term; the managers who complain about the City presumably wish to take decisions of this sort. When delay and risk are involved,

the trustees, like the management, can be expected to require a higher reward than with shorter term or less risky propositions. It has been suggested that trustees should ensure that their preferences are clearly reflected in the investment guidelines set for fund managers.

38. The guidelines could also usefully cover the desirable extent of turnover of existing portfolios in the light of the evidence that higher rates of turnover are not justified by higher returns net of transactions costs.

39. Little progress seems to have been made on any of this. Nor has there been any detectable change in the length of fund managers' appointments or the period over which their performance is judged by trustees. It is surprising that so little has been done, since John Banham pointed out in a speech at the CBI 1988 Conference:

> "These are matters under our control; as the American Civil War General is alleged to have said on returning from a reconnaissance: "I have seen the enemy; and he is us"."

40. The Government might ask the CBI during the presidency of Sir Brian Corby, Chairman of the Pru, to stimulate progress and in particular an effort to train trustees, perhaps as part of a wider approach to the CBI and other employer groups on short termism.

<u>Wider Share Ownership</u>

41. Wider individual share ownership (WSO) has been promoted by the Government for a variety of reasons including the supply side benefits of participating in a capital owning democracy through a direct relationship between companies and individual shareholders. But it is also seen as countering the growing proportion of shares held by financial institutions and by pension funds within the institutional total (see Annex C). The Government has done a great deal in this field and last November the CBI set up a task force to look at obstacles to wider share ownership apparently partly on the grounds that a larger individual shareholder base is a stabilising factor in the stock market.

42. It is uncertain how far WSO will in fact counter alleged effects of institutional shareholding. First, despite the trebling in the number of individual shareholders as a result of privatisation, extended tax relief for employee share ownership, PEPs, and changes in pension legislation, the proportion of shares held by individuals has continued to fall. The same trend is evident in America despite the existence of a retail distribution network there. But in the USA individuals still own nearly 50 per cent of all shares compared with about 20 per cent here.

43. Secondly, holdings of fewer than 1000 shares in privatised companies have not been very stable, though this may be partly explained by capital gains available on issue in some cases.

44. Nevertheless it is likely that individual shareholders are less quick to sell, partly because of inertia and partly because their transaction costs are typically a multiple of the institutions'.

<u>Tax Changes</u>

45. A great deal has already been done through tax changes to promote individual share ownership. This includes the creation of PEPs and the enlargement of employee share incentives. Personal pensions have been successfully introduced. In the last two years Treasury Ministers have conducted detailed reviews of the taxation of pensions, life assurance, and unit trusts; and tax changes arising from these reviews dominated the last Finance Bill. The introduction of the cap on the tax privileged pension in the last Budget attracted considerable controversy and it is unlikely that Ministers would wish to reopen this debate by floating any more radical proposals for reducing pensions' tax privileges at this stage, especially in view of the pledge to provide a Green Paper before major tax changes affecting pensions.

<u>The Role of Boards and shareholding institutions</u>

46. Much attention has focussed on how the institutions might be encouraged to take a more active, and therefore perhaps more long term, interest in their holdings.

47. Increasing the number and role of independent non-executive directors is widely seen as a means of providing both effective pressure on management short of takeover and a reliable channel of communications to large shareholders. The Bank of England, the clearing banks, the CBI, the Stock Exchange and other bodies have sponsored a campaign by PRONED (Promotion of Non-Executive Directors), which included the circulation to all listed companies of a Code of Recommended Practice. This called for each Board to have strong, independent non-executive directors to number at least three and to be one-third of the board with a controlling majority on audit and directors' remunerations' committees. Their main task should be to help the board provide the company with effective leadership, to ensure the continuing effectiveness of executive directors and management and to ensure financial probity. The code makes the obvious point that such directors need support from the chairman and relevant information in good time. It is, important, however, that the non-executive director should not be in the pocket of the full time management.

48. Surveys in 1983, 1985 and 1988 of the Times 1000 companies show that the number of non-executive directors as a percentage of the total board has increased from 33 to 36 per cent, but that the momentum slowed in the last three years. 44 per cent of companies had fewer than three non-executive directors. There has, however, been a marked shift towards more 'independent' non-executive directors - 75 per cent in 1988 of them against 65 per cent in 1985 had not served as an executive or had a professional relationship with the company.

49. Possibilities for encouraging non-executive directors further include:

(a) persuading companies to consult major institutional shareholders about non-executive directors. The institutions would not wish to see their own employees on the board, but their involvement might lead to non-executive directors being more widely seen as an appropriate channel for shareholder concern;

(b) in principle major institutions might share out the lead role in applying shareholder pressure through a non-executive director on companies in whom they all had an interest. However, despite attempts to encourage a move in this direction, the Bank say that there is insufficient consensus at present to make this workable;

(c) encouraging or requiring institutional shareholders to exercise their voting rights, or at least consult the beneficial owners, particularly in the election of directors. At present, only some 11 per cent of proxies are exercised. In the USA the Department of Labour argues that the trustees of certain funds are obliged to vote their shares after considering the best way of protecting beneficiaries' long term interests. The same may be true here. There is a risk that in practice institutions would exercise their voting rights passively, and follow the company management's own recommendations with little questioning. But this area may deserve further work;

(d) formally requiring, either through Stock Exchange listing requirements or company law, a set number of non-executive directors on boards of listed companies over a certain size. However, the Government has opposed backbench amendments to this effect to Companies Bills, arguing that companies themselves should determine the most effective management and supervisory structure.

50. The Bank will continue to encourage more non-executive directors but, short of compulsion as in (d) above, progress is likely to be slow.

<u>Making Banks More Important</u>

51. Critics of short termism in the UK point to the beneficial long term involvement of the banks in Germany and Japan as an alternative model. Hostile takeovers are practically unknown and

any necessary corrective action is administered informally but effectively by the banks. It is not practicable, however, to expect to transfer this aspect of the German system to the UK without changing the entire basis of corporate financing to mirror the much greater emphasis placed in Germany on debt rather than equity finance. UK banks play a rather different role in relation to industrial companies from the German universal banks. In Germany, banks have historically been direct providers of equity capital, and they protect their interests in the companies by fairly direct involvement in management. In the UK, the capital markets are regarded as the proper source of risk capital for industry, and the banking supervisors discourage direct investment for general prudential reason.

<u>Changes in Takeover Policy Practice and Accounting</u>

52. The ease with which takeovers can be mounted in the UK and carried through against the opposition of incumbent management, and the consequent diversion of management effort to erect defences and build up short term profits, is often quoted by industrialists as a symptom of short termism. Although the value of individual takeovers has increased vastly, the number of takeovers in 1988 was no higher than the previous peak of 1973; takeover activity fell off by more than 20 per cent in 1989 (as shown in Annex B Chart 6). Continued high interest rates and the well-publicised difficulties of a number of leveraged buy-outs mean that takeover activity seems unlikely to recover in the near future and may decline further.

53. Attempts to reduce the prevalence of takeovers further would, at the extreme, place a burden of proof on the bidding company. At present, both the Takeover Panel and the mergers procedure take an essentially neutral view of whether takeovers as a whole are good. The CBI proposed a number of changes to the takeover code, all intended to give companies more notice of attempts to build significant hostile holdings or to make takeovers more costly and difficult.

54. A Working Party established by the Takeover Panel concluded in 1989 that two minor changes should be made, which have now been implemented. More fundamental changes proposed by the CBI and others were rejected. These included: the lowering of the mandatory bid threshold; a requirement that shareholders should make a "statement of intent" when their holding reaches 5 per cent; restrictions on companies being "put into play"; bidders required to issue a detailed prospectus setting out plans for the target company; and an extension of the one year period before an unsuccessful bid may be renewed.

55. The CBI's proposal has not since been raised again and the Government attitude has been that these are matters for the Takeover Panel to determine.

56. The Labour party's recent statement on "Technology and Training in the new industrial age" proposes:

> "new takeover procedures which will offer large ... companies who invest in reseach greater protection from corporate raiders".

57. Reviving proposals to make takeovers more difficult could be considered, but it would be a mistake to weaken the one weapon shareholders currently use to discipline management without providing an alternative channel for continuous pressure for good performance. Reducing the fear of takeover without enhancing the informal influence of institutional investors along German lines could simply result in more complacent management. It would also be a major volte face for the Government which has consistently maintained the virtues of market forces as a discipline except where a merger would weaken competition or, exceptionally, raise other public interest issues (as with the KIO holding in BP). It would also undermine the UK's initiative designed to remove or reduce barriers to takeovers in other EC countries. The UK has won Commission support of this initiative but other member states, particularly Germany, are likely to resist strongly. It would stand little chance of success, and so UK firms would continue to be denied fair access to overseas companies, if the UK was seen to reverse its own stance and begin introducing barriers to takeovers in the UK.

58. If the recently published draft accounting standard on goodwill is applied, it might reduce some of the short termist pressure in companies. Goodwill is the excess of the price paid for an acquisition over the value of its assets. The UK has until now differed from most other countries in allowing goodwill to be written off against reserves, with the result that it has no impact on reported profit and loss results. Arguably this is wrong, since the profits from the company acquired (for which good will is effectively the price) will be shown in the Company's future results. The new draft standard proposes that goodwill should be written off against profits over a period of up to 20 years: this would have a significant impact on "predator" companies. For example, Hanson has written off over £4 billion against reserves between 1986 and 1989 as a result of acquisitions: applying the draft accounting standard would have depressed Hanson's profits after extraordinary items by some 20-25 per cent, though the earnings per share would be only about 10 per cent lower. It is precisely those companies which have been most acquisitive who stand to lose most from this change. As a result, it may reduce the incentives to takeovers, although those that are rooted in sound business sense should not be affected.

14 February 1990

iae.sb/IAE3/Stephens/119s

ANNEX A

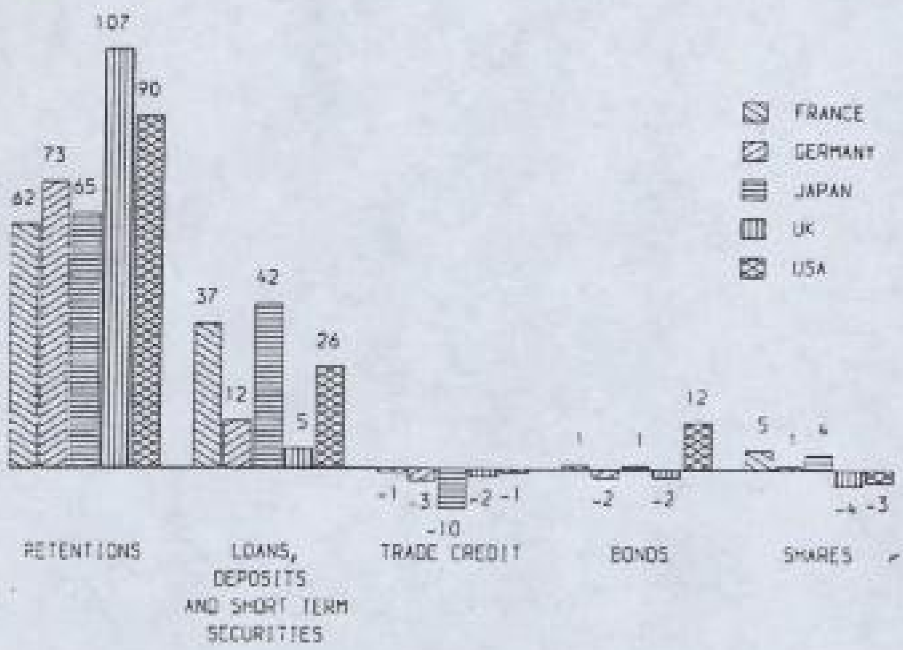
TABLE 1: Stock Market Capitalisation

% of GDP, 1988

UK	94
USA	58
Japan	134
Germany	21
Canada	50
France	26

SOURCE: Bank of England

CHART 2: Average net Financing of Private Physical Investment by Enterprises, by source, 1970-85



SOURCE: New issues in corporate finance, C Mayer

TABLE 2: Sources of UK company finance in the 1980s*

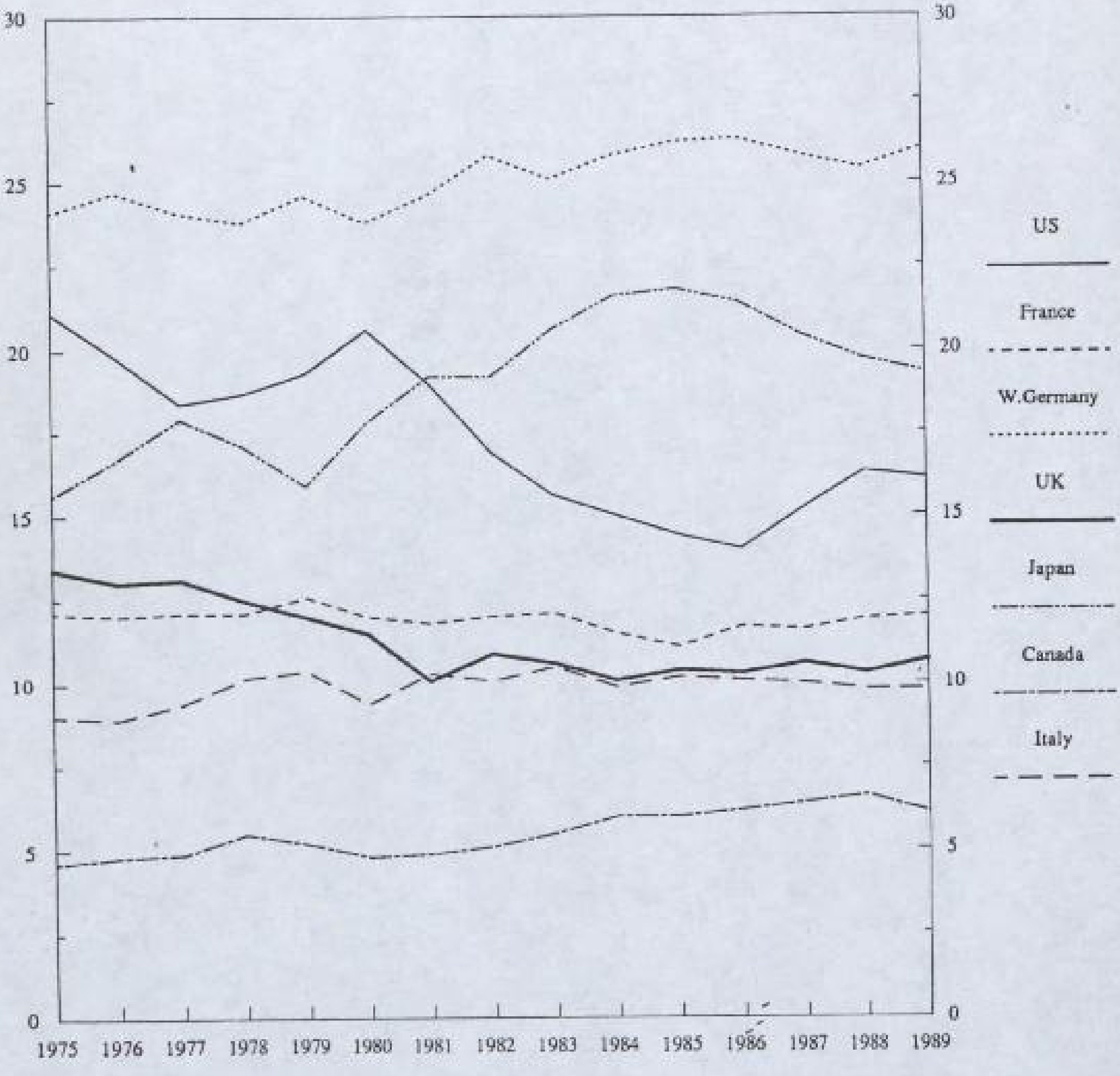
	1986	1988
	%	%
Internal Finance	57.0	45.8
Trade Credit	-.3	0.1
External Debt	24.3	43.3
Equity	12.3	6.8

SOURCE: Bank of England

* Figures do not add to 100 per cent because of rounding

ANNEX B

CHART 1: Comparison of volume shares of world trade in manufactures (%)



Note: 1988 and 1989 figures are tentative HMT projections based on forecast growth in exports of total goods.

Source: UN Bulletin of Monthly Statistics.

TABLE 2: Output per person Employed in Manufacturing+

(annual average percentage change)

	1960-1970	1970-1980	1980-1988++
UNITED STATES	3.5	3.0	4.1
JAPAN	8.8	5.3	3.1
GERMANY	4.1	2.9	2.2
FRANCE	4.5	3.2	3.1
UNITED KINGDOM	3.1	1.6	5.3
ITALY	6.2	2.5	3.0
CANADA	3.4	3.0	3.5
G7+++	4.4	3.2	3.6

NOTES:

+ Exact coverage differs between countries

++ Average of 1988 whole year for all countries

+++ Weighted using 1980 GDP weights

Source: OECD annual and quarterly indices of manufacturing production and employment except UK (CSO index of manufacturing output per person employed) and France and Italy (IMF indices of manufacturing employment).

TABLE 3: Spending financed by industry on Research and Development

	% of GDP		Average annual % increase* 1983-1987
	1983	1987	
JAPAN	1.6	1.9	8.7
GERMANY	1.5	1.8	7.9
USA	1.3	1.2	4.2
UK	0.9	1.1	8.7
FRANCE	0.9	0.9	4.6
ITALY	0.4	0.5	9.5

* In real terms, deflated by GDP deflators

SOURCE: OECD, Main Science & Technology Indicators April 1989.

TABLE 4: Total investment as per cent of GNP/GDP

	1974	1979	1985	1988
US	18.6	20.4	18.1	17.1
Japan	34.8	31.7	27.8	30.6
Canada	23.7	23.1	19.8	22.0
Germany	21.6	21.8	19.7	19.9
France	25.8	22.4	19.2	20.1
Italy	27.5	23.1	21.1	19.9
UK	**20.9**	**18.7**	**17.0**	**19.2**
G7	23.3	22.8	20.2	20.5

SOURCE: OECD, CSO

TABLE 5: Investment growth

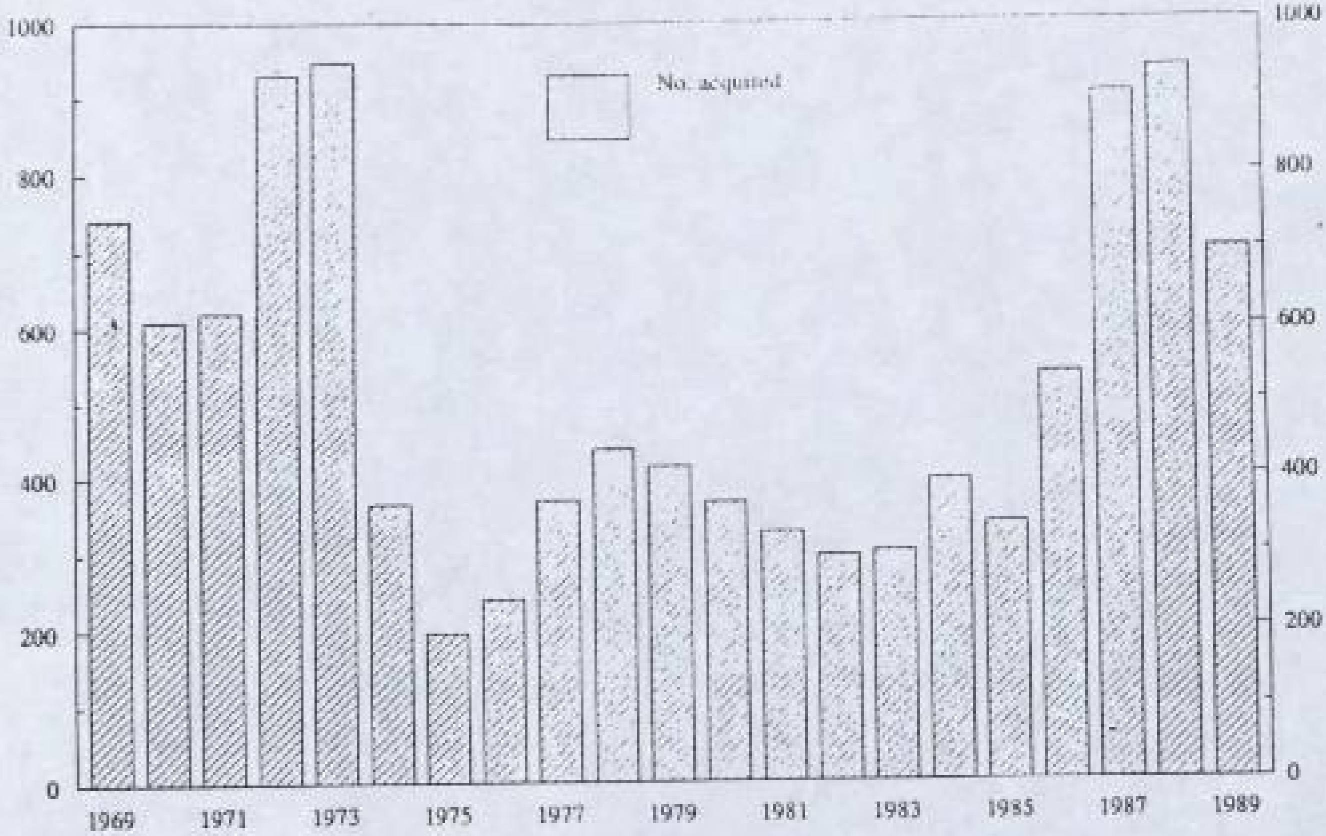
Average annual percentage change

	Whole Economy		Business*	
	1970-1980	1980-1988	1970-1980	1980-1988
United Kingdom	**0.4**	**4.5**	2.3	7.6
US	2.5	4.1	3.7	3.4
Japan	3.5	5.4	2.8	8.0
Germany	1.4	0.6	1.8	2.3
France	2.5	1.0	2.4	1.9
Italy	2.1	1.2	3.4	1.3
Canada	6.1	5.0	7.5	4.6
G7	2.7	3.8	3.4	4.3

*OECD definition of private non-residential fixed capital formation. This includes investment of privatised companies only from point of privatisation, which increases UK growth rate in years affected. Excluding privatised companies reduces UK figure but UK still has second fastest growth among G7 in 1980-88

Source: OECD, CSO.

CHART 6: Acquisitions of independent companies, by number



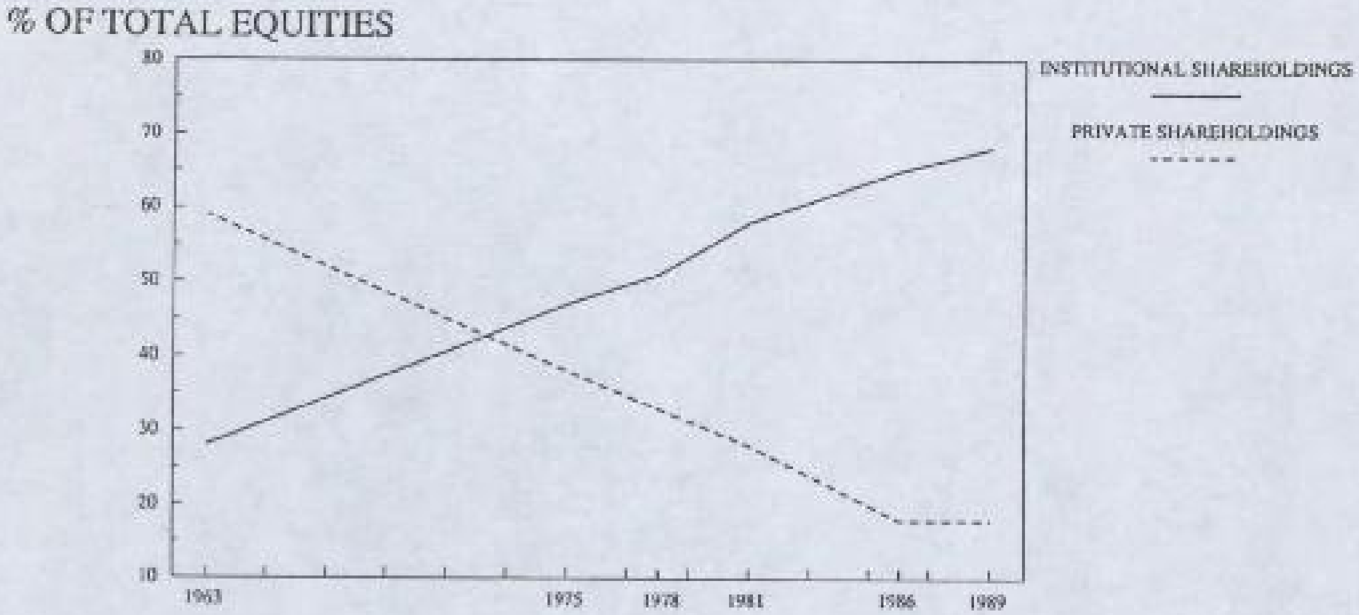
SOURCE: CSO Business Monitor, Quarterly Statistics

Institutional share ownership

Figures 1-4 give statistics on the shareholdings of institutions, showing that through the 1980 s the pension funds increased the proportion of their total assets held in shares.

Figures on the proportion of shares held by institutions and individuals are difficult to establish. (No complete set of strictly comparable data exists and figures 1 and 2 below should not be quoted). A 1987 Bank of England paper suggested that in 1981 institutions held 58% of Stock Exchange shares by value (up from 29% in 1963) while individual shareholders held 28% (down from 54%). Since 1981, although the number of individual shareholders has increased substantially, it is thought the proportion of total shares held by them has continued to decline, to perhaps 18-20%. This decline in individual shareholding is reflected in the US, although the proportion remains much higher there (61% of corporate equities in 1987, down from 94% in 1945).

Figure 1 THE PROPORTION OF TOTAL UK EQUITIES HELD BY INSTITUTIONAL AND PRIVATE SHAREHOLDERS



Source: Warburgs.

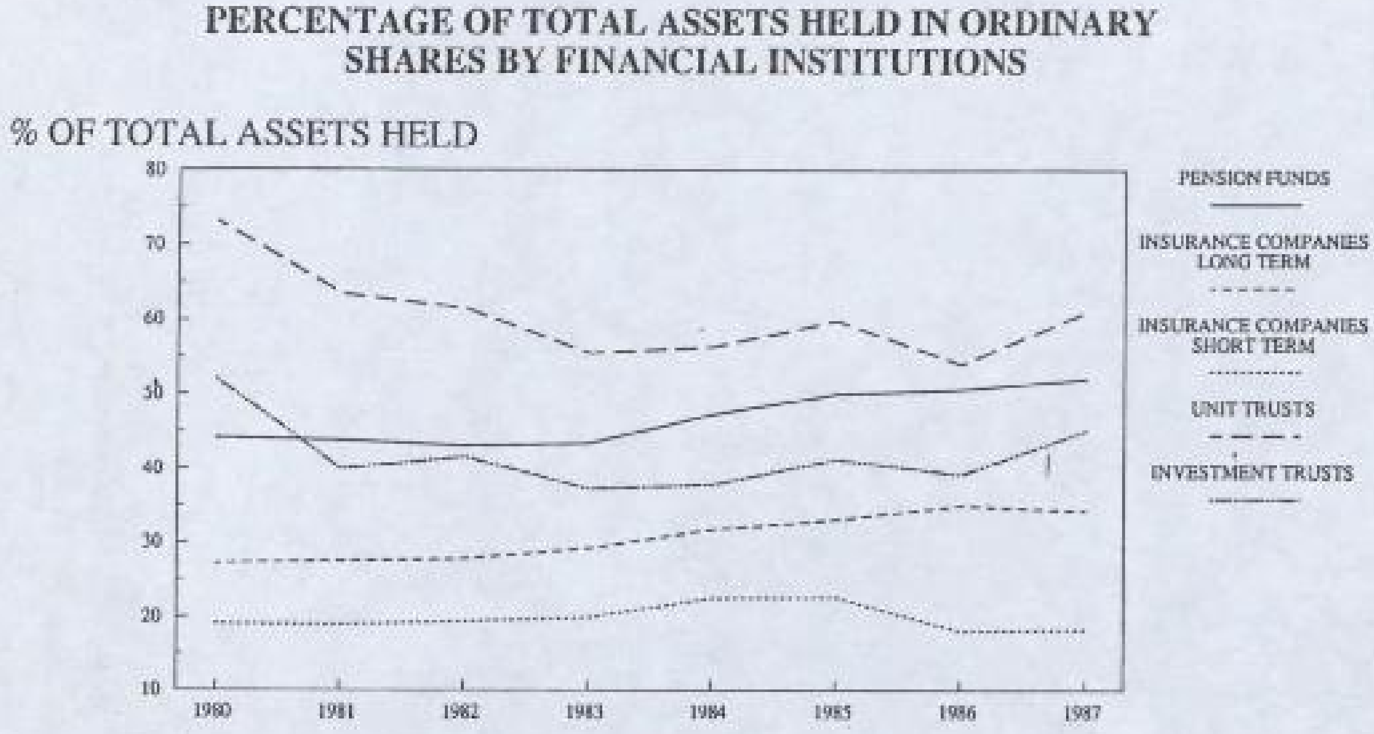
Figure 2: Institutional shareholdings (including pension funds) and private shareholdings as a % of total equity market capitalisation.

	1963	1975	1978	1981	1986	1989
Pension Funds	5.6	15.1	18.1	30.0	32.2	na
Insurance Companies	6.3	13.3	18.6	21.0	20.6	na
Unit Trusts	1.1	4.0	4.3	3.6	5.5	na
Investment Trusts	7.0	6.2	5.9	3.4	2.7	na
INSTITUTIONAL HOLDINGS AS A % OF TOTAL EQUITY MARKET	28	47	51	58	65	68
PRIVATE HOLDINGS AS A % OF TOTAL EQUITY MARKET	59	38	33	28	18	18
OTHER	13	15	16	14	17	14
TOTAL	100	100	100	100	100	100

Source: constituent parts of total institutional holdings - CSO Financial Statistics. All other figures - Warburgs.

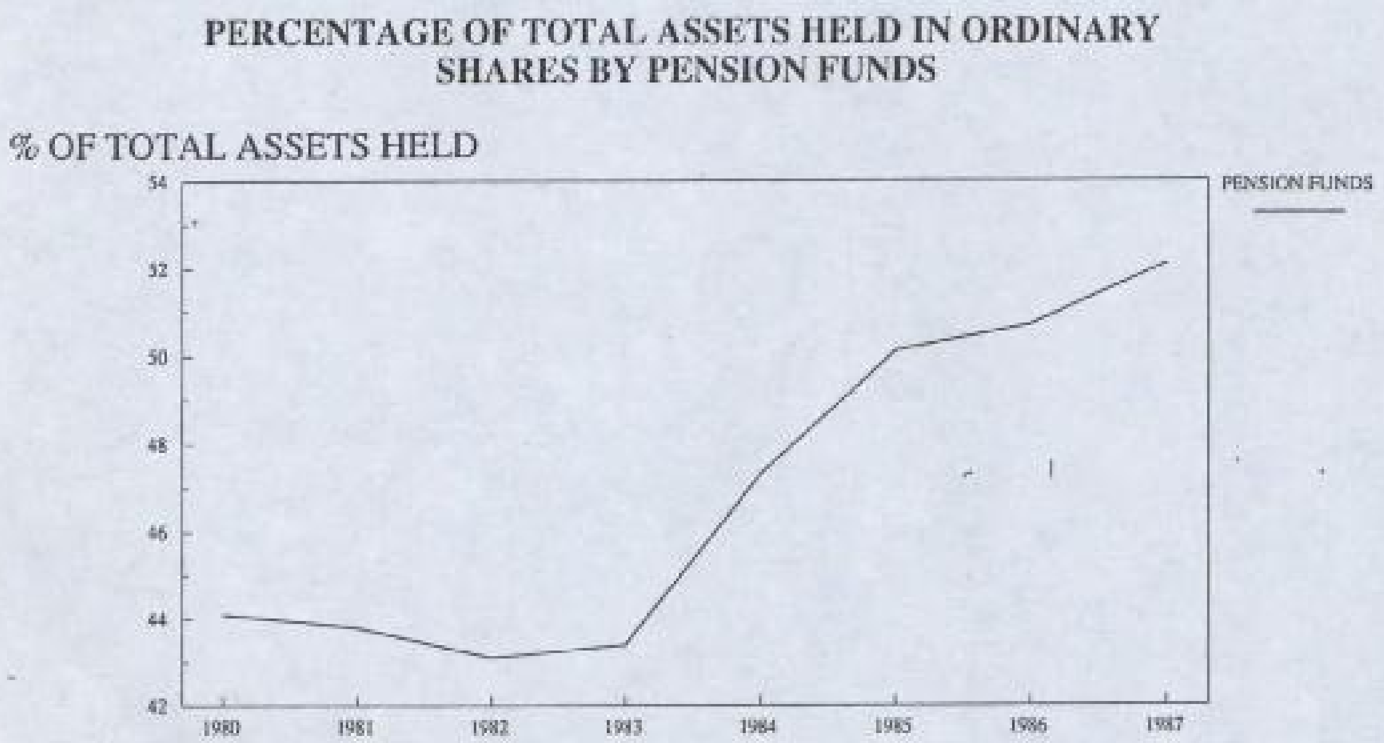
fim2.md/brimson/feb.7.1

Figure 3



Source: CSO Financial Statistics

Figure 4



Source: CSO Financial Statistics

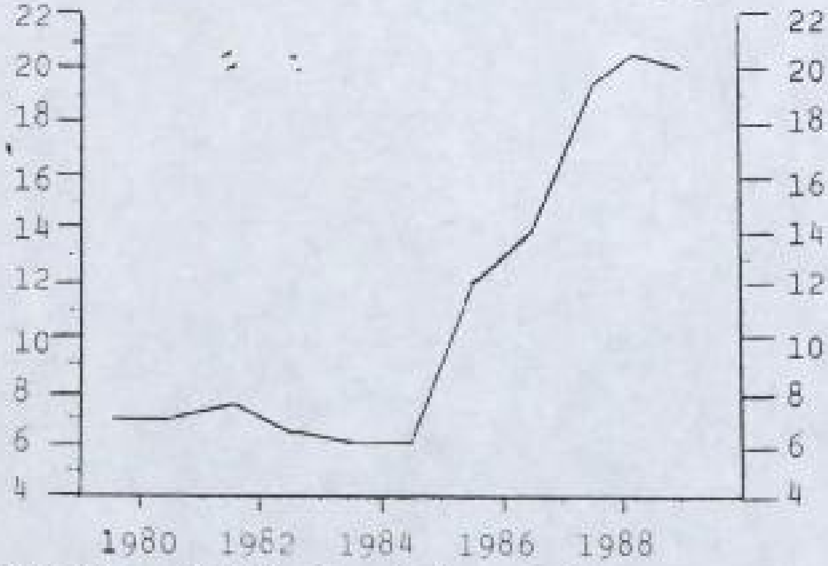
fim2.md/brimson/feb.7.1

Individual Share Ownership

The joint Treasury and Stock Exchange Survey carried out in January and February 1989 showed that 20 per cent of the adult population own shares directly, compared with 7 per cent in 1979; a threefold increase. The figure is now comparable to the approximately 25% of the US adult population who hold shares.

Figure 5: Growth in individual share ownership

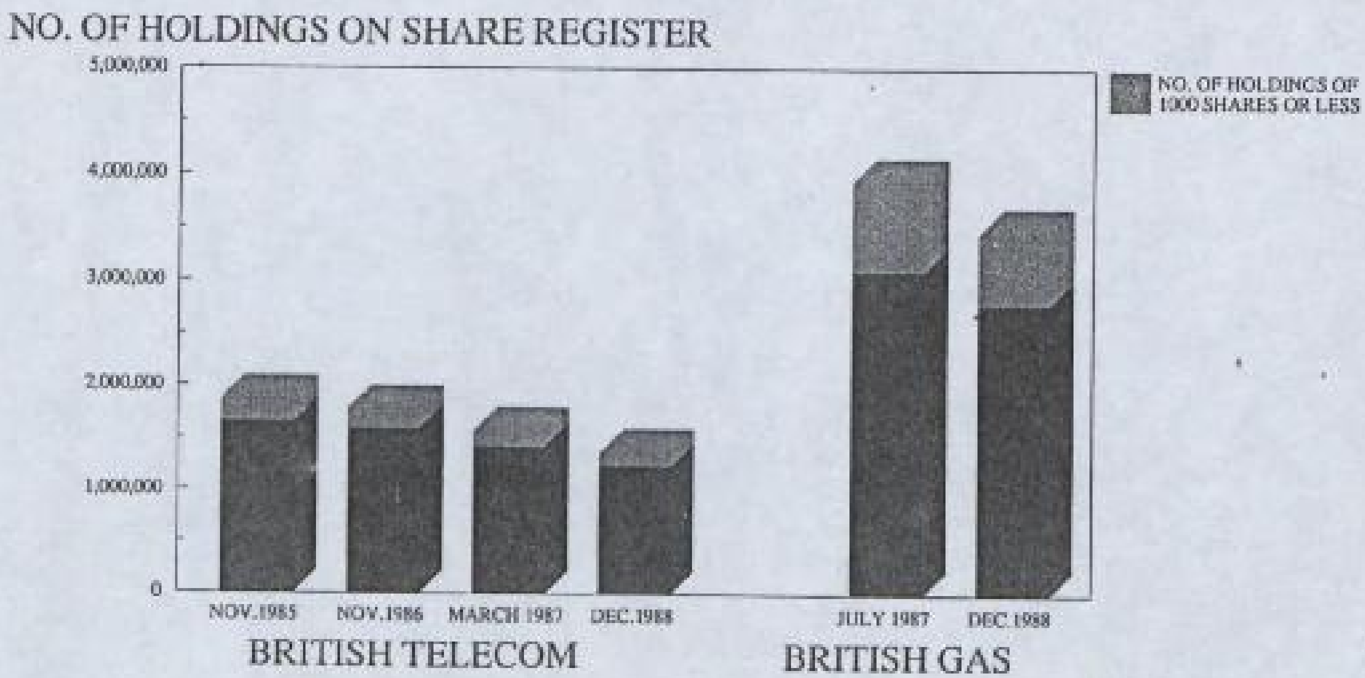
Shareholders as a percentage of the adult population.



Source: 1979 Q2 to 1985 Q3, Target Group Index
1986 Q1 to 1989 Q1, Treasury-Stock Exchange Survey.

Figure 6 shows that individual shareholders are not necessarily less short-term: the numbers of small shareholdings in BT and British Gas declined more sharply after privatisation than the total number of holdings. This may of course disguise a far higher number of transactions between institutions, than between individuals.

NUMBER OF SMALL SHAREHOLDINGS



fim2.md/brimson/feb.7.2

WIDER SHARE OWNERSHIP

There have been measures to encourage wider share ownership. These include Personal Equity Plans (PEPs), personal pensions structure of privatisations and employee share schemes.

Transaction Costs

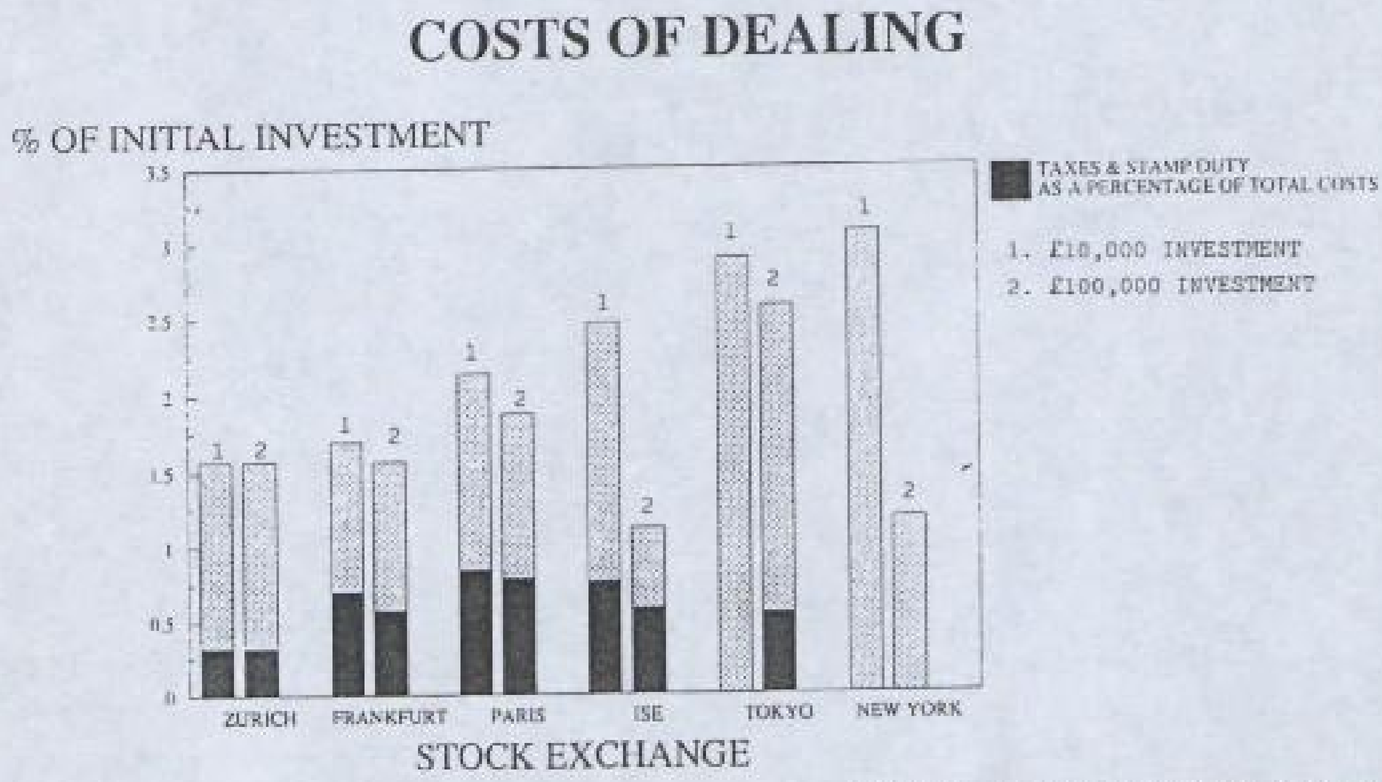
A comparison of dealing costs prepared by the International Stock Exchange's Quality of Markets Unit in January 1989 shows (although it does not cover the small investor) that the ISE is more expensive than other European centres for small deals:

Figure 7

Costs (including taxes and stamp duty) to a domestic investor of buying and selling an initial investment of:

	£10,000	£100,000
	(% of initial investment)	
Zurich	1.57 (1.25)	1.57 (1.25)
Frankfurt	1.70 (1.00)	1.57 (1.00)
Paris	2.14 (1.30)	1.88 (1.10)
ISE	2.47 (1.71)	1.12 (0.54)
Tokyo	2.90 (2.90)	2.58 (2.04)
New York	3.07 (3.07)	1.18 (1.18)

Figure 8



Source : ISE Quality of Markets Report (January 1989)

ECON POL: Venture Capital, June B.

VR

DEPARTMENT OF EDUCATION AND SCIENCE

ELIZABETH HOUSE YORK ROAD LONDON SE1 7PH

TELEPHONE 01-934 9000

FROM THE SECRETARY OF STATE

NBPM at this distance in time mis

N L Wicks Esq
Principal Private Secretary
10 Downing Street
LONDON SW1

29 January 1987

Dear Nigel,

1. Your letter of 10 November to Timothy Walker at DTI invited our comments on the suggestion that there may be cause for disquiet about the uptake of venture capital by "high" science.

2. We agree that there is a gap between venture capital and scientists. On the one hand some venture capitalists are unrealistic in the rate of return they expect from high technology start-ups, which characteristically grow slowly and incur losses in their early years. On the other hand, some scientists are unrealistic about what to expect from the venture capital market. The existence of this gap is not a particularly British problem: we understand that it is common to most European countries.

3. The Government have already acted to give scientists more incentive to look for financial backing to exploit ideas and inventions. The Government's major initiative in this area was the abolition of the BTG's right of first refusal to exploit Research Council-funded inventions, coupled with the setting up of a standing group of officials under SERC chairmanship to authorise universities to exploit their own inventions. 48 universities and colleges have now been so authorised. Other specific Government-backed initiatives to bring venture capitalists and academic scientists closer together include:

i) circulation of a directory of venture capital companies prepared by Peat Marwick & Mitchell to academic institutions;

ii) establishment of a comprehensive database (BEST) of academic expertise in science and technology which can be accessed by all subscribers;

iii) moves by the Science and Engineering Research Council to encourage the publication of research results in trade journals as well as in the scientific literature;

iv) the promotion by the patent office library of its own database as a source of information on inventions.

4. Generally the climate in higher education and Research Councils is changing. Scientists are becoming more conditioned to thinking positively about technology transfer and exploitation. The evidence for this can be seen in the development of science parks, the establishment of university- and Research Council-linked companies for commercialising research and the new emphasis throughout the system on marketing research skills and findings. But there is still some way to go: it takes time to break down entrenched anti-business attitudes in the academic world. Equally it takes time for the UK's venture capital community to develop experience in judging potential in the high-tech field.

5. Your letter asked whether there was anything further the Government could do to improve the uptake of venture capital by high science. DES Ministers will continue to stress the importance for the country of translating good science into profitable products and services; and the Government's LINK initiative will provide a focus for building up collaborative activity between scientists and all sectors of industry. George Walden is specifically pursuing how best to engage venture capital interests in LINK programmes.

6. I am copying this letter to Timothy Walker and John Fairclough.

Yours sincerely,

Rob Smith

R L SMITH
Private Secretary

Econ Pol: Venture Capital 6/81

NBPM

W0370

MR WICKS - No. 10 12 January 1987

I have delayed offering the advice requested in your letter of ~~10~~ 11 November to Timothy Walker about venture capital companies until I had seen his reply. This reflects consultation with my staff, and I therefore have only a few additional points to offer, based partly on ACARD discussions on this and related subjects.

2. I agree with the view implicit in Timothy Walker's letter that there is in general no shortage of finance for "sound business propositions", ie proposals containing an acceptable degree of technical and market risk, and where the management resources are deemed likely to be equal to the tasks imposed on them. But the views of venture capital companies and would-be entrepreneurs on what constitutes a "sound business proposition" frequently differ, and only a small proportion of the proposals put before venture capital companies are recognised as "sound". This may be because the proposals are not fully articulated, the market has not been accurately identified, the technical risk has not been evaluated honestly, costing is unrealistic, or there are deficiencies in managerial expertise. But it may also reflect the fact that, with some conspicuous exceptions, the level of knowledge and debate on R & D in UK financial circles is poor compared with that in other countries, notably the US.

3. In addition to the macroeconomic changes to which Timothy Walker draws attention, E(RD) are, as he says, considering measures to encourage private sector funding of R & D, with the aid of advice from ACARD and the Technology Requirements Board of DTI. Two specific proposals particularly relevant to this question which are under consideration are that DTI's advisory services should

be extended to cover advice on project selection, evaluation and presentation, and that disclosure of R & D in company accounts should become mandatory. The former is intended to improve the quality of new business propositions, whilst the latter is intended, amongst other things, to raise the level of knowledge and debate about R & D in the financial markets. It is argued that mandatory disclosure by quoted companies in the US has been a strongly beneficial influence on attitudes to R & D there.

4. I am copying this letter to Timothy Walker, and to Rob Smith (DES).

JOHN W FAIRCLOUGH
Chief Scientific Adviser

ECON POL Venture Capital
June 81

Fpe

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5422
GTN 215)
(Switchboard) 01-215 7877

PS/
Secretary of State for Trade and Industry

RESTRICTED

22 December 1986

Nigel Wicks Esq
Principal Private Secretary
to the Prime Minister
10 Downing Street
London SW1A 2AA

Prime Minister 2
This report was prompted by Lord Rothschild's unhappy experience with his Biotechnology Venture capital company (Flag A)
NLW 22.12

Dear Nigel

Thank you for your letter of 10 November which reported some comments made to the Prime Minister on venture capital companies and difficulties some had experienced in identifying companies in which to invest funds. You asked in particular whether the DTI agreed that there was a cause for disquiet about the uptake of venture capital by high science, including those involved in biotechnology.

DTI receives two clear messages, apparently contradictory, about the relation of venture capital to high tech; first from those who cannot find funds for new developments and second from those who have difficulty identifying potential investments. The picture is not, therefore, clear-cut and probably reflects the naturally different perspective of those who raise money and those who invest.

The complaint about lack of venture capital does not reflect accurately the current postion since the UK has experienced a rapid growth in the number of venture capital companies; in 1979 there were only 20; they now number 120. Investments by venture capital companies has risen from a negligible level to £279m in 1985. Indeed when my Secretary of State addressed the BVCA conference earlier this month, he was impressed by the general confidence expressed by those present.

JG3AIX

1786
1986
BOARD OF TRADE
BICENTENARY

999-1

RESTRICTED

Despite the availability of venture-capital finance, however, there is no doubt that such finance tends to concentrate on companies with established track records or where projects are close to producing marketable products. There are some companies specialising in seedcorn finance - the recent establishment of British Biotechnology (FT 3 December) is another example - but there are some complaints that seedcorn finance, and in particular small sums of investment are not available.

As you comment, there are some signs of a corresponding mismatch where venture capital companies have difficulty in identifying suitable subjects for investment. In part this reflects a lack of information available to investors or those seeking finance, and a number of agencies are now trying to provide a "marriage broker" service. There are some venture capital newsheets providing details of potential projects while local enterprise agencies are also active. In any case my Secretary of State believes that the provision of risk capital is essentially one for the private sector, a view reinforced by experience in the US.

Nevertheless, the DTI and other Departments of course recognise that there are some difficulties and have introduced some measures to improve the position. SMART, the Small Firms Merit Award for Research and Technology, is one example. This competition, presently confined to the fields of biotechnology and instrumentation provides 75 per cent of costs in the first year and 50% in the second year. It has been well received. The BTG is also active on a wider front.

Part of the difficulty also relates to the contact between industry and universities or polytechnics, although this is now improving. The growth in science parks is one example of the closer involvement between industry and education and the better exploitation of new developments. The announcement of LINK should also help. E(RD), under my Secretary of State's chairmanship, is also looking closely at any difficulties in this field and further work is also being undertaken on encouraging private sector R&D initiatives. However the most important thing the Government can do is to continue to improve the balance between the risks of investment and the rewards; the changes in taxation introduced over the last few years have helped as has the improving economic climate.

JG3AIX

RESTRICTED

In sum, the growth of venture capital companies over recent years and deepening links between higher education and industry are encouraging signs of improvement in this area. But as your letter indicates, there is still evidence of mis-matching between supply and demand. This Department and others are acting to meet this problem though specialised schemes and the encouragement of higher education/industry links. We shall continue to keep a close eye on any major difficulties which may emerge and will report on further developments.

Yours sincerely

Timothy Walker

TIMOTHY WALKER
Private Secretary

JG3AIX

ECON POL Venture Capital June 81

LORD ROTHSCHILD

Telephone: 01-280 5000

Telex: 888031

N.M. Rothschild & Sons Ltd.
New Court
St. Swithin's Lane
London EC4P 4DU

3rd November 1986

Personal

Dear Prime Minister,

You may just care to glance at the enclosed Annual Report of a company which I created five years ago, to enable the public to take an interest, by way of shares, in Biotechnology. Financially speaking, the company has been successful, but in spite of a great effort on my part, the amount of financial support it has been possible to give to British undertakings is very low. I bent over backwards to help the most important Biotechnology company in this country, Celltech, and made in them the biggest investment (£3 million) that we have so far made in any undertaking in any part of the world. Unfortunately, however, the Director we put on Celltech's Board, Sir Francis Tombs, resigned in protest at their financial incompetence or ignorance - I am not sure which.

Although, as we both know, there are people at our Universities who are just as good as their opposite numbers in America, Japan, France, Germany or elsewhere, the problem of translating that excellence into an efficient business is still unsolved in the U.K. (Celltech contains excellent scientists.)

Yrs
Victor

PRIME MINISTER

I attach a draft letter for you to send to Lord Rothschild in response to his of 3 November about the difficulty in finding British biotechnology companies worthy of financial support by his company, Biotechnology Investments Limited.

If you agree to write as suggested, I will take up his general point with the Ministers concerned and the Cabinet Office to see whether there is anything more that Government can do to translate our scientific excellence into efficient business.

Agree to sign the letter and proceed in this way?

(No need to read the Annual Report enclosed with Lord Rothschild's letter.)

N.L.W.

N.L. Wicks

7 November 1986

MJ2CNY

hle (63) ECL

10 DOWNING STREET

From the Principal Private Secretary 10 November 1986

The Prime Minister has been told that venture capital companies, especially those investing in biotechnology enterprises, are still finding it difficult to identify companies in which to invest their funds. She has been further told that though there are people at our universities who are just as good as their opposite numbers in America, Japan, France, Germany or elsewhere, the problem of translating that excellence into an efficient business is still unsolved in the UK.

The Prime Minister would like to know whether your Department agrees that there is cause for disquiet about the uptake of venture capital by high science, including those involved in biotechnology. She wonders too whether there is anything further that the Government can do in this direction.

I am sending a copy of this letter to Rob Smith (Department of Education and Science) and to John Fairclough (Chief Scientific Adviser in the Cabinet Office) for their views as well.

(N.L. Wicks)

Timothy Walker, Esq.,
Department of Trade and Industry.

10 DOWNING STREET

From the Private Secretary 14 March 1986

The Prime Minister has asked me to thank you for your letter of 11 March. She was grateful to you for sending a copy of your book which she will look at with interest. She wishes you every success in pressing home the message to business everywhere about the importance of proper cash flow analysis.

(Mark Addison)

B.C.J. Warnes, Esq.

Midland Bank
Venture Capital Limited
a member of the Midland Bank Equity Group
47 Cannon Street London EC4M 5SQ Telephone 01-638 8861 Telex 895 6886

BCJW/JB

The Prime Minister,
10 Downing Street,
London. S.W.1.

11th March 1986.

Dear Prime Minister,

I have much pleasure in enclosing a copy of The Cash Flow Handbook, which has recently been issued in Hardback as a companion to The Genghis Khan Guide to Business. } IN ATTACHED FLAP.

It applies an up-rated version of the Guide's very powerful Business-Planning and Monthly-Monitoring system to two, real-life, company-turnround situations.

The two books between them set out a range of techniques that are probably as powerful, in achieving business success, as any available anywhere; and may even identify the full secret of Japanese success (the last link falling into place, after the Handbook was published, with the publication of the McKearney report in January).

The wheel has, for me, now come full circle. When I was in the Foreign Office in the late 50s, we encountered difficulty getting money out of the Treasury for a £1m aid programme for Nepal. We were told Great Britain "was too poor to afford it" - despite being a country that, just before the First World War, was owed £10,000m by America alone, in the currency of the day. The search that began on that day to discover just what has gone wrong has taken a painstaking 25 years to unearth the full answer, but at last all the various aspects now seem to be in place, completing the picture.

Prime Minister, I would love to come along and explain these techniques to you, in their now compact, complete, form (which should take no more than 1/2 - 1 hour). I am convinced that if they could be disseminated to every British business, say in the form of a short pamphlet or video cassette, radical transformations could begin to occur, and within a timescale of no more that 6-9 months (MBVC's experience).

Registered in England No. 1407886 Registered Office: 27/32 Poultry, London EC2P 2BX
A subsidiary of Midland Bank plc

If this could be done in the next few months, fairly substantial benefits could begin to emerge, nationwide, as early as 1987, particularly in terms of job-creation and on a scale that is clearly going to be necessary to deal adequately with the unemployment problem. I really do believe, after 25 years of patient effort, the full secret of achieving business success - be it Japanese, American, German or British - is now within our grasp, and radically improved employment prospects with it.

I was lecturing on 3rd March at the Trent Polytechnic to a group of businessmen running companies in the £1/4m - £5m turnover range. Three events stood out :

1) One businessman came up in the interval to say he had heard the lecture 9 months ago. He had been so stirred (or was it shaken) that he had gone back and begun to apply some of the procedures to his own company. It is now coming right. But only in the light of what he now knows, does he realise how precarious was his situation previously. If he had not changed course (which of course he could not do until he had the necessary knowledge) he would almost certainly have gone under. 12 jobs have been preserved which would otherwise have been lost. The same story is happening on an increasing scale - which makes all the effort very much worthwhile.

2) Another, an engineer/scientist, unprompted said "for the first time I realise why, despite our being so good at inventing things, we as a nation are so poor at turning them into commercial realities" (my own sentiments entirely, dating from University days at Oxford and seeing potentially magnificant commercial products lying fallow in the laboratory). "Now I know what to do to put this right. You have given me the tools to do so. It is startlingly simple really" (a general sentiment).

3) A third businessman, listening to the lecture, said "I want to go home. You are horrifying me" as he progressively realised the damage he had, quite unwittingly, been doing to his company.

On other matters, in June 1984, three months after the publication of the Guide, there seemed to be a concerted effort on the part of by the Accountancy profession to get me eased out of the Midland Bank - or so it seemed. Grist to the mill, this provided a heaven-sent opportunity to force the very members of the Profession who were most entrenched in their views to focus on the issues. And when they did, predictably, there was a very rapid backtracking. The antagonism vanished almost literally overnight. (Thank you for any help given behind the scenes at this fairly crucial time, incidentally).

Astonishingly there has not been a single adverse comment on the technical content of the Book(s) - not from anyone - since the Guide was published. Most people have understood, and rapidly adapted to, the Breakeven technique. Within 2 short years it has come into almost universal use, particularly by the banking system, as a navigation marker helping to steer companies safely through a sea of figurework and change. Managements speak of "It all falling into place for us". "You have given us the accurate bench-marks we have so long needed to assess, guide and target our day-to-day actions" - just as with any other form of navigation of course.

However, it has more or less stopped there. No more than a comparative handful of people (businessmen, accountants and bankers alike) have successfully digested the central, cash flow, chapters of the Guide (hence the publication of the Handbook); or progressed beyond that to complete the profit-improvement story; although many who have come to grips with the later chapters have expressed strong welcome for the Value-Added techniques (which we have used, to great effect, in MBVC, particularly during the last 18 months). Case histories are available if required, incidentally, one company moving from a loss of £13,000 in February 1985 to a profit of £19,000 in May the same year, on much the same turnover. What was described as a "terrible" market, suddenly became "marvellous, why do you ask?" as management discovered a wholly new-found (pricing) strength in the marketplace.

Bankers have taken to Genghis Khan in a big way and it is now in use in virtually all the main clearing bank training colleges, particularly Barclays and the Midland (where courses are being specifically structured for up to Grade 8 managers, senior line bankers in their late 40s/early 50s), one tutor saying he "could not move without it".

Two firms of accountants have gone overboard on the techniques, Armitage & Norton and Grant Thornton, the latter having developed a computer-based business planning and monitoring service from their Crawley office (about which I have written to Lord Young). For the rest, Accountants appear not yet to be close enough to the front-line experience to appreciate the full worth and need for such techniques, but they are adapting, at various speeds.

Roger Brook of PW's got hot under the collar last year about remarks made at the November 1984 ICA conference; but he not only climbed down when taken through the issues, but went so far as to ask how many years ahead of the game we, in MBVC, considered we were? To which the answer, very sadly, is that we built certain features into MBVC when it was set up in 1979 to solve certain problems. Only today are the problems themselves beginning to be appreciated, let alone the solutions.

Happily things are going so well that there is confident expectation that this gap will be rapidly closed in the next year or two. Incidentally, BES has had an enormously valuable effect in educating the market, accountants in particular, on the value of equity and the true nature of company behaviour. Appreciation (almost amounting to wonder) is also often expressed that Government policies seem so neatly dovetailed to solving the problems of business e.g. the Death Valley syndrome. (I always say in such circumstances, that you too have read the Book.)

Businessmen have varied. The unknowledgable have taken the techniques avidly to heart, without question. More senior (eg BIM) managers sadly tend, too often, to feel their position and authority threatened and (like the accountants originally) clamp up. But, again like the accountants (helped by the new mood you have so vigorously created in the country) are becoming ever more flexible and more receptive.

Indeed once they cross the knowledge-divide and begin to appreciate the dangers they have inadvertently been putting their companies in they even begin to ask, why the **** they were not told before..... Dr. Miller of the Engineering Council has been kind enough to remark that it took his team 7 years to sort out Vantona and that, if they had known e.g. about the breakeven techniques it would have taken less than half that time. A wholly new excitement, challenge, and enthusiasm is beginning to emerge.

Finally, the Business Schools: some like Cranfield, Trent Polytechnic and Sir Frederick Crawford at Aston, are galloping ahead in honing onto what is required (Sir Frederick's TVI laboratory in particular holds very great educational promise - incidentally I hope there will be something in the Budget to encourage companies to use such valuable distance-learning techniques). Others, like London, are still implaccably hostile.

But overall, a very encouraging scene indeed - if only dissemination of the (brief) key knowledge can now be considerably accelerated, for instance through the action proposed earlier. A mere 2 to 3 hours spent with the company whose case history starts on page 99 of the Guide has taken it from certain bankruptcy, in early 1982, to the point where it made £90,000 pre-tax profit on sales of £419,000 in the year to March 1985 - which must be one of the highest returns, at 21.5% net of any engineering company of its size in the UK. (Incidentally Management, in reporting the result, apologised for the fact that, as we would appreciate, they still seemed to be having great difficulty differentiating gross margin from net.)

If only such achievements could now be replicated countrywide . . . It is in our ability, it is in our grasp, as a Nation to do so.

The attached note hints at some of the potential, but I would like the privilege of explaining the issues to you, personally, in more detail, so the Government can best decide how to get maximum (employment) benefit out of them.

Yours sincerely

Brian Warnes

B.C.J. Warnes
Managing Director

NOTE TO :

FROM : B.C.J. WARNES

26th February 1986

MBVC's 'Abbreviated' Business Planning and Reporting Formats

At last Wednesday's Board meeting, the question was raised of whether MBVC's procedures were applicable to the larger company.

Although MBVC has successfully applied the techniques to companies with monthly turnovers down to as little as a few thousand pounds, they are <u>not</u> small-company techniques. In fact, the larger the company, the more effective they can be.

They were developed in the late 60's (in the Commonwealth Development Corporation) and early 70's (in Spey) with a two-fold purpose :

1) to cut down the sheer time and paperwork involved in regular budgeting and monitoring; and

2) to pinpoint (and thereby help management understand) the significance of key issues.

In the 70's they were put to the test in a wide range of tough, turnround situations. A £10m-£20m turnover company (Sweetheart Plastics) was taken from £1/2m pa loss to a £2-3m profit, for instance. One of the first companies in MMIF where they were used was of course UHS, which was taken from £700K loss to £1.7m profit.

The challenge of MBVC was whether these ostensibly big-company techniques could be applied to the small company. What they set out to do is this:

1) Achieve much more accurate forecasting and control of working capital in particular (using a layout that shows underlying stocks, debtors and creditors rather than receipts and payments. Unilever incidentally, is said to have changed to a similar system in 1977, for similar reasons, in order to improve control of its agricultural projects).

2) They throw up readily-identifiable bench-marks, like breakeven point, against which the significance of sales and orders can be assessed and actual profit/loss levels derived as they happen (long before any books of account come to be written up).

3) They can give a company much greater pricing flexibility in the marketplace, sometimes considerably enhancing its prospects of success even in very difficult markets (Albany moved from £16K per month loss to £22K profit in four months, for little overall change in turnover.)

5) They can play a major role in helping to optimise production efficiencies and sustained profitable output.

6) The play a strong 'educative' role for management in the general principles of business.

The techniques probably at least match best practice in the best Japanese Multi-Nationals; and in terms of comprehensiveness (15 sets of figures compared side by side), brevity (one page - see attached) and speed (one column updated each month) may be significantly superior to best Japanese practice.

They are certainly superior to the techniques used in most American companies. (By and large the Americans seem not to be as good at understanding business as the Japanese - as their planning and reporting systems reflect; the acid test).

As far as the U.K. is concerned, by and large we are behind the Americans. Certain types of company, where there is great focus eg on optimising working-capital, like the major Stores groups, are very well run. ICI has probably reached a similar level of sophistication (but only since this was forced on them by the 79/80 downturn - the results of which are certainly now showing through in improved performance). Then there are the 'financial' conglomerates like Hanson.

For the rest, many companies, particularly manufacturing companies, seem to struggle on, largely in a morass of management incomprehension - and their performance reflects it. Where this can be remedied, major cash flow and profit strengths can begin to emerge, even from seemingly very difficult, or even hopeless, starting points eg Airwheel. Similarly, with enhancing the performance of already-successful companies.

If Leyland, Rolls Royce, Westlands and other British companies had been using these methods over the years, it is unlikely they would have ended up the way they have.

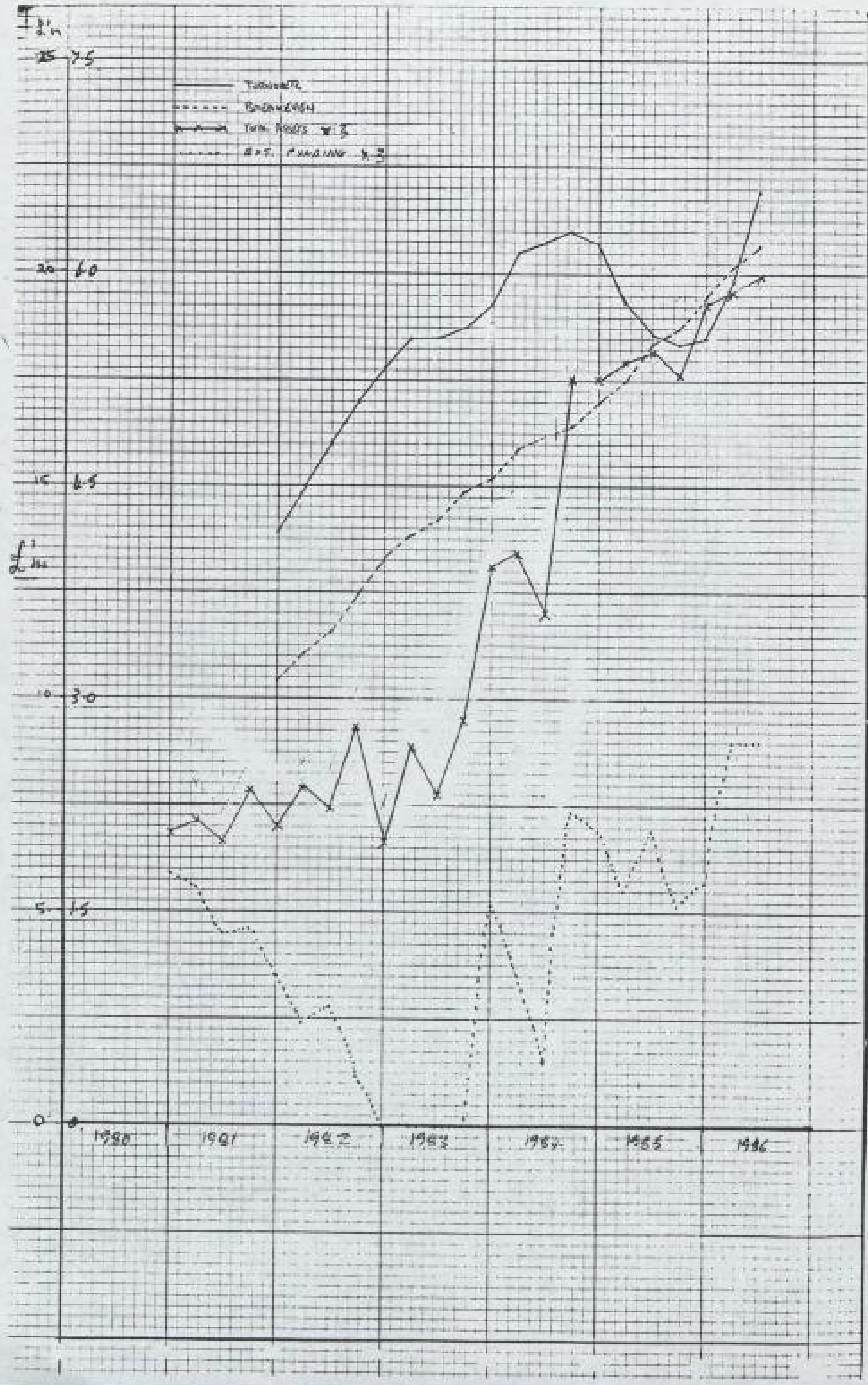
Paradoxically, the control techniques needed for small companies have to be very much stronger, more incisive, more sophisticated than those applied to the medium or large-sized companies - because the trends (good or bad) surface so much more quickly. Certainly this is true in MBVC.

Where the techniques have not worked, it has been due to our own failure to get management to understand their meaning and purpose, and therefore to understand the underlying nature of business, on which success seems so much to depend.

If you would like to know more, I would be more than happy to host a normal half-morning seminar, perhaps for all the MBVC/MBE directors. Meanwhile I have much pleasure in attaching your own personal signed copy of the Handbook to go with the Guide.

The techniques may eventually come to rank amongst the most powerful to be found, at any level, in any company, anywhere - although this would only be provable by getting hold of the internal management information of, for instance, a company like Mitsubishi, and analysing whether, for instance, it shows the trade-off between gross-margin and NCA requirement, uses the NCA method for cash flow, deals with breakeven-point in relation to sales and orders, use Value-Added for pricing, costing, WIP valuation and production control, and so on - and does so very briefly and in such a way that <u>trends</u> over a period can readily be identified (enabling graphs like the attached to be routinely maintained).

BCJW



£m
25 7.5
TURNOVER
BREAKEVEN
20 6.0
15 4.5
£m
10 3.0
5 1.5
0 0
1980
1981
1982
1983
1984
1985
1986

FCG RM

10 DOWNING STREET

THE PRIME MINISTER

19 March, 1984

Dear Mr. Warnes.

Thank you for sending me a copy of your new book. I strongly support your efforts to achieve a more financially alert and market-orientated style of management in British companies, and perhaps even more important, among the banks and accountants that advise them. The Government is striving to rekindle a spirit of enterprise in this country, which is no different from the "barrow boy" mentality to which you refer. It is heartening to see this cause being taken up with such vigour in the private sector. I am sure your book, written as it is in such a direct style, will prove very helpful. No-one would be more delighted than I if this revolution in attitudes could be achieved in the time-scale you have suggested.

Yours sincerely

Margaret Thatcher

B.C.B. Warnes, Esq.

010

CONFIDENTIAL

CC NO.

NBPM
BF 6.13

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

5 March 1984

The Rt Hon Norman Tebbit MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON SW1H OET

Dear Norman

MANAGED VENTURE CAPITAL FUNDS

will request if required

Thank you for your further letter of 17 February.

I myself doubt whether the listing requirement to secure CGT exemption is in practice the insuperable barrier which you suggest - I see that a number of what might be termed venture capital companies have already secured a listing on the Stock Exchange.

I am sure you are right to encourage the institutions to direct more of their investment to innovatory small companies. But I am not convinced that we need a change in the tax law. From further discussions which the Inland Revenue have been holding with some of the investing institutions at my request, it appears that removal of the listing requirement is not seen as a very effective way of increasing their investment in this area and that it would have some considerable drawbacks. Nevertheless, I agree with you that it would be sensible for our officials to get together to discuss this matter further.

I am copying this letter to the Prime Minister and Sir Robert Armstrong.

Yours
Nigel

NIGEL LAWSON

Econ Pol: Venture Capital June 81.

Midland Bank Venture Capital Limited

22 Watling Street
London EC4M 9BR
Telephone 01-638 8861

CF PA?

BCJW/JB

Extn. 1599

21 1st

13th March 1984.

The Prime Minister,
10 Downing Street,
London. S.W.1.

Dear Prime Minister,

U.K. Business/Economic Situation

It is with the greatest pleasure I send you a signed copy of the book, which you, in terms of creating the general environment, have done so much to make possible.

Things have moved light-years since last I wrote.

When I saw Eddie Ray in January 1983, he at once appreciated the importance of the breakthrough represented by the financial control techniques we were using. However, he said accountants were a traditional lot. Most of them were small, provincial, firms living comfortably on undemanding tax and audit work. The prospect of getting them to change their ideas and approach "would take the best part of 25 years".

I said the time-scale could not wait. The approach had to be changed in 2-3. Too much depended on it in terms of the performance (or rather lack of it) of British industry. I offered to take part in training courses run by the Institute. This was welcomed but "accountants don't come on courses". I offered to set the ideas down on paper (the origin of the book) and he offered to circulate them to all members, but doubted if it would be effective. "Accountants don't read books". While the spirit was there, we both felt equally disillusioned by the end of the meeting

Accountants had to be the first port of call in getting them to change their ways, for Bankers, Business Schools and Businessmen were taking their techniques, as standard, from them. There was also the problem of engineeers failing to get into the centre of business, where they were so much needed, for much the same reason. They would not pick up the threads sufficiently - per Chapters I, XV and XVIII.

Registered in England No. 1407886 Registered Office: 27/32 Poultry, London EC2P 2BX
A subsidiary of Midland Bank plc

So something fairly dramatic had to be done to try and put all this right and in a tenth of the 25 year time-scale (realistically) quoted by Eddie Ray.

I am glad to say the somewhat draconian techniques adopted since then are already beginning to have the very effect intended.

The idea was to scare hell out of the accountants, by implying that their comfortable tax and audit world was about to crumble on them. Hence the series of articles that have appeared in the press since then (e.g. the attached, which you have already seen). The fact that they were sensitive on this point was shown by Michael Lafferty being run up by "a senior Partner of Peats" (my old firm) last March telling him "to have nothing to do with Brian Warnes". I welcomed this as an indication that the powers that be were sufficiently worried to be really stung into action.

Sweetness came at a seminar on Venture Capital, run by Peats, at the Plaisterers' Hall in the Autumn when Sir John Grenside repeatedly made the point that "accountants were not just auditors and tax experts" but were getting increasingly involved in "financial services" work.

These and other measures have had the effect of focussing rigid attention on Brian Warnes and creating apprehension about what his book was going to show.

Then for the denouement. Deliberately it is nothing like as bad as feared. Indeed, it is designed very much to go the other way in offering the accountant a bright new world of challenge, fascination and interest, going well beyond anything he has experienced up to now; to the lasting benefit of the companies he serves, and with it the British economy.

Already this has happened on a small scale in talking to the young high-flyers in Arthur Anderson, Coopers, Clark Whitehill, Robson Rhodes, Neville Russell and others. I now have no doubt, at all, that given the full story, as set down in the book, the brighter, younger members of the profession will rapidly take to the techniques and we then will begin to see a sea change taking place in the profession, as the knowledge spreads out to the older members and the smaller firms (hence "Osmosis"). It is the facination, thrill and fun of using these techniques in a real-life company that will sway the issues in the end.

As to the other two sectors, Business Schools and Banks, from indications already (at Aston and Sundridge) the former will change, overnight, as soon as the prevailing climate changes.

Banks suffer the same problems as accountants. Bankers over about 55 are unlikely to change their ways, but they are not going to be around for too long anyway. The younger members are bored and restless with the mundaneness of traditional techniques and positively looking for new excitements. MBVC is a classic case of being able to take raw bankers and turning them into real entrepreneurs. So the potential is there.

Something very interesting has been going on in the Midland over the past year. The Bank's training colleges have increasingly been receptive to the in-feeding of these new ideas. By last Autumn it got to the point where they said "yes, we are all ready to go, but it needs the green light from on high", which was held up.

Then the Bank hit the problem of whether to set up a business advisory service and if so how. Whether to use outside accountants, or internal bankers.

The debate was solved by an incisive stroke from John Greenwell, head of domestic banking. He came to hear about MBVC and invited us round for a chat. He asked why, if our form of financial control was so good, it had not been endorsed by the accountants ?

To which the answer was, despite several attempts to get a view from the Institute it had been refused. Powerful members of the profession felt it would be handing Bankers fee-earning work at the expense of the profession.

Faced with this problem, John Greenwell asked Arthur Anderson for a view. They fully endorsed the new techniques, and actually helped the Midland to computerise them. Bank staff were selected to become Business Advisers (a most welcome development, in educational terms) and they now have Sirius micros with the fully-fledged programme on it (providing the layout set out in the Appendix to the book).

This is a breakthrough. Branch Managers who commission the Business Advisers to do a study on a company for them will have to learn to "read" the result. Betchworth is now moving formally to teach it. Accountants associated with those companies are also going to have to come to terms. And what Midland start doing the other Banks will follow, particularly now the information is available in book form.

This book, in its own right, should be a powerful influencing tool. A company's management reads it, partly understands it, and turns to their Banker and Accountant for a fuller explanation . . . . Are the latter going to risk losing a customer, by admitting they don't understand . . .? They will buy the book. And so the knowledge will spread outwards and downwards. . .

I genuinely believe that within 1 1/2 to 2 1/2 years these techniques could become standard throughout the British scene - with significant benefits for British Industry, unemployment and the economy in general from the resulting better-run companies.

A Genghis Khan approach maybe. But I am sure one you would approve of.

Yours sincerely

Brian Warnes.

B.C.B. Warnes
Managing Director

The accountant's role — a banker's view

The British accounting profession is well placed to lead the country into the small business age. It has brilliant minds and abundant skills but many of its techniques are outdated, more suited to an era when 'historic' accounting was the order of the day. In the austere and highly competitive climate of the 80s business needs real time accounting and rapid access to information, says Brian Warnes, managing director of Midland Bank Venture Capital and a chartered accountant. The profession must adapt to take its place at the forefront of business life otherwise others will take its place. MARGARET MARLEY reports.

WHEN a small business goes to the wall and it is happening at the rate of 2000 a week, the receiver prepares a statement of affairs showing assets and liabilities. Sometimes the bank finds that an apparently secure loan is at best a partial recovery and the bank manager who made the loan finds himself on the hook. 'Why did you make such a loan to a company in this state of health,' his superior inevitably asks.

The beleagured manager refers back to the audited accounts, the figures on which he based his decision, but the picture they present often bears too little resemblance to that of the receiver's report, even allowing for the differences between a 'going-concern' and a 'gone' basis.

If the bank manager feels let down in such circumstances, so can the managing director who often looks on an audit as a clean bill of health. For a small business with unacknowledged weaknesses is in no shape to face up to market pressures; whereas given the right kind of information and financial control it might be able to survive.

Between 7-800,000 audits are done in the UK every year, mostly small business audits by small practitioners. Most are never put to the test because the business survives, but with more than 50 per cent of the small business start-ups folding, criticism of the traditional audit is growing. And it is criticism on a fairly significant scale.

It is a criticism that has significance far beyond the accounting profession, because Britain's small businesses contribute less to GNP than do those of the US, Japan or France; and a lot of money and resources are being poured in to make them the spearhead of economic revival. But there is a one-in-five failure rate of small businesses using the Loan Guarantee Scheme, and it is raising fundamental questions about the annual audit, the accountancy profession and the British businessman in general.

The annual audit is the only financial record kept by many UK firms; notable exceptions are the highly efficient, big league companies. A great number do not have any kind of monthly management accounts, they just keep cash books on a day-to-day basis. Then three months after year-end the auditor comes in and takes two to three months to audit the accounts. By the time the management sees the figures some of them are 18 months old, hopelessly out of date and irrelevant to current costs.

Far too late the managing director realises, for instance, that his prices bear no relation to costs. These are much too low, but he has to let his current order book run out for another two or three loss-making months. In today's austere climate, a small firm needs much closer financial control and few can survive this kind of misjudgment.

By contrast there are relatively few collapses among firms with a good financial management system and at the other end of the scale the highly successful, well-run company will have a sophisticated weekly or monthly, real time accounting system.

Take GEC for example, a group which controls 250 companies. A full description of the financial behaviour of the entire group is on Lord Weinstock's desk every Tuesday morning. It is exactly the same for Oxford Instruments and undoubtedly Racal, British companies that have taken world markets apart. They run weekly accounting systems which describe output, orders, manpower statistics, cash-flow and all the information that is necessary to allow the management to keep a finger on the pulse of business life.

'The sophistication of the management information system is usually a mirror image of the business perception of the people running the business. The two seem to go together,' says Brian Warnes.

Unfortunately good business perception is not a natural British characteristic and British success stories are the exception rather than the rule. We produce products of high technical excellence which are commercial flops because we have not mastered the business logic that the commercial benefit of a product must be in proportion to its cost; Concorde for example. 'The British are just not as good as they should be at business; they seemingly lack the barrow-boy instinct that makes profits out of indifferent products.'

It is a question of culture block, the legacy of empire when the country, with assured wealth and captive markets all over the world, directed its best brains into administration, the civil service, the army, the professions. And business was very much a dirty word.

Traces of these attitudes still remain and the difficulties and challenge of the business world are largely underestimated. A man will decide to go into business overnight, if he can raise the steam. He sees no need to learn the basic ground work and if trouble arises he will push up his prices and hope they stick. It becomes a trial and error process; there is is no scientific method of deciding on the right price at the outset.

In the cold light of the 1980s, British attitudes are changing. The severe and prolonged recession has decimated the number of safe, prestigious jobs, and under the influence of the Thatcher government, the small business is gaining acceptance and respect; it is seen as a key element in the nation's economy.

But the budding businessman is labouring under a tremendous handicap. There is no source of hereditary business wisdom to draw upon; no distilled business knowledge and experience turned into formalised procedures and techniques. While individual companies have excellent real time accounting systems many have been self-developed, worked out empirically, and they remain outside the mainstream of British business life. They have not been codified nor made the basis of teaching.

There is a growing awareness that business needs real time rather than 'historic' accounting and bankers are forcing the pace in this direction. The annual audit is under attack, both as an indicator of a company's credit-worthiness and as a relevant tool that will help keep a firm on the straight and narrow path. But in a large number of cases no other figures are available and, in sheer desperation, some banks are launching their own monthly accounting systems.

'It is purely a question of investment protection', says Brian Warnes. 'The banks don't want to pinch the financial services of the accountant, but they know that the information available is not good enough as a basis for seasoned judgment. The motive is to provide the proper background for better investment judgments.'

MBVC, which has investments in about 55 companies, insists that each company adopt MBVC's standard cash-flow plan, a simplified accounting system which monitors a company's progress from month to month. Lloyds has adopted the Carl accounting system and already is handling the monthly accounts of 600 customers.

Barclays and NatWest have powerful computer bureau subsidiaries, Baric and Centre-file, which are rapidly moving into the monthly accounting field. AIDS, the independent computer bureau which specialises in monthly accounting for the 5 to 50 employee firm, plans to establish 225 franchises throughout the country and to develop a 5000-strong client base. 'The banks are giving us every encouragement', says AIDS director Mike Salinger. 'We have been assured of introductions to clients through the branch network.'

But it is really the accountancy profession that should be leading the way and developing simplified, real time accounting systems for every-day business use, says Mr Warnes. Instead, when the accountant is called in to do a formal exercise reams upon reams of paper emerge, a veritable jungle of figures, words and jargon. The audit costs thousands and may be a valuable bench-mark for the professional, but it is incomprehensible to the average managing director. It remains an academic exercise that is irrelevant to the day-to-day running of a business.

There is a desperate need for simple real time systems. 'The engineer who sets up a small business knows all about product development, but he does not understand cash-flow or how to keep a business afloat. He needs a simple system that will cover the key issues, orders, sales, overheads, breakeven point, gross margin, debtors, etc, which will tell him at a glance how the firm is doing.'

But the simpler the system the more sophisticated the thinking behind it. A consultant charging £250 a day will take two or three weeks to design a one-off system for a small firm, but at £6000 to £7000 the cost is prohibitive. 'I can see no reason why the profession, and in particular the Institute, should not step in and develop half a dozen standard systems for different business applications', says Mr Warnes. 'The profession, in intellectual terms, is probably the strongest in the world. It has all the sophistication and skills necessary for the job.'

A whole range of systems might cost £10,000 to £30,000 to develop, but the institute could find the money from the profession at large. It could punt out the systems to 100 firms to operate on a year's trial, get an evaluation and then produce almost a *Which* report. Then, with the systems fully refined, they could be distributed to accountants up and down the country so that the small practitioner need only put his hand into a drawer and pull out a suitable accounting system for his small business client.

'I am highly critical of the profession for not having crossed this frontier', says Mr Warnes. 'These problems are in desperate need of solution. Companies are failing or not growing as they should; they are remaining small and vulnerable, weak and nervous because they are not getting the right kind of business guidance. The profession should be moving into this field very fast.'

Once a real time accounting system is developed, the accountant must then make the best use of it; interpreting it for the managing director, explaining the significance of what is happening, forecasting what is going to happen. The system becomes a sensitive barometer which enables a firm to pick-up the changing pattern of business behaviour and to tailor output and pricing accordingly. 'If the accountant can adapt to the needs of the day and develop a real understanding of business there is an enormous role for him to play in the revival of British industry.'

But at the moment the accountant's advice is often far from accurate: it does not tie-up with what actually is happening and his credibility is prejudiced. A firm about to embark on a major contract will ask the accountant what cash needs are likely to be. He prepares a cash-flow forecast but six months later the firm runs out of money. 'How come', asks the managing director. 'Well of course the cash-flow prediction is wrong', says the accountant, 'time scales were different six months ago and your sales have not come up to expectations'. 'This is no valid excuse for not achieving forecasting accuracy', says Mr Warnes. 'It highlights a serious deficiency in accountancy training.'

The problem is that both the accountant's training and his conventional tools equip him to deal with static problems, with historic figures. But business life is fast moving and dynamic and what is required is a man trained to cope with changing patterns, to get cash-flow forecasts right in spite of fluctuations in the market-place. There is a great difference between the engineer who understands dynamics and the one who is limited to statics; the first can design a missile to hit a moving target, the second can only hit a stationary one.

'The average accountant is good at statics', says Mr Warnes, 'but he hasn't got the training to enter the world of dynamics. Conventional accounting systems are not suitable. Technically they are just not able to cope with the dynamics of business life.'

MBVC has introduced a simple accounting system to the 55-odd firms that it has invested in, and 'it has had a dramatic effect. Some of MBVC's best investments are light engineering firms, so many of which are in trouble'.

The MBVC cash-flow plan is the distillation of 14 years business experience. 'I started out in company doctoring work, in rescue operations', says Mr Warnes, 'and I had to develop a format of cash-flow to help me understand what exactly was happening in the company. It proved a useful tool for teaching the managing director, for sharpening his business understanding. Now we put a system into every company we touch, explain it to the managing director, watch him while he tries it out, and suddenly realisation dawns and he's on his way.'

The cash-flow plan applies barrow-boy knowledge to a company. It explains that breakeven point is the level of sales needed to cover overheads, shows where it lies and what value-added-per hour a company needs to breakeven. A managing director can tell at a glance whether monthly sales and order levels are running above or below breakeven point and he can adjust output and prices until he gets the equation right.

An electronic components firm, with a good product and full order books, ran into a cash-flow problem and MBVC was called in. The business was analysed and tabulated in the cash-flow format which showed that while running costs amounted to £10 an hour some of the biggest jobs were only earning £5 an hour value added. The managing director saw the point, redesigned the layout of the electronic unit so that assembly took 40 minutes instead of 1½ hours. He effectively doubled output and income through the same cost structure and could now meet customer demand.

'Why didn't you do this in the first place', asked MBVC 'It didn't seem worthwhile. The extra 40 minutes seemed to be merely another £2 in production costs. The cash-flow plan has changed the focus of things and the business operates within a different framework. Six months ago I was an engineer making a loss of £15,000 a month', says the managing director. 'Today I'm a business man earning £30,000 and I can see £50,000.'

George Lingard, managing director of Severn Controls, ran into trouble when a major contract went wrong — due to a sub-contractor's error — and had to be redone. The business cost £10,000 a month to run but while the remedial work was going on nothing was being earned. The cash-flow plan showed that given the orders, sales value, material and labour content the business had huge margins and could afford to double the workforce to keep the main core of work flowing through.

Doubling the workforce while debts mounted seemed to violate common sense but it made good business sense and the firm pulled through. 'We wouldn't be here today without the system', says Mr Lingard. 'I was very sceptical about the extra figure work initially, but

Brian Warnes, managing director of Midland Bank Venture Capital (MBVC). He is a chartered accountant, having qualified with Peat, Marwick and Mitchell. He read physics at Oxford, has worked for the Foreign Office and the Commonwealth Development Corporation. His practical experience in company doctor, rescue operations gives him a sharp insight into the problems of British business.

now I've got it down to one day a month and it gives tremendous day-to-day control.'

The Japanese understand this approach and its one of the reasons for their outstanding success. Perhaps it is because nearly all Japanese businessmen are engineers, says Mr Warnes. 'About 77,000 Japanese engineers graduate every year compared with 6000 or so in the UK. They understand about dynamics and the country grafts on a sound business training; and once you have an engineer designing a product in the financial context you have a real business.'

The British business climate is breaking and changing and Mr Warnes is optimistic about the future. He believes that the accountancy profession is pre-eminently well placed to lead the country forward provided it is prepared to adapt to the needs of the day. 'If the accountant can develop a real understanding of business, there is an enormous role for him to play in the revival of British industry.' □

Econ: Pol. Venture Capital

June 87

Midland Bank Venture
Capital Limited

22 Watling Street
London EC4M 9BR
Telephone 01-638 8861

BCJW/JB

19th January 1984.

M. Scholar Esq.,
Private Secretary,
10 Downing Street,
London. S.W.1.

CF Mr Warnes is writing again. B/f when he does
AT 6/2

Dear Mr Scholar,

The Ghengis Khan Guide to Business

Further to my telephone call a little while ago I now attach the "Acknowledgements" section from the proposed book, which is due to be published shortly.

I would be grateful for confirmation that there is no objection to what is said, particularly when taken in conjunction with the last paragraph.

As always a word of warm gratitude for your help.

Yours sincerely

Brian Warnes.

B.C.J. Warnes
Managing Director

ACKNOWLEDGEMENTS TRIBUTES AND TESTIMONIALS

How this Book came to be written

At a meeting in January 1983 between the author and Eddie Ray, President of the Institute of Chartered Accountants in England and Wales, the idea was first mooted of setting down on paper the techniques that eventually became the subject matter of this book. The meeting was arranged on the introduction of Ian Hay Davison, senior partner of Arthur Anderson & Co., Chartered Accountants; and also of Lord Benson, Business Adviser to the Bank of England as a result of involvement by the Central Policy Review Staff, under Sir John Sparrow (the "Think Tank") and the Prime Minister herself. Whether these distinguished supporters are pleased (or appalled) by the result remains to be seen . . .

After this auspicious start, a number of key people in industry have valuably helped mould the subsequent content by commenting on the relevant sections. Particularly helpful have been the views of those like Frank Fitzpatrick, Director of Finance at BL.

Tributes

Sir Kenneth Corfield, Chief Executive of Standard Telephones & Cables plc, which was until recently part of the ITT group of which he was also a director, and President of Engineering Society, is an engineer who started life as a small businessman making cameras. He comments (on an earlier draft) as follows:

> "It happens to express the self same principles that have contributed more to my own modest success than any other single factor of which I am aware.
>
> The importance of breakeven point and of testing the market value of a product or service by pricing it truly profitably seems so commonplace to us—and yet is so much neglected.
>
> The 'barrow-boy' mentality I may have practiced but the phrase was first used in my presence by Mr. Hugh Barker, then Chairman of Parkinson Cowan Limited in the early sixties.

Every year or so another company in my own province displays just the characteristics you so vividly describe. We have to change the management—perhaps your book will help more, otherwise intelligent, people to survive and help the Country.

The various Engineers Institutions (there are 57 altogether) should be approached to review the book, recommend it and make it available from their libraries.

Every good wish for success."

At the other end of the scale, the production director of one of the small companies in the book remarks:

"I am bound to say I found it quite compelling reading, keeping me up until 2.30 a.m.—my wife thinks I'm mad!

In general I think the style and presentation was marvellous. Not only did I understand it, I found I was actually enjoying reading it!

Best wishes for its success."

To the author remarks such as these have been tremendously heartening, in demonstrating that the "barrow-boy" understanding, on which all business rests, can indeed be quickly, accurately and successfully conveyed to the relative layman, given the right approach.

Appreciations

Thanks are also due to John Beevor, David Bloomfield, Robin Bellis-Jones, Michael Franks, Sir Kenneth Sharp and the many others who have provided such invaluable comment on recurrent drafts; and in particular to Janet, my long suffering secretary, without whose good-natured tolerant efforts on the word processor well beyond the call of duty (often in the face of extreme aggravation!) quite genuinely the book could never have appeared.

Finally, a word of very warm thanks to Grania and my family, to whom this book is dedicated, for all their kind sympathy and understanding while the midnight oil was being burned night after night.

Author's View

It goes without saying that the views that follow are entirely the author's and do *not* necessarily represent the views of anyone mentioned above or in the book itself. Nor do they reflect the official or unofficial views of the Institute of Chartered Accountants or of the Bank or Fund for which the author works. Indeed, often the reverse. The book to at least some extent sets out to pioneer new ground . . .

A.c.k. 2

ECSW PR

Ventura Corp

June '81

1

PRIME MINISTER

MR. BRIAN WARNES

While you were away, I had a telephone call from Mr. Brian Warnes. He has been working on a book, an early version of which was sent to you in June. I believe it was called something like "An Entrepreneur's Guide to Business". A letter went back to Mr. Warnes indicating that you would be looking at it over the Recess.

He is now working on a revised version of the book which is to be published shortly. He is proposing to send a copy of this new version to you. I think he is angling for an endorsement that you have read and approved the book which he can deploy in the publicity material.

Even if you have read and approved the book you may not feel it is appropriate for Mr. Warnes to use this fact to promote his book.

Did you in fact ever look at the book? Do you agree the cautious line suggested above?

AT

Is it the Midland Bank Business venture man? The surname seems familiar.

Mrs I have not had time to read the book. MT

29 November 1983

Entrepreneur's Guide to Business

10 DOWNING STREET

Andrew -

Bob Young phoned tonight and left a message for you about Brian Warnes.

Chris Beaumen - ex CPRS staff confirmed that Mr Warnes approached them with his ideas on small businesses in June, 1982.

The then head of the CPRS, John Sparrow, sent a favourable report on Warnes' work to the PM.

Bob Young suggested that you might like to phone John Sparrow at Morgan Grenfell, on 588 4545.

If you have problems contacting him, Chris Beaumen is on the same number & would be more than willing to help. Finally if need be, Bob Young can be contacted at Westland Helicopters, Yeovil.

Warnes 638 8861

x 1599

PTO

Chris Beaumen will be at home tomorrow morning on 435 1773 should you wish to contact him there. (He will be getting ready to go to a funeral)

Cameron

17/11/88.

cc Econ Pol: Venture Capital

SUBJECT FILED ON:
SCIENCE + TECH.
Public Seminar
Mar '83

10 DOWNING STREET

From the Private Secretary

CABINET OFFICE
W ...
30 SEP 1983
FILING INSTRUCTIONS
FILE No. ......

29 September 1983

Dear Mr. Warnes,

I am writing in the Prime Minister's absence in North America to thank you for your letter of 23 September. I will place your letter before the Prime Minister immediately upon her return to this country.

I know that Mrs. Thatcher will be most interested to read your views and I will ensure that the substance of your letter is conveyed to those who have been charged by the Prime Minister to carry forward work in this most important area.

Yours sincerely,

Michael Scholar

B.C.J. Warnes, Esq.

Midland Bank Venture Capital Limited

22 Watling Street
London EC4M 9BR
Telephone 01-638 8861

Extn. 1599

BCJW/JB

Subject filed on: Science + Tech Public Seminar Mar '83

23rd September 1983.

c.c. Dr. Nicholson
cc Econ Pol: Venture Capital

The Prime Minister,
10 Downing Street,
London. S.W.1.

Dear Prime Minister,

Seminar on Science, Technology and Industry

I have allowed a few days to elapse before writing to thank you for the impeccably organised Conference at Lancaster House on 12th September.

Previous letters have mentioned the need to change British attitudes towards business; and small business in particular. Given that change - a role for which the Government is pre-eminently well placed of course - others, like myself, can begin to make headway in bringing about tangible change on the ground.

I do believe, as you know, that a relatively large perceptual gulf exists between the (few) barrow-boys who really do know how to run business; and the rest. Striking (and most unexpected) confirmation of this comes from Sir Kenneth Corfield, whose remarks are attached.

The importance of a brain-storming event like the Lancaster House Conference was to highlight the nature of this gulf. I thought it did it very well indeed.

One small example. When I saw Ian Hay Davison last December on the merits of the MBVC form of improved financial control (which, in principle, he very much welcomed), he said "the only way to force through such a fundamental change within the timescales needed (months rather than years), would be for the Banks to agree to lend only to companies whose accountants/auditors possess these skills. Small accountancy practices up and down the country would then be compelled to come to grips with the new techniques in order to hold onto their traditional audit and tax work".

cont/d....

Registered in England No. 1407886 Registered Office: 27/32 Poultry, London EC2P 2BX
A subsidiary of Midland Bank plc

For various reasons the idea was not fully practical, but a version of the same thing has now been successfully achieved (e.g. see attached article from The Accountant). The Banks themselves, particularly the Midland, have moved light-years on this in just the last few months, which is "pulling" the rest of the scene with them.

A year ago an article such as this could never have been published with any hope of success. Now, thanks very largely to you in changing national attitudes, the prospects are rather different. Equally important moves are taking place with the business schools, Aston and Sundridge Park in particular.

On a parallel theme, there is now a rather different explanation for the relatively poor investment record of British Industry. On every page of Professor Alan Hankinson's "Study of Investment Behaviour of South Wessex Small Engineering Firms 1979-82" "confidence" is shown to lie at the root of whether a company expands, invests, takes on more staff; or not. This has always been taken to mean confidence in the Economy, confidence in the buoyancy of the business climate.

But consider whether it might not, instead, really involve the inner confidence of the Managing Director himself, in his own business skills? And that, only where such inner confidence exists - the sureness and confidence of a Sir Kenneth Corfield for instance - does a business really begin to take off.

The Lancaster House Conference was a further step towards putting all this right on a national scale. But it highlighted how very much more needs to be done. For instance Michael Heseltine's admirable initiative in extracting products from Government Research Departments for the benefit of the entrepreneur, will be stillborn unless great pains are taken also to provide facilities needed to re-engineer, and perhaps even re-design, the products themselves and their associated production processes to dovetail specifically with clearly identified and carefully researched market needs.

There is the old saying that business is not to do with products and services but with buying and selling production hours; with buying for £1 and selling for £2 (or £3 or £4). The products and services themselves are only the outward manifestation of this process, which, as people like Sir Kenneth Corfield would undoubtedly have it, goes to the very root of understanding the true nature of business.

This flavour did come across at the Conference, particularly from people like Sir Robert Telford describing the ALFI project, but perhaps not nearly enough. The main business strengths of this country must come from enhancing existing products and services as well as going out on a limb with new products; where, again as mentioned, the success rate can be as little as only 2-3%. The overall potential for business in this country - correctly handled (and the proviso is crucial) - is therefore very much greater than is commonly supposed.

Overall, a very good and a very important Conference. It was a privilege to attend.

With many thanks,

Yours sincerely

Brian Warnes.

B.C.J. Warnes
Managing Director

12th September, 1983

B.C.J. Warnes Esq.,
Managing Director,
Midland Bank Venture Capital Limited,
22 Watling Street,
London, EC4M 9BR

YOUR BOOK

This is a very good and well written treatise.

It happens to express the self same principles that have contributed more to my own modest success than any other single factor of which I am aware.

The importance of break even point and of testing the market value of a product or service by pricing it truly profitably seems so commonplace to us - and yet is so much neglected.

The 'barrow boy' mentality I may have practiced but the phrase was first used in my presence by Mr. Hugh Barker, then Chairman of Parkinson Cowan Limited in the early sixties.

Every year or so another company in my own province displays just the characteristics you so vividly describe. We have to change the management - perhaps your book will help more, otherwise intelligent, people to survive and help the Country.

The various Engineering Institutions (there are 57 altogether) should be approached to review your book, recommend it and make it available from their libraries.

Every good wish for success,

ORIGINAL SIGNED BY
KENNETH CORFIELD

The accountant's role — a banker's view

The British accounting profession is well placed to lead the country into the small business age. It has brilliant minds and abundant skills but many of its techniques are outdated, more suited to an era when 'historic' accounting was the order of the day. In the austere and highly competitive climate of the 80s business needs real time accounting and rapid access to information, says Brian Warnes, managing director of Midland Bank Venture Capital and a chartered accountant. The profession must adapt to take its place at the forefront of business life otherwise others will take its place. MARGARET MARLEY reports.

WHEN a small business goes to the wall and it is happening at the rate of 2000 a week, the receiver prepares a statement of affairs showing assets and liabilities. Sometimes the bank finds that an apparently secure loan is at best a partial recovery and the bank manager who made the loan finds himself on the hook. 'Why did you make such a loan to a company in this state of health,' his superior inevitably asks.

The beleagured manager refers back to the audited accounts, the figures on which he based his decision, but the picture they present often bears too little resemblance to that of the receiver's report, even allowing for the differences between a 'going-concern' and a 'gone' basis.

If the bank manager feels let down in such circumstances, so can the managing director who often looks on an audit as a clean bill of health. For a small business with unacknowledged weaknesses is in no shape to face up to market pressures; whereas given the right kind of information and financial control it might be able to survive.

Between 7-800,000 audits are done in the UK every year, mostly small business audits by small practitioners. Most are never put to the test because the business survives, but with more than 50 per cent of the small business start-ups folding, criticism of the traditional audit is growing. And it is criticism on a fairly significant scale.

It is a criticism that has significance far beyond the accounting profession, because Britain's small businesses contribute less to GNP than do those of the US, Japan or France; and a lot of money and resources are being poured in to make them the spearhead of economic revival. But there is a one-in-five failure rate of small businesses using the Loan Guarantee Scheme, and it is raising fundamental questions about the annual audit, the accountancy profession and the British businessman in general.

The annual audit is the only financial record kept by many UK firms; notable exceptions are the highly efficient, big league companies. A great number do not have any kind of monthly management accounts, they just keep cash books on a day-to-day basis. Then three months after year-end the auditor comes in and takes two to three months to audit the accounts. By the time the management sees the figures some of them are 18 months old, hopelessly out of date and irrelevant to current costs.

Far too late the managing director realises, for instance, that his prices bear no relation to costs. These are much too low, but he has to let his current order book run out for another two or three loss-making months. In today's austere climate, a small firm needs much closer financial control and few can survive this kind of misjudgment.

By contrast there are relatively few collapses among firms with a good financial management system and at the other end of the scale the highly successful, well-run company will have a sophisticated weekly or monthly, real time accounting system.

Take GEC for example, a group which controls 250 companies. A full description of the financial behaviour of the entire group is on Lord Weinstock's desk every Tuesday morning. It is exactly the same for Oxford Instruments and undoubtedly Racal, British companies that have taken world markets apart. They run weekly accounting systems which describe output, orders, manpower statistics, cash-flow and all the information that is necessary to allow the management to keep a finger on the pulse of business life.

'The sophistication of the management information system is usually a mirror image of the business perception of the people running the business. The two seem to go together,' says Brian Warnes.

Unfortunately good business perception is not a natural British characteristic and British success stories are the exception rather than the rule. We produce products of high technical excellence which are commercial flops because we have not mastered the business logic that the commercial benefit of a product must be in proportion to its cost; Concorde for example. 'The British are just not as good as they should be at business; they seemingly lack the barrow-boy instinct that makes profits out of indifferent products.'

It is a question of culture block, the legacy of empire when the country, with assured wealth and captive markets all over the world, directed its best brains into administration, the civil service, the army, the professions. And business was very much a dirty word.

Traces of these attitudes still remain and the difficulties and challenge of the business world are largely underestimated. A man will decide to go into business overnight, if he can raise the steam. He sees no need to learn the basic ground work and if trouble arises he will push up his prices and hope they stick. It becomes a trial and error process; there is is no scientific method of deciding on the right price at the outset.

In the cold light of the 1980s, British attitudes are changing. The severe and prolonged recession has decimated the number of safe, prestigious jobs, and under the influence of the Thatcher government, the small business is gaining acceptance and respect; it is seen as a key element in the nation's economy.

But the budding businessman is labouring under a tremendous handicap. There is no source of hereditary business wisdom to draw upon; no distilled business knowledge and experience turned into formalised procedures and techniques. While individual companies have excellent real time accounting systems many have been self-developed, worked out empirically, and they remain outside the mainstream of British business life. They have not been codified nor made the basis of teaching.

There is a growing awareness that business needs real time rather than 'historic' accounting and bankers are forcing the pace in this direction. The annual audit is under attack, both as an indicator of a company's creditworthiness and as a relevant tool that will help keep a firm on the straight and narrow path. But in a large number of cases no other figures are available and, in sheer desperation, some banks are launching their own monthly accounting systems.

'It is purely a question of investment protection', says Brian Warnes. 'The banks don't want to pinch the financial services of the accountant, but they know that the information available is not good enough as a basis for seasoned judgment. The motive is to provide the proper background for better investment judgments.'

MBVC, which has investments in about 55 companies, insists that each company adopt MBVC's standard cash-flow plan, a simplified accounting system which monitors a company's progress from month to month. Lloyds has adopted the Carl accounting system and already is handling the monthly accounts of 600 customers.

Barclays and NatWest have powerful computer bureau subsidiaries, Baric and Centre-file, which are rapidly moving into the monthly accounting field. AIDS, the independent computer bureau which specialises in monthly accounting for the 5 to 50 employee firm, plans to establish 225 franchises throughout the country and to develop a 5000-strong client base. 'The banks are giving us every encouragement', says AIDS director Mike Salinger. 'We have been assured of introductions to clients through the branch network.'

But it is really the accountancy profession that should be leading the way and developing simplified, real time accounting systems for every-day business use, says Mr Warnes. Instead, when the accountant is called in to do a formal exercise reams upon reams of paper emerge, a veritable jungle of figures, words and jargon. The audit costs thousands and may be a valuable bench-mark for the professional, but it is incomprehensible to the average managing director. It remains an academic exercise that is irrelevant to the day-to-day running of a business.

There is a desperate need for simple real time systems. 'The engineer who sets up a small business knows all about product development, but he does not understand cash-flow or how to keep a business afloat. He needs a simple system that will cover the key issues, orders, sales, overheads, breakeven point, gross margin, debtors, etc, which will tell him at a glance how the firm is doing.'

But the simpler the system the more sophisticated the thinking behind it. A consultant charging £250 a day will take two or three weeks to design a one-off system for a small firm, but at £6000 to £7000 the cost is prohibitive. 'I can see no reason why the profession, and in particular the Institute, should not step in and develop half a dozen standard systems for different business applications', says Mr Warnes. 'The profession, in intellectual terms, is probably the strongest in the world. It has all the sophistication and skills necessary for the job.'

A whole range of systems might cost £10,000 to £30,000 to develop, but the institute could find the money from the profession at large. It could punt out the systems to 100 firms to operate on a year's trial, get an evaluation and then produce almost a *Which* report. Then, with the systems fully refined, they could be distributed to accountants up and down the country so that the small practitioner need only put his hand into a drawer and pull out a suitable accounting system for his small business client.

'I am highly critical of the profession for not having crossed this frontier', says Mr Warnes. 'These problems are in desperate need of solution. Companies are failing or not growing as they should; they are remaining small and vulnerable, weak and nervous because they are not getting the right kind of business guidance. The profession should be moving into this field very fast.'

Once a real time accounting system is developed, the accountant must then make the best use of it; interpreting it for the managing director, explaining the significance of what is happening, forecasting what is going to happen. The system becomes a sensitive barometer which enables a firm to pick-up the changing pattern of business behaviour and to tailor output and pricing accordingly. 'If the accountant can adapt to the needs of the day and develop a real understanding of business there is an enormous role for him to play in the revival of British industry.'

But at the moment the accountant's advice is often far from accurate; it does not tie-up with what actually is happening and his credibility is prejudiced. A firm about to embark on a major contract will ask the accountant what cash needs are likely to be. He prepares a cash-

Brian Warnes, managing director of Midland Bank Venture Capital (MBVC). He is a chartered accountant, having qualified with Peat, Marwick and Mitchell. He read physics at Oxford, has worked for the Foreign Office and the Commonwealth Development Corporation. His practical experience in company doctor, rescue operations gives him a sharp insight into the problems of British business.

flow forecast but six months later the firm runs out of money. 'How come', asks the managing director. 'Well of course the cash-flow prediction is wrong', says the accountant, 'time scales were different six months ago and your sales have not come up to expectations'. 'This is no valid excuse for not achieving forecasting accuracy', says Mr Warnes. 'It highlights a serious deficiency in accountancy training.'

The problem is that both the accountant's training and his conventional tools equip him to deal with static problems, with historic figures. But business life is fast moving and dynamic and what is required is a man trained to cope with changing patterns, to get cash-flow forecasts right in spite of fluctuations in the market-place. There is a great difference between the engineer who understands dynamics and the one who is limited to statics; the first can design a missile to hit a moving target, the second can only hit a stationary one.

'The average accountant is good at statics', says Mr Warnes, 'but he hasn't got the training to enter the world of dynamics. Conventional accounting systems are not suitable. Technically they are just not able to cope with the dynamics of business life.'

MBVC has introduced a simple accounting system to the 55-odd firms that it has invested in, and 'it has had a dramatic effect. Some of MBVC's best investments are light engineering firms, so many of which are in trouble'.

The MBVC cash-flow plan is the distillation of 14 years business experience. 'I started out in company doctoring work, in rescue operations', says Mr Warnes, 'and I had to develop a format of cash-flow to help me understand what exactly was happening in the company. It proved a useful tool for teaching the managing director, for sharpening his business understanding. Now we put a system into every company we touch, explain it to the managing director, watch him while he tries it out, and suddenly realisation dawns and he's on his way.'

The cash-flow plan applies barrow-boy knowledge to a company. It explains that breakeven point is the level of sales needed to cover overheads, shows where it lies and what value-added-per hour a company needs to breakeven. A managing director can tell at a glance whether monthly sales and order levels are running above or below breakeven point and he can adjust output and prices until he gets the equation right.

An electronic components firm, with a good product and full order books, ran into a cash-flow problem and MBVC was called in. The business was analysed and tabulated in the cash-flow format which showed that while running costs amounted to £10 an hour some of the biggest jobs were only earning £5 an hour value added. The managing director saw the point, redesigned the layout of the electronic unit so that assembly took 40 minutes instead of 1½ hours. He effectively doubled output and income through the same cost structure and could now meet customer demand.

'Why didn't you do this in the first place', asked MBVC 'It didn't seem worthwhile. The extra 40 minutes seemed to be merely another £2 in production costs. The cash-flow plan has changed the focus of things and the business operates within a different framework. Six months ago I was an engineer making a loss of £15,000 a month', says the managing director. 'Today I'm a business man earning £30,000 and I can see £50,000.'

George Lingard, managing director of Severn Controls, ran into trouble when a major contract went wrong — due to a sub-contractor's error — and had to be redone. The business cost £10,000 a month to run but while the remedial work was going on nothing was being earned. The cash-flow plan showed that given the orders, sales value, material and labour content the business had huge margins and could afford to double the workforce to keep the main core of work flowing through.

Doubling the workforce while debts mounted seemed to violate common sense but it made good business sense and the firm pulled through. 'We wouldn't be here today without the system', says Mr Lingard. 'I was very sceptical about the extra figure work initially, but now I've got it down to one day a month and it gives tremendous day-to-day control.'

The Japanese understand this approach and its one of the reasons for their outstanding success. Perhaps it is because nearly all Japanese businessmen are engineers, says Mr Warnes. 'About 77,000 Japanese engineers graduate every year compared with 6000 or so in the UK. They understand about dynamics and the country grafts on a sound business training; and once you have an engineer designing a product in the financial context you have a real business.'

The British business climate is breaking and changing and Mr Warnes is optimistic about the future. He believes that the accountancy profession is pre-eminently well placed to lead the country forward provided it is prepared to adapt to the needs of the day. 'If the accountant can develop a real understanding of business, there is an enormous role for him to play in the revival of British industry.' □

Midland Bank Venture Capital Limited

22 Watling Street
London EC4M 9BR
Telephone 01-638 8861

BCJW/JB

Prime Minister (4)

MCS 23/6

21st June, 1983.

The Prime Minister,
10 Downing Street,
London. S.W.1.

Dear Prime Minister

Thank you very much for your letter of 16th June. If you are going to read the book yourself, could I suggest particular concentration on Chapter XII, dealing with the role of Engineers and Japanese competition; which can best be understood once Chapters I-IV have been digested along with Chapters VIII-X. The attached cutting reinforces the context of what is said.

The book is deliberately designed to cultivate and appeal to the various interests that need to be got together to create a really effective business scene; rather than alienating them. So areas where existing techniques are letting businesses down, or even actively misleading and harming them, have been glossed over. They can however be recognised by the codewords "conventional accounting systems . . ." or "don't blame the accountants . . ." and include conventional costing systems (second paragraph Page 40), Accountants' seeming preoccupation with Profit rather than Cash Flow, Chapter V, and particularly techniques for forecasting and monitoring cash flow (top of Page 33).

?

Unfortunately this has not stopped the wrath of half the Profession descending, including some hard things said by my old firm, Peats. However someone has to have the courage to make the breakthrough in the name of better business direction in this country.

A spare Appendix A is enclosed, if one is not already attached to the book. I hope you enjoy reading it.

Please don't bother to acknowledge.

Yours sincerely

B.C.J. Warnes

B.C.J. Warnes
Managing Director

Registered in England No. 1407886 Registered Office: 27/32 Poultry, London EC2P 2BX
A subsidiary of Midland Bank plc

ECON POL: Venture Capital June 1981

1/ Book

Engineers are let down by their narrow education

Survey also reveals engineers feel neglected by employers

Britain's engineers are still neglected, according to a new research report to be unveiled this week. A three-year survey of practising engineers by Leicester Polytechnic shows that engineers feel let down by their education and neglected by their employers. The survey confirms yet again the main findings of the Finniston inquiry into the engineering profession published three years ago. Finniston said that the poor status and education of engineers were threatening the performance of industry, and therefore proposed setting up a statutory engineering authority to initiate reforms. Finniston himself, who has written the introduction to the report, says he hopes "that action will be taken now and not in any indeterminate future."

One of the main thrusts of the survey, which asked for views from 200 non-engineers as well as 250 practising engineers aged 25-35, is that engineering education is still too narrow and too academic. Another criticism that emerges from their colleagues is that engineers are very poor at expressing themselves and translating engineering into other people's terms, and are even worse at understanding the arguments of their more business-oriented colleagues. One engineer admits that in meetings with the marketing department he tends

Finniston: no change with present policies

to keep quiet because "the marketing whizz-kids rip me apart". In the opinion of one personnel director, engineers' ability to communicate is "scandalous — everything has to be edited and done again".

In consequence, it is hardly surprising that engineers play so little part in decision making. An engineer says ruefully: "Accountants rule the roost. There is enormous wastage, because decisions are made by the wrong people." Another engineer comments: "Accountants are not aware of long-term problems. They buy cheap equipment to make the product cheap, but then maintenance costs are much higher."

The survey gives one reason why many engineers never go into industry at all and by implication why many do not even enter the profession — the sheer frustration of it all. Typical comments are: "It is anti-graduate here. They use us as technicians. We don't need a degree at all." Or, "Coming here is a culture shock. It's slow moving, with frustration and delay beyond your control." Others complain of being kept in the dark, not knowing what their objectives are and being unable to plan.

The survey shows up the pitiful level of company training of engineers. One-third of those interviewed had had no formal training at all, while of those who had, about a third said it had not been useful. This means that about half the sample of engineers had never been on a well-thought-out training course.

The engineering institutions, most of which attacked the Finniston report as being unduly unfair to them, come in for criticism also. Of those interviewed, 68% were members of an engineering institution but even they regarded the institutions as being of limited relevance. The report says that the comments on engineering education are a reflection on the institutions' accreditation criteria.

The report concludes that Britain's engineers are being seriously under-used. "Many of the organisations which employ engineers have features which do not encourage innovation." More alarmingly, the report says: "Not only were these engineers not involved in the policy process, many of them knew little or nothing of the organisation's technology or product-development or marketing policies."

The authors now intend to follow their £80,000 survey with a three-year £100,000 study to suggest ways of remedying the weaknesses in engineering education. Finniston questions: "Will the lessons revealed by this study and the government inquiry be listened to and acted upon sooner rather than later in major measure rather than peripherally? Present policies do not favour a change of heart in society's attitudes to engineering." □

Midland Bank
Venture Capital Limited

CASH FLOW FORECASTING

CASH FLOW FORECASTING

The motto over the main entrance of one of America's leading companies is said to read: "Our job isn't making steel, it's making Money".

Companies with a strong sense of commercial know-how will make money out of even the most indifferent products. They apply the Barrow Boy technique: "If goods are bought for £1, if the stall costs £20 a day to run, if only £40-worth of stock can be afforded at any one time, at what price should sales be made?"

"If sold at £2 per item, "overheads" are covered after 20 sales, total costs after 30, and whatever the sales price after that it is all surplus. The market can be played accordingly. The lowest average price for which all 40 items can be sold without making a loss is £1·50. If only 30 can be sold an average price of £2·50 is needed to make an acceptable profit". And so on.

These relationships are governed by measuring where the "breakeven" points lie, which can be done by simple calculation once the information is organised properly. Buying or manufacturing policies—what?, at what price?, in what quantity?—can then be laid down with confidence. The specific nature of the product is unimportant. The price/cost/demand relationship is.

Conversely, the record is strewn with Product-strong companies, on the face of it having magnificent commercial potential, who in practice perform indifferently or even go under because the equivalent commercial instinct is not present in the same strength. Indeed it can often become submerged and lost sight of altogether by that very technical excellence on which the company has built its reputation. Some of the most pre-eminent names spring to mind, from Rolls-Royce downwards; in contrast the Barrow Boy can afford to go to the West Indies on holiday every year.

If you, as Managing Director, are not complete master of such factors in your own company then the enclosed schedules are designed to help. The issues are by no means commonsense; for instance, in the attached example the January Actuals show a company making a loss that has a stronger, better cash flow than one making a profit, with a greater chance of living within its overdraft limits—a seemingly absurd contention. Likewise it seems illogical that uncertainties or errors in stock valuations cannot affect the overall cash flow pattern and can therefore safely be ignored.

It needs a certain amount of painstaking work to come to grips with the principles involved and to really master such issues, but it is hoped that the detailed explanations given in the following pages will help you to do so, and do so successfully. The purpose is not so much to achieve good profitability for your company but to provide a stable and secure financial base from which it can expand strongly and successfully. Such a business plan should be drawn up for the next 12 months and agreed with MBVC. Ideally, you should do all the work yourself in the first instance and only seek the help of your financial experts in putting the final seal of approval to the figures.

Should MBVC investment get under way, the resulting format will form the blueprint for monitoring actual progress against Budget—January Actuals have been inserted in the attached example. In February, February's Actuals will replace the January Budget column, giving comparison with February Budget, and so on. The comparison shows not just *whether* the cash flow is going wrong but *where* and *why* (e.g., debtors) so specific remedial action can be taken; and taken well ahead of any resultant cash flow crisis.

One particular simplification should be noted. All stocks, work in progress and finished goods are recorded by reference to their labour and materials content only. *No* overheads or mark-ups of any kind are included. This considerably simplifies the task of compiling the forecast and also allows the company to record only materials and labour costs on all stock and job cost records. The MBVC legal agreements lay down that Actual progress is to be reported against Estimate within 14 days of the end of each month. To enable you to meet this deadline the introduction of simplified records will be necessary, if not in use already;

again this is an area where your professional advisers will be able to help. The ultimate aim is to give you fingertip control and understanding of your company, for a minimum of time, cost and effort as events unfold.

Good Luck. Please do not hesitate to contact us direct if you have any problems or queries.

B. C. J. Warnes, MA FCA.,
Managing Director,
Midland Bank Venture Capital Ltd.

Reference should be made to the completed forecast examples, contained in the back pocket of this booklet, whilst reading through the steps outlined below, in order to fully understand them.

A further blank set of forecast forms is also provided for your use.

I Estimate **Monthly Sales** (Line 1) pre VAT, allowing for fact that:

1) For start-ups, build-up is nearly always much slower and takes longer than expected, and starts later.

2) Holiday months (e.g. July/August, December) are usually poor.

3) Seasonality should properly be taken into account (e.g. peak sales pre-Christmas, poor January etc.)

II Deduct **Direct Sales Costs** (2) namely:

1) Trade discounts

2) Any other discounts or commissions, *calculated as a percentage of sales price*

3) Outward delivery costs, freight, duty etc.

III Decide on pricing policy e.g. percentage mark-up on labour and material costs to arrive at sales price. Express the resulting labour, material and direct sales-cost (Step II above) as a percentage of sales price. The balance will be the Gross Margin percentage. Most companies need to achieve at least 30% Gross Margin to survive, and really need between 40% and 70% to do well.

Insert **Gross Margin Percentage** at (23) and apply to Sales at (1) to give **Gross Margin** (12) by value, allowing for:

1) for start-ups, additional costs incurred in completing design and development work and to produce, test, finalise and production-engineer any prototypes

2) problems likely to be encountered in early months of production until procedures are got right (resulting in extra material wastage, excessive labour hours etc.)

3) Defective work e.g. rejected product returned by the customer

4) Pilferage of materials

5) Supplier problems—late deliveries, wrong specification, additional costs from last minute buying etc.

All of which may result, particularly for start-ups, in low and possibly even negative, margins for a period, until the various problems can be identified and got right.

IV Estimate **Material Deliveries** (5) (including sub-contract parts) needed to build-up stocks to maintain uninterrupted production.

V Estimate the **Labour Costs** (6) needed to support production, allowing for:

1) the addition to basic wages of Employers' NHI, Pension Contributions etc.

2) Ditto Holiday pay entitlement.

VI Insert **Opening Stock** (4) for month 1, from the "Opening Balance" figures at (32) + (33) + (34).

VII Derive **Closing Stock** (10) for month 1, having summed lines (1) to (12). Insert as opening stock (4) for month 2. Repeat through to month 12. Sum lines (1) to (12). Check the above stock figures are approximately correct as follows (Material and Labour Content only):

Raw Material (32) If say 6 weeks production requirement is carried, January's Stock should total January's Material Purchases (5) plus half December's (5).

Work in Progress (33) If work takes say on average one month to pass through the factory, January's Work in Progress should be equivalent to January's Cost of Sales (11).

Finished Goods (34) If say 2 months stock is carried, January's Finished Goods should be broadly equivalent to December's plus January's cost of sales (11).

Check **Closing Stock** (10)=(32)+(33)+(34) for same month.

Check **Opening Stock** (4)=(32)+(33)+(34), for the previous month.

Note 1: If the above *very approximate* calculations show the opening and closing stocks previously inserted at (4) and (10) are seriously understated, monthly material purchases (Stage IV) and Labour costs (V) should be increased and the stock figures (Stage VII) reworked.

Note 2: Stocks of packing materials, publicity leaflets, etc. should be included with Finished Goods (34). Any amounts actually *used* in the month, in sales at (1), should be included in costs of sales (11).

Note 3: The following complexity is *not* recommended and for forecasting purposes should, if possible be ignored, but if the company insists on showing an "overhead" content in stocks, rather than valuing stocks at just labour and material cost, the content should be separated out of (33) and (34) and the total shown at (19), with (20) being the equivalent for the previous month.

VIII Estimate **Overheads** (marketing, administration, legal, accountancy, office, travel, etc.) and insert at (13). Allow for:

(1) Additional legal, etc. costs at start of new business

(2) Any building renovation, removal, machinery installation, etc.

(3) During year, such factors as inflation of pay and staff increases.

Note: Ignore Interest (16) for the time being (see later).

IX Estimate the finance needed to support credit given to customers. If say two months credit given, **Trade Debtors** (30) will be the total of last two months sales, so January Debtors will total January's sales (1) plus December's sales (1). Include any element of debtors financed by factors, i.e. show the *gross* amount owing to the company plus what is owing to the factors. Assume **Other Debtors** (31) are zero for forecasting purposes.

X **Progress Payments** (35) can also be ignored for forecasting purposes. (These are amounts invoiced to the customer, whether or not yet paid for by him, before a contract is technically "completed"; and down payments or advances before the contract starts; or progress payments during it. Note that such amounts should *not* be regarded as "sales" at (1) until the contract has been "*completed*", whereupon the whole contract value should be treated as a sale, regardless of when invoiced and when the work was done.)

XI **Trade Creditors** (37). If suppliers give say 2 months credit, January's trade creditors will be December's+January's material deliveries (5).

XII **Other Creditors** (38). Include PAYE, VAT, Interest owing and accrued expenses, etc. Assume, say, equivalent to current month's overheads (17), or ignore for forecasting purposes.

XIII Derive **Net Current Assets** (40) by deducting (39) from (36). (This figure should approximately equal total sales for the past three months, for a typical manufacturing company.)

XIV Moving now on to the Cash Flow as such, derive the **Increase or (Decrease)** in **Net Current Assets** (41). January's (41) will be January's (40) less December's (40).

XV Estimate gross **Capital Expenditure** (42) in the month, for purchase of buildings, plant, vehicles, etc. (before deducting e.g. any Hire Purchase arrangements).

XVI **Research and Development Expenditure.** Ignore (43) for forecasting purposes. Any labour and material cost included in (5) and (6), which has been diverted to Research and Development in the month, should be taken out again as a **Credit** at (7). Include total labour and material costs together with all direct salary costs etc. in administration (13).

XVII Derive (44)=(41)+(42)+(43), giving the gross additional funding need in the month.

XVIII The contribution from **Cash Profits** (48) i.e. (22) plus Depreciation, will *reduce* the monthly net cash requirement; Cash Losses (45) on the other hand will of course *increase* it.

Profits are however reduced by interest charges (16) calculated on total borrowings (57), which in turn depend on profits. To break the vicious circle assume, initially, that interest (16) is zero and derive a rough profit (loss) figure for month 1 by deducting (13) from (12). Insert at (45). Add Depreciation (46) and Amortisation (47) to extent included in Administration Costs (13). Derive (48) and deduct, if a profit, from (44) to arrive at the rough net cash requirement (49). Add if a loss.

XIX Insert **Opening Balances** prior to the start of the 12 month period at (50) to (56) and total (57). Add to this the rough cash requirement at (49) for month 1 to arrive at a new total borrowing figure (57) as at end of month 1.

XX Calculate **Interest,** for one month, on the total (57) and insert at (16) for month 1. Derive (17), (18) and (22). Insert the more accurate figure at (45) and rework **Total Borrowings** (57), Derive **Closing Overdraft** (56), having inserted the relevant closing balances for **Factoring** (54), **Loans** (51), (52), and **Hire Purchase** (53) for month 1.

XXI Work through the same cycle for month 2. And so on to month 12, which will then show peak funding need and what month it occurs.

XXII Calculate **Breakeven Point** (24) i.e. the level of turnover needed just to cover overheads (17), at the gross margin percentage in question (23) i.e. (17)× 100 ÷ (23).

At 25% gross margin every £4K of sales above breakeven will produce a profit of £1K, every £4K below breakeven a loss of £1K. The company can be controlled accordingly by comparing order intake (25) and orders in hand (27) with actual sales (1).

Note, if the Gross Margin the company *thinks* it is achieving (26) and (28) as worked out from its Costing and Pricing data begins to be substantially higher than is *actually* being achieved (23), the Costing and Pricing assumptions should immediately be rechecked to bring the two into line. The accuracy of the gross margin percentage calculated at (23) in turn should be frequently checked, particularly in the early months of a new company, by basing closing stock (10) on physical stocktakes (Labour and Materials only) until broad agreement begins to emerge. The task is often for a period a tedious one, but any company that does not know its *real* gross margins is likely to fail, possibly quite quickly.

MONTHLY MONITORING

Within 14 days of the end of each month, at least approximate results for the month should be inserted (January Actual in the example) for comparison with Budget. Next month, February's Actuals will over-write January's Budget to give comparison with February Budget. And so on.

Immediate rebudgeting for the rest of the year should take place if it becomes apparent from the emerging pattern of Actuals that the basis on which the Budget has been compiled is inaccurate, in order to give maximum advance warning of impending problems.

Printed by Howard Jones Printing Service Ltd., London.

MONTHLY PROFIT AND LOSS ACCOUNT (£'000)

	Actual		Budget												
Months	D	J	J	F	M	A	M	J	J	A	S	O	N	D	Total
SALES															
1 Gross Sales	3·0	5·0	10·0	10·0	12·0	12·0	14·0	14·0	8·0	12·0	15·0	20·0	20·0	3·0	150·0
2 Direct Sales Costs	0·3	1·0	1·0	1·0	1·2	1·2	1·4	1·4	0·8	1·2	1·5	2·0	2·0	0·3	15·0
3 **NET SALES**	2·7	4·0	9·0	9·0	10·8	10·8	12·6	12·6	7·2	10·8	13·5	18·0	18·0	2·7	135·0
MATERIALS AND LABOUR															
4 Opening Stock	22·0	25·0	25·0	27·0	29·0	30·8	32·6	32·7	32·8	31·0	26·8	28·8	35·3	37·8	25·0
5 Material Deliveries	—	7·0	3·0	5·0	6·0	6·0	5·0	5·0	—	—	7·0	10·0	10·0	—	57·0
6 Labour	5·0	4·0	5·0	3·0	3·0	3·0	3·5	3·5	5·0	3·0	4·0	4·5	4·5	5·0	47·0
7 (R & D)	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
10 Closing Stock	(25·0)	(32·5)	(27·0)	(29·0)	(30·8)	(32·6)	(32·7)	(32·8)	(31·0)	(26·8)	(28·8)	(35·3)	(37·8)	(38·1)	(38·1)
11 **COST OF SALES**	2·0	3·5	6·0	6·0	7·2	7·2	8·4	8·4	6·8	7·2	9·0	8·0	12·0	4·7	90·9
12 **GROSS MARGIN**	0·7	0·5	3·0	3·0	3·6	3·6	4·2	4·2	0·4	3·6	4·5	10·0	6·0	(2·0)	44·1
13 Administrative Costs	3·0	2·0	1·5	1·5	1·5	2·0	2·0	2·0	3·0	2·0	2·5	2·5	2·5	3·5	26·5
16 Interest	0·6	0·5	0·6	0·6	0·8	1·0	1·0	1·0	1·0	1·0	1·0	1·0	1·0	1·0	11·0
17 *Sub-Total*	3·6	2·5	2·1	2·1	2·3	3·0	3·0	3·0	4·0	3·0	3·5	3·5	3·5	4·5	37·5
18 **NET**	(2·9)	(2·0)	0·9	0·9	1·3	0·6	1·2	1·2	(3·6)	0·6	1·0	6·5	2·5	(6·5)	6·6
19 Overheads in Closing Stock	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
20 (*Less* in Opening Stock)	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
21 (Sundry Income)	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
22 **PRE TAX PROFIT (LOSS)**	(2·9)	(2·0)	0·9	0·9	1·3	0·6	1·2	1·2	(3·6)	0·6	1·0	6·5	2·5	(6·5)	6·6
23 **GROSS MARGIN PERCENTAGE** (12) × 100 ÷ (1)	23·3%	10·0%	30·0%	30·0%	30·0%	30·0%	30·0%	30·0%	5·0%	30·0%	30·0%	50·0%	30·0%	NEG	29·4%
24 **BREAKEVEN POINT** (17) × 100 ÷ (23)	15·4	25·0	7·0	7·0	7·6	10·0	10·0	10·0	80·0	10·0	11·7	7·0	11·7	NEG	127·5
25 **ORDERS** Taken In Month	1·0	10·0													
26 Estimated GM %	40·0%	26·0%													
27 **ORDERS** In Hand at Month end	11·0	16·0													
28 Estimated GM %	27·0%	27·0%													

MONTHLY PROFIT AND LOSS ACCOUNT (£'000)

MONTHLY CASH FLOW (£'000)

	Actual		Budget												
			Net Current Assets Per Balance Sheet												
	Opening Balances	J	J	F	M	A	M	J	J	A	S	O	N	D	
DEBTORS															
30 Trade	23·0	8·0	13·0	20·0	22·0	24·0	26·0	28·0	22·0	20·0	27·0	35·0	40·0	23·0	
31 Other	1·0	1·0	—	—	—	—	—	—	—	—	—	—	—	—	
STOCK															
32 Raw Material	3·0	5·0													
33 Work in Progress	4·0	5·0	27·0	29·0	30·8	32·6	32·7	32·8	31·0	26·8	28·8	35·3	37·8	38·1	
34 Finished Goods	18·0	22·5													
35 (Progress payments)															
36 *Sub-Total*	49·0	41·5	40·0	49·0	52·8	56·6	58·7	60·8	53·0	46·8	55·8	70·3	77·8	61·1	
37 Creditors Trade	9·0	15·0	3·0	8·0	11·0	12·0	11·0	10·0	5·0	—	7·0	17·0	20·0	10·0	
38 Other	—	1·0	—	—	—	—	—	—	—	—	—	—	—	—	
39 *Sub-Total*	9·0	16·0	3·0	8·0	11·0	12·0	11·0	10·0	5·0	—	7·0	17·0	20·0	10·0	
40 **NET CURRENT ASSETS**	40·0	25·5	37·0	41·0	41·8	44·6	47·7	50·8	48·0	46·8	48·8	53·3	57·8	51·1	
			Cash Flow												Total
CASH OUT															
41 Increase (Decrease) NCA		(14·5)	(3·0)	4·0	0·8	2·8	3·1	3·1	(2·8)	(1·2)	2·0	4·5	4·5	(6·7)	11·1
42 Capital Expenditure Assets		4·0	5·0	—	10·0	—	—	—	—	—	6·0	—	—	—	21·0
43 R & D		—	—	—	—	—	—	—	—	—	—	—	—	—	—
44 *Sub-Total*		(10·5)	2·0	4·0	10·8	2·8	3·1	3·1	(2·8)	(1·2)	8·0	4·5	4·5	(6·7)	32·1
CASH IN															
45 Profits (Losses)		(2·0)	0·9	0·9	1·3	0·6	1·2	1·2	(3·6)	0·6	1·0	6·5	2·5	(6·5)	6·6
46 Depreciation Assets		0·3	0·3	0·3	0·3	0·4	0·4	0·4	0·4	0·4	0·4	0·4	0·4	0·4	4·5
47 Amortisation R & D		—	—	—	—	—	—	—	—	—	—	—	—	—	—
48 *Sub-Total*		(1·7)	1·2	1·2	1·6	1·0	1·6	1·6	(3·2)	1·0	1·4	6·9	2·9	(6·1)	11·1
49 **NET CASH REQUIREMENT (SURPLUS)**		(8·8)	0·8	2·8	9·2	1·8	1·5	1·5	0·4	(2·2)	6·6	(2·4)	1·6	(0·6)	21·0

MONTHLY CASH FLOW (£'000)

MONTHLY CASH FLOW (£'000) continued

	Closing Balances per Balance Sheet													
	Actual		Budget											
	Opening Balances	J	J	F	M	A	M	J	J	A	S	O	N	D
50 New Equity	—	—	—	—	—	—	—	—	—	—	—	—	—	—
51 Debentures	15·5	15·0	15·0	15·0	15·0	14·5	14·5	14·5	14·0	14·0	14·0	13·5	13·5	13·5
52 Medium Term Loan	—	—	—	—	—	—	—	—	—	—	—	—	—	—
53 Hire Purchase	—	—	—	—	8·0	7·9	7·8	7·7	7·6	7·5	7·4	7·3	7·2	7·1
54 Factoring	—	—	—	—	—	—	—	—	—	—	—	—	—	—
55 (Cash in Hand)	—	—	—	—	—	—	—	—	—	—	—	—	—	—
56 Overdraft	30·8	22·5	31·6	34·4	35·6	38·0	39·6	41·2	42·2	40·1	46·8	45·0	46·7	46·2
57 **TOTAL BORROWINGS**	46·3	37·5	46·6	49·4	58·6	60·4	61·9	63·4	63·8	61·6	68·2	65·8	67·4	66·8

MONTHLY CASH FLOW (£'000) continued

MONTHLY PROFIT AND LOSS ACCOUNT (£'000)

	Budget												
	1	2	3	4	5	6	7	8	9	10	11	12	Total
SALES													
1 Gross Sales													
2 *Less:* Sales Comm. freight etc.													
3 **NET SALES**													
MATERIALS AND LABOUR													
4 Opening Stock													
5 Material Deliveries													
6 Labour													
7 (R & D)													
10 Closing Stock													
11 **COST OF SALES**													
12 **GROSS MARGIN**													
13 Administrative Costs													
16 Interest													
17 *Sub-Total*													
18 **NET**													
19 Overheads in Closing Stock													
20 (*Less* in Opening Stock)													
21 (Sundry Income)													
22 **PRE TAX PROFIT (LOSS)**													
23 **GROSS MARGIN PERCENTAGE** (12) × 100 ÷ (1)													
24 **BREAKEVEN POINT** (17) × 100 ÷ (23)													
25 **ORDERS** Taken In Month													
26 Estimated GM %													
27 **ORDERS** In Hand at Month end													
28 Estimated GM %													

MONTHLY PROFIT AND LOSS ACCOUNT (£'000)

MONTHLY CASH FLOW (£'000)

	Actual	Budget												
		Net Current Assets per Balance Sheet												
	Opening Balances	1	2	3	4	5	6	7	8	9	10	11	12	
DEBTORS														
30 Trade														
31 Other														
STOCK														
32 Raw Material														
33 Work in Progress														
34 Finished Goods														
35 (Progress payments)														
36 *Sub-Total*														
37 Creditors Trade														
38 Other														
39 *Sub-Total*														
40 **NET CURRENT ASSETS**														
		Cash Flow												Total
CASH OUT														
41 Increase (Decrease) NCA														
42 Capital Expenditure Assets														
43 R & D														
44 *Sub-Total*														
CASH IN														
45 Profits (Losses)														
46 Depreciation Assets														
47 Amortisation R & D														
48 *Sub-Total*														
49 **NET CASH REQUIREMENTS (SURPLUS)**														

	Actual	Budget												
	Opening Balances	1	2	3	4	5	6	7	8	9	10	11	12	
50 New Equity														
51 Debentures														
52 Medium Term Loan														
53 Hire Purchase														
54 Factoring														
55 (Cash in Hand)														
56 Overdraft														
57 TOTAL BORROWINGS														

Closing Balances per Balance Sheet

MONTHLY CASH FLOW (£'000) continued

hls

10 DOWNING STREET

THE PRIME MINISTER

16 June, 1983

Dear Mr. Warnes.

Thank you very much for sending me a copy of your book, which I shall read with great interest, probably in the Recess.

I am glad that the CPRS were of help to you in producing the book. I entirely agree with you that much remains to be done; reducing unemployment is the biggest challenge we face.

Yours sincerely

Margaret Thatcher

B. C. J. Warnes, Esq., M.A., F.C.A.

Qa 06394

To: MR SCHOLAR

14 June 1983

From: JOHN SPARROW

1. Mr Warnes's book is a guide to business, written primarily for the small businessman and those not financially sophisticated, and couched in terms which that audience should readily understand and enjoy. As he says in his covering note, the techniques and the lessons are just as applicable to big business (where they are not always readily understood); for example, they should be part of the armoury of anyone managing or monitoring a nationalised industry. And particular points apply to all organisations, including Government - the paramountcy of cash, the need for quality rather than quantity in information flows.

2. You might like to draw the Prime Minister's attention to the passages I have marked on pages 39 and 71 of the draft (which I return herewith).

3. I see two possible uses for the book in Government. One would be as a handbook for DTI Counsellors, although they should be aware of most if not all that Mr Warnes has to say. The other would be as part of the 'business education' of people in sponsorship roles, particularly those coming new to the task. In her reply, I do not think that the Prime Minister should go further than you suggest (except that she might say that she is pleased that we were able to help). But it could be worth getting the sponsor departments, and DTI in particular, to circulate copies of the book, when published, to relevant staff.

4. I know that Mr Warnes has discussed his ideas with Ken Sharp, with whom I had a brief word today. He suggested that another possible use would be at the Senior Finance Course, but is under the disadvantage of not having seen the book. You might like to send him this copy, so that he can comment more fully.

Better for Mr Sharp to get his own copy. MES

JS.

Econ. Pol

10 DOWNING STREET

From the Private Secretary

Mr. Sparrow

The Prime Minister has received the attached letter from Mr. Brian Warnes, Managing Director, Midland Bank Venture Capital Limited.

I envisage that the Prime Minister will send a reply to Mr. Warnes, simply acknowledging receipt, and thanking him for sending her a copy of this interesting work. I would be grateful if you could have a quick look at the book to see if there is anything else which, in your view, she might say.

To save photocopying, I am sending our only copy of this document. I would be grateful if you could return it to me when you reply.

M. C. SCHOLAR

13 June, 1983.

Midland Bank Venture Capital Limited

22 Watling Street
London EC4M 9BR
Telephone 01-638 8861

BCJW/JB

9th June, 1983.

The Prime Minister,
10 Downing Street,
London. S.W.1.

Dear Prime Minister,

The Economy

Congratulations on your win, although clearly Unemployment nearly became the Achilles Heel of the campaign.

On the latter, many factors are of course involved but, as you know, I feel lack of Business Professionalism is one main cause, which publication of the attached book (conceived with your very kind help as an indirect outcome of discussions with the Central Policy Review Staff; please see covering note in particular) will contribute, in however small a way, towards trying to put this right.

However, very much more needs to be done, doesn't it ?

Yours sincerely

Brian Warnes.

B.C.J. Warnes
Managing Director

Kerry
for you?
AJ 17/1.

File

BoE

10 DOWNING STREET

From the Private Secretary

MR. SPARROW
CPRS

Mr. Brian Warnes
(Midland Bank Venture Capital Limited)

Thank you for your minute of 10 January about your discussions with Mr. Brian Warnes.

I showed this to the Prime Minister over the weekend. She made no comment.

17 January 1983

Prime Minister

GR
PPS ?
c/F

CA 12/1

M. clarity

2

Qa 06211

To: MR SCHOLAR

MT

From: JOHN SPARROW

10 January 1983

Mr Brian Warnes (Midland Bank Venture Capital Limited)

1. Following Mr Warnes's letter to the Prime Minister of 9 November and your note of 15 November, I have been in touch with Mr Warnes to explore further his findings. His key point is that far too many businesses, especially small businesses, fail because they do not possess basic 'barrow-boy' techniques. Hence businesses with good products often fail either because the products are under-priced, or alternatively because they are over-elaborate and too costly for their market. The essence of the 'barrow-boy' technique is to design and price a product so as to achieve an adequate gross margin, and a realistic break-even point. This is required to make a business financially robust, and give it the best chance of survival.

2. Mr Warnes correctly argues that this puts a premium on a system of financial analysis which clearly demonstrates that profit or loss result from the inter-relationships among volume of sales, gross margins and fixed costs, and which enables break-even volumes to be ascertained for any given price/cost structure and compared with a range of forecast volumes. Such a system also facilitates analysis of the sensitivity of profits to variations in volume sales, prices and costs.

3. These techniques are not new and are in fact fairly elementary - they were popular at Ford twenty years ago. However, Mr Warnes's experience suggests that not only do most businesses (not only small ones) fail to use these analytical techniques, but that their bank managers and accountants are also ignorant of them and hence unable to help them to prosper. To the extent that this is true it requires a re-orientation of the training given to bank managers and accountants.

4. This is clearly primarily a matter for the clearing banks and for the accounting profession, and Mr Warnes will be taking his message to them: if there is a role for Government here it may be -

(i) an input into the DoI Small Firms programme (which John MacGregor is considering);

(ii) the Bank of England acting as a catalyst with the clearing banks and accountancy profession (which Mr Warnes is pursuing directly); and

(iii) an input into programmes which encourage the understanding of business in schools.

5. More broadly the implication of Mr Warnes's message is that when Ministers promote enterprise and encourage new businesses they should make it clear that success in business is not easy and requires just as professional an approach as in other walks of life.

6. We are pursuing our discussions with Mr Warnes. I will let you know if there are significant developments.

7. I am sending a copy of this minute to the recipients of your note of 15 November.

G.

file

RM

cc D/Ind
HMT
CPRS

10 DOWNING STREET

THE PRIME MINISTER

29 November 1982

Dear Mr Warnes

I was very interested in what you had to say in your letter of 9 November, and in particular in your conclusion that the chief constraint on small and young companies is not the lack of potential financial support but the lack of business understanding of the people seeking that support.

I have asked John Sparrow, as head of the CPRS, to get in touch with you in order to explore this problem and discuss possible solutions with you. I look forward to hearing the outcome of that meeting.

Yours sincerely

Margaret Thatcher

B.C.J. Warnes, Esq.

10 DOWNING STREET

(2)

Prime Minister

Mr MacGregor (D/I) will join with Mr Sparrow in seeing Mr Warnes.

I have asked Sue Goodchild to include Mr Warnes on a suitable lunch list.

MCS 26/11

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 0002
SWITCHBOARD 01-212 7676

From the
Parliamentary Under Secretary of State

Michael Scholar Esq
10 Downing Street
LONDON SW1

24 November 1982

Dear M. Scholar,

You wrote to Margaret O'Mara on 15 November, enclosing a copy of a letter from Mr B C J Warnes, Managing Director of Midland Bank Venture Capital Ltd. Both Margaret and the CPRS replied on the 18th.

Mr MacGregor has seen the correspondence and is content that Mr Warnes should meet Mr Sparrow. This Department, like the Treasury, would like to join in that meeting, if Mr Sparrow agrees.

Mr MacGregor has asked me to say that he attaches considerable importance to the points made by Mr Warnes, with whom he is in correspondence and whom he will be meeting in the near future.

I am copying this to Mr Spence at CPRS.

Yours sincerely,
Tom Cassidy.

T J CASSIDY
Private Secretary

CABINET OFFICE

Central Policy Review Staff

With the compliments of
John Sparrow

70 Whitehall, London SW1A 2AS
Telephone 01-233 7765

Qa 06148

To: MICHAEL SCHOLAR

From: G B SPENCE

18 November 1982

Midland Bank Venture Capital Limited

1. I enclose a draft reply for the Prime Minister to send in response to the letter of 9 November from Mr B J Warnes of Midland Bank Venture Capital Limited. The draft reply has been cleared by Treasury officials.

2. As mentioned in the reply Mr Sparrow will shortly meet with Mr Warnes and I will keep you and copy recipients in touch with developments.

3. I am sending copies of this minute and attachment to Margaret O'Mara, Treasury, and Jonathan Spencer DOI.

Pl type for PM

DRAFT LETTER FOR THE PRIME MINISTER TO SEND TO MR B J WARNES

I was very interested in what you had to say in your letter of 9 November, and in particular in your conclusion that the chief constraint on small and young companies is not the lack of potential financial support but the lack of business understanding of the people seeking that support.

I have asked John Sparrow, as head of the CPRS, to get in touch with you in order to explore this problem and discuss possible solutions with you. I look forward to hearing the outcome of that meeting.

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

18 November 1982

Michael Scholar, Esq.,
No.10 Downing Street

Dear Michael,

Thank you for your letter of 15 November attaching a copy of a letter to the Prime Minister from Mr. Warnes of Midland Bank Venture Capital Limited.

The official Treasury have agreed with the CPRS that Mr. Sparrow will furnish you with a draft reply offering, as you suggested, a meeting with Mr. Warnes. The Treasury would like to join in that meeting if Mr. Sparrow agrees.

I am sending copies of this letter to Mr. Sparrow and Jonathan Spencer (Department of Industry).

Yours sincerely,

Margaret O'Mara

MISS M. O'MARA

B C J. WARNES

29/11

file KB

10 DOWNING STREET

From the Private Secretary

15 November 1982

I attach a copy of a letter the Prime Minister has received from Mr. B. C. J. Warnes, the Managing Director of Midland Bank Venture Capital Limited. The Prime Minister was much interested by what Mr. Warnes has to say, and has commented that she would like to be kept in touch with his findings. She has also suggested that Mr. Sparrow (to whom I am copying this correspondence) should, on her behalf, get in touch with Mr. Warnes.

I should be grateful if you, in consultation with John Sparrow, would let me have a draft reply for the Prime Minister's signature by Monday 29 November.

I am copying this correspondence to Jonathan Spencer (Department of Industry).

M. C. SCHOLAR

Miss Margaret O'Mara,
H.M. Treasury.

flexo

10 DOWNING STREET

From the Private Secretary

15 November 1982

I am writing on behalf of the Prime Minister to thank you for your letter of 9 November.

The Prime Minister read your letter with great interest. A substantive reply will be sent to you as soon as possible.

M. C. SCHOLAR

B. C. J. Warnes, Esq.

lo

Please add Dr Warry to one of our luncheon lists (2)

Midland Bank Venture Capital Limited

BCJW/JB

Prime Minister

Of some interest.

I am acknowledging on your behalf.

MES 12/11

22 Watling Street
London EC4M 9BR
Telephone 01-638 8861

9th November 1982.

I must reply – I should like to be kept in touch with his findings. I suggest he talks to John Sparrow not.

The Prime Minister,
10 Downing Street,
Whitehall,
London. S.W.1.

Any pps?

Dear Prime Minister

I have written to you twice before in a private capacity.

When I was in the NEB I very much held the view that there was an equity gap and that the City and Banks in general were doing nothing like enough to support small, and particularly young, companies.

The Midland, bless them, gave me a chance to see if this, widely held, view was right. MBVC was set up almost exactly three years ago and now, in terms of number of companies, we appear to be one of the largest operators in the field.

Because we adopted, from the outset, a "hand-on" policy, particularly in the field of vigorous financial control, we are now accumulating a factual month-by-month record of precisely what happens in companies, that is probably unequalled anywhere.

One of the stark conclusions to emerge is that funding, traditional investment attitudes, and so on are not the constraint. In a number of cases we have deliberately flaunted the conventional wisdom and made investments that, by traditional criteria, were "unsound". In nearly every case the companies concerned have failed, despite all our efforts, which tends to suggest the boundary between what can be backed with any hope of success, and what cannot i.e. leading to almost certain failure - which serves nobody's interest - has been correctly drawn.

The problem lies in the "business understanding" of the people seeking backing. It is woefully poor.

That would not matter if there was somewhere they could turn to for help, but we have come to the very reluctant conclusion that there is nowhere. This lack of understanding, with the rare exception (e.g. Racal Electronics) is general throughout the Economy, in the Professions, in the Business Schools (most surprisingly) and in business, of all sizes, themselves - one reason why so many companies have suffered much more than they should in the recession.

This is an astounding conclusion, but I think we can now prove it with hard cold fact. The attached article sets out some of the issues. Putting this right does not require much money, but it does require a great deal of skill and ingenuity.

I would be delighted to talk to one of your advisers about what is needed, given backing in principle for the initiative.

Yours sincerely

Brian Warnes.

B.C.J. Warnes
Managing Director

With many thanks for your real help on previous occasions.

BL

Mid-page Article

Midland Bank Venture Capital Limited

by Brian Warnes, Managing Director

Brian Warnes was educated at Wellington and St Peter's College, Oxford where he read physics.

After a spell in the Foreign Office, working in the S.E. Asia department, he qualified as an accountant with Peat, Marwick and Mitchell in London. In 1964 he became the new business development executive with the Commonwealth Development Corporation, working in London until 1968, and in Nairobi until 1972.

He then worked for Spey Investments until 1976, when he became a deputy divisional director of the NEB. He joined Midland Bank Industrial Finance in 1978, and was appointed Managing Director of MBVC in October 1979.

History

Midland Bank Venture Capital Limited (MBVC) was set up in October 1979 as a wholly owned subsidiary of the Midland Bank. It has a respectable pedigree traceable back to the day in 1969 when the Midland joined forces with Samuel Montagu Limited to set up Midland Montagu Industrial Finance Limited (MMIF), a joint venture, unique for the time — and in many ways still unique — between a major Clearing Bank and a respected City Merchant Bank, the combined benefits, skills and experiences of which flow through into the present day. Subsequently, on MMIF becoming wholly owned, it was renamed Midland Bank Industrial Finance Limited (MBIF) and the funding available enhanced by attracting two pension funds, British Gas Central Pension Funds and the Prudential Assurance Society, to join with the Midland in setting up Moracrest Limited in 1977, which now provides equity funding of up to £2m or beyond.

MBIF and Moracrest operate broadly along traditional investment-banking lines of backing companies with an already-successful business and management track record, although they do occasionally handle the larger start-up.

MBVC on the other hand was set up to cover a much broader spectrum, including companies with little or no track record like Start-Ups and those still in, or just emerging from, their initial, loss-making years. The evident risks of operating at this very vulnerable end of the scale were off-set, at least to some extent, by limiting the size of investment, initially to £50,000, now £100,000 or more; by spreading investment over a relatively large number of companies; and by introducing the more established company along-side the Start-Ups, including traditional, already successful, "growth" companies and Management Buyouts.

Problem not lack of Science, but v. a woefully poor 'business understanding' —

Present Operation

MBVC deliberately moved cautiously and felt its way slowly during its first two or three years. It now has a substantial spread of investments of which just under half were Start-Ups or near Start-Ups, i.e. less than 2½ years old, at time of investment. With its procedures now beginning to bed down well, the rate of investment is accelerating, particularly as MBVC becomes better known both inside the Bank (where it operates throughout the Midland's 2,500 Branches) and externally.

The Funding Problem

As will be known, Banks essentially lend against a company's existing Equity base. If a Proprietor puts £20,000 of his own money into a company by way of ordinary shares, and secures a £20,000 overdraft, then as retained profits further enhance the equity base, lending can be increased — and perhaps by more than pro rata once a successful track record begins to emerge.

The Impact of Losses

However, in young companies *losses*, not *profits*, usually occur in the initial years. Losses *erode* the Equity Base and therefore *reduce* the Borrowing Capacity of the company. MBVC's function is to try and make good this equity deficit. In fact it tries to go further and to actually *enhance* the net equity base, even after allowing for the adverse effect of likely losses, so that the company can also attract a substantially higher level of borrowing, both initially and as it grows.

It is just as well, because most companies find they need substantially more finance than initial appearances suggest to get safely launched and to be able, subsequently, to keep up with growth in turnover, particularly if they have to establish a position in the market place quickly in order to fend off competition.

Funding Need

Not only do fixed assets have to be financed (plant and machinery, building etc.); but also the run-in losses; start-up costs; research and development expenditure; and in particular the stock and debtor requirement associated with growing turnover, which, as a very rough rule of thumb, and allowing for some contribution from creditors, can amount to around 27% of turnover for the typical manufacturing company i.e. £27,000 for every £100,000 of turnover.

A company that reaches break-even at say £¼m turnover will thus have to fund around £70,000 of working capital, plus losses accrued to date (which could amount to £50,000 or more), plus capital expenditure, plus any other needs of the business.

All of which begins to make the Proprietors' original equity stake of £20,000, plus bank overdraft facilities of a similar amount look somewhat inadequate. The danger here is that the company runs out of money at just the wrong moment with further funds then either impossible to raise or only raisable on terms that, effectively, remove control from the proprietor.

MBVC's Funding Role

MBVC attempt to combat these dangers by being able to provide up to several *times* the proprietor's own equity stake, as equity, without taking control. This is done by creating a separate class of equity, usually preference shares, to which reduced voting and capital rights are attached, representing usually between ¼ and ½ of the company. Quite apart from the motivational aspect of structuring an investment in this way, MBVC, being part of a major clearing bank, cannot in any case be seen to get into a position of control. MBIF and Moracrest work similarly.

Time Scale

MBVC has attempted to streamline its procedures to the point where it is possible, in cases of real need, like a management buyout, to complete the investment within not more than two-three weeks. More normally, it takes two to three months.

Method of Application

Application is made either direct to MBVC in London or through any branch of the Midland Bank. The applicant will be handed a Business Presentation Guideline giving details of the information required, in a four to five page proposal. The product and market sides are then checked-out by specialist departments of the Bank, for instance where appropriate the Bank's Electronics Adviser. If satisfactory, the client is asked to draw-up a business plan in standard MBVC, cash flow, form. This may go through several re-drafts, in the light of MBVC's own experience of the behaviour of companies in their early years, before becoming acceptable. The plan also, if the investment goes ahead, forms the blueprint for subsequent monitoring on a month-to-month basis against a fairly tight, 14 day, deadline.

"Educative" Aspect

The purpose of Business Presentation Guideline and the Cash Flow Plan is not so much just to assemble relevant data on the project, but to help guide management on all the aspects that have to be covered, and thought through, in creating a successful business.

So many proposals reflect just the selective strengths of

their creators, product-orientation for instance, without covering other equally essential aspects like marketing or finance or particularly whether the "barrow boy" instinct is present in the strength required (as discussed below). The Business Presentation Guideline ensures all aspects are taken into equal account.

It is almost uncanny how this short Business Presentation betrays whether or not those behind the business have the necessary understanding. If they do not, nobody's interests are served, neither the Investor's, nor the Company's, in putting money behind it, only to see it later collapse. However where a proposal shows a clear absence of particular skills, the proposal is still open for reconsideration if those skills can be made good, e.g. by another shareholder being brought into the company.

Once a company is up and running, similar considerations apply. Many would-be entrepreneurs have admirable technical skills, but simply have not had the opportunity to learn equivalent business skills to the same degree. But until they are actually set up in business, how are they going to learn? MBVC tries to bridge this gap through the simplified monitoring systems it lays down, *for the benefit of management*, in effect using the company as a real-life business case study as events unfold.

The "Barrow Boy"

Here we come onto a very wide-ranging and fascinating subject that goes to the root of success in business. Why can your local barrow boy who sells very run-of-the-mill goods, of low intrinsic value, go to the West Indies on holiday every year, whilst product-strong companies, potentially having magnificent commercial potential, seem so often to get it wrong? The record is littered with casualties over the last decade, from Rolls Royce downwards.

There are three key areas:

1. Product conception.
2. Product commercialisation.
3. Company control.

Product Conception

A product will only sell if it produces an economic benefit — for someone. Thus a yoghurt pot specifically designed to look attractive on the supermarket shelf, will sell, despite its higher cost, if it helps the customer, the food manufacturer, to sell more of his own product; and if, also, the benefit to that customer from higher sales is a good deal more than the extra he has to pay.

Such considerations are often well hidden and are by no means apparent to the outside world. Which is perhaps why they are so often neglected.

This in turn leads to products being developed from the point of view of technical excellence alone, which thus fail because they do not achieve a commercial benefit proportionate to their cost. A classic example is the wind generator. Most of the designs currently being hawked around, trying to attract investment, are beautifully designed and beautifully engineered and work as perfectly as it is possible for any mechanical device to work. But they are not economic. The value of the energy generated is uneconomically small in relation to the capital and operating costs of the device. Usually the better engineered the product, the more this is so! The same is true, to a lesser extent, of solar panels.

All of which leaves the poor old product developer more than a little perplexed and more than a little resentful when he fails to get backing for his ideas. But he fails because his idea lacks the cost/benefit concept. Because he, the investor, lacks it also, the would-be investor has a particularly difficult task in satisfactorily convincing him of just why he has been turned down!

There are cases of course where a product is still apparently viable even though the benefit may not be financial. MBVC supports a company that has developed a new range of titanium microsurgical instruments including a diamond knife illuminated internally, via an optic fibre in the handle to produce greatest intensity just beneath the cutting edge, instead of tending to cast a shadow under the blade, as with normal instruments. If the pun will be pardoned, completely new areas of microsurgery are, as a result, being opened up (e.g. internal operations).

It may be thought that price is of no concern in such cases. But sooner or later the cost of the operations made possible have to be weighed against what private patients or the National Health Service can, or will, afford, given all the other competing calls on their resources, body scanners, sophisticated X-ray equipment and so on. Only so much is possible and that may exclude certain operations on cost grounds alone. The vexed question of the cost of heart transplants is a case in point.

Defence is another area where at first sight cost does not matter, the security of the nation seemingly being all-important. But tell that to the Navy at the present time in the face of Government cuts. There is a strong suspicion that our frigates in the South Atlantic could have been better protected; that the technically excellent hardware *was* available, but costs precluded its use.

Concorde is another example of technical excellence that, at the end of the day, will be abandoned because the economics just are not right. It would never have got off the ground in the first place as an independent business venture.

So unless a product is designed with this underlying cost/benefit relationship clearly in view, however technically excellent it is, it is unlikely to succeed in commercial terms. It requires great skill, certainly more than goes into the idea itself, to design the necessary economic benefit or added value into the product, and the chance of doing so accidentally without having a very sharp awareness of what needs to be striven for is fairly remote. Which is why MBVC, and many other institutions like it, have to turn-down so many of the ideas put to them, ideas which flow so admirably through the pages of Venture Capital Report for instance. One can detect at once whether or not the necessary "cost benefit" instinct is present to the degree required.

Product Commercialisation

Here we come to an even more vital area. It is said the British are very good at inventing things, very poor at turning them into successful businesses. One of the likely reasons has just been discussed but, even so, it is undeniable that even those products that *do* have the necessary cost-benefit in them don't get turned into successful business; whereas in America or Japan or Germany or France they do. Indeed many good British ideas get transferred abroad and taken-up by others for this very reason. It is said the Japanese, for instance, spend 92% of their efforts on commercialisation of existing products and only 8% on inventing new ones. The ratio must be the other way round in the UK. And yet if our product inventiveness is anything to go by, we could and should be even more skilful in the commercialisation field.

As an example of what is meant by commercialisation, the writer was once a director of a large plastic container manufacturer. It produced yoghurt pots and food containers. The product was meeting severe competition in the market-place and despite losses running at £½m p.a. there appeared little scope for raising prices.

The cups were made on four thermoforming lines costing £¾m apiece and capable of producing ½ million cups a day. With raw material costs accounting for over 50% of final product price, efforts were made to see whether savings could be made. Equipment *was* in fact available to scan the sheets with a radio-active source and control the jaws of the extruders to a greater degree of accuracy, but it cost over £100,000 per line and only achieved savings of between 2% and 8% in raw material useage. Clearly not worthwhile, particularly in the current state of the company.

Or was it? Turnover was then about £4m p.a. per line. Raw material cost was therefore around £2m and the annual savings were therefore between £40,000 and £160,000 a year, giving a maximum pay-back of not more than 2½ years, perhaps as little as 7½ months. And the combined effect of installing the equipment on all four lines overnight more than halved the losses.

Various other similar steps were taken, the installation of co-extruders to put a white gloss on the outside of the cup; up-grading the printing machinery to produce clearer, brighter, more multi-coloured markings, re-design of certain pot ranges — all with the intention of making the products look better on the supermarket shelves, so attracting the house-wife to buy X's food products in preference to Y's.

By such means the company, still making the same type of container on essentially the same type of thermoforming equipment, in the mid-70s during a period of acute consumer recession (which paradoxically helped the company, as the food manufacturers positively went for their containers to keep sales up in the face of reduced housewife purchasing), and with oil prices and therefore raw material prices having quadrupled in the last three years (which of course quadrupled the benefit of the radio-active scanning equipment!), an overall loss of £½m was turned into a profit of several million within the space of 2 to 3 years.

This is but one of many similar examples of a much neglected area in British industrial life. We have the technical skills, in abundance, in the universities; in government research departments; in the laboratories of big companies; in the work of private consultants. But it is not being applied; certainly not on the scale needed. Many companies have suffered in the adversities of the 70s as a result. Many opportunities in world markets have also been foregone, the Japanese, the Americans and the Europeans moving in at British industry's expense.

Company Control

The third area, and one particularly dear to MBVC's heart, which its cash flow systems are designed to try and promote, lies in applying the "barrow-boy" concept equally to the actual financial running of a company. The first thing a barrow-boy will know is where his Breakeven Point will lie. Indeed he will know what a Breakeven Point is in the first place!

And he will know what to do if *current* sales and order levels are running at below breakeven.

He won't make the classic mistake of increasing selling costs and reducing prices to achieve more volume, knowing that by so doing he will be increasing the breakeven point by perhaps substantially more than the increase in sales, producing an even wider, loss-making, gap.

Going back to the plastics company. Like any start-up it lost money in its first few years. It was losing £½m when running at only 50% capacity. It was generally thought however that by the time output was up to around 70% capacity it would be in profit. So prices were dropped to try and stimulate the extra volume. With disastrous consequences. As volume rose, so did the losses, a sure sign that breakeven point was rising faster than build-up of sales.

The first move was to measure where the breakeven point in fact lay. It came out to 140% of capacity! Quite apart from the evident absurdity of running at that level, 140% of capacity was, in the conditions of the time, nearly 2½ times

market size.

However seemingly impossible therefore the first move *had* to be to get the breakeven point down to below *existing* sales and order intake levels i.e. around 50% of capacity.

Breakeven Point

Breakeven point of course is the level of sales needed just to cover overheads and is found by dividing fixed costs by gross margin percentage. A company with £10,000 per month overhead will break even at sales of £40,000 if operating a 25% gross margin; £20,000 at 50% gross margin, and so on.

Breakeven can thus be reduced by:

1. Increasing gross margin
2. Reducing overheads.

The good "barrow-boy" will know where to pitch sales prices, sales volumes, and costs to get this equation right for the particular market in which he is operating. The specific nature of the product is unimportant. The price/cost/demand relationship is.

The "Creative" v. Administrative Type

So let's look now, against this background, at the sort of person needed to run a successful company. The classic thesis is that the successful business will consist of two types:

1. The shambolic, creative type, who is always thinking up brilliant new ideas but is a disorganised chaotic in his daily life;
2. The other, a meticulous organiser and disciplinarian, the "man who makes the camels arrive on time";

two very different personalities. If they can genuinely work together, and genuinely understand each other's moods and attitudes and cope with them, a strong formula for success can be forged.

An example to see how this works in practice. The product innovator will never be wholly satisfied with his product, always wanting to improve it. The businessman on the other hand will know when Mark I is ready to take to the market-place. He will ban the product innovator to the Outer Hebrides — so that he can't interfere — while he "commercialises it; gets the production engineering right; enforces the necessary production, quality control, and after-sales procedures; and launches it without further ado, however imperfect it may be in the eyes of the innovator. Furthermore the businessman will use the product, having ensured faultless reliability, to build-up a brand image in the marketplace, through which later products can be channelled, knowing that it is the creation of the image, if it can be achieved, that is more important than the specific qualities of the product itself. All these aspects require painstaking attention to detail and rigorous self-discipline. Not something the creative type will easily acclimatise to.

Conversely the meticulous administrator is probably so disciplined in his outlook that he could never indulge in the sheer flights of fantasy, the sheer excitements of taking the creative risks and gambles, that are the very essence of the birth of the truly original idea. It requires the two attitudes, both, however, operated within that stern framework of cost/benefit already discussed.

An Example

The writer is a director of two small high technology companies run by a very interesting mixture of Academics and Businessmen. It is a wholly unfair standing joke in one company, that, in a crisis, the Academic will write a report — the bigger the crisis the longer the report; with the Businessman however, well knowing the critical time-scales involved (of which more later) it will be a question of: the less the formalities, the quicker the action and the more incisive the results. Conversely, of course, without the product strength provided by the Academics, equally there would be no business. Both work together in a very happy relationship, well knowing their limitations and strengths and taking care not to encroach on each other's territories.

The Academic World

Perhaps because of inherited cultural attitudes, the technical potential, as applicable to business, of a large part of the academic world, particularly in the universities in the UK, lies largely untapped. This potential *needs* tapping, on the product creation side certainly, but even more so on the "commercialisation" side. Fortunately the current vogue for instance for Science Parks is starting to bring the two cultures together, but it is going to take a long time, unless special efforts are made, before full cross-fertilisation occurs and Academics fully acquire the correct feel for the dynamic of business — in contrast to America of course where it is second nature.

For instance the contrast could not be more stark between having a regular job and secure income, perhaps for life, and knowing that if you don't get such and such a contract out of the door by the end of the week, the salaries and wages won't be paid, including of course your own. Knowing for instance, that if such and such an order, which has been promised for months is not received within the next two or three weeks, the company will run out of money from lack of work and drastic action may have to be taken involving loss of jobs and maybe even loss of the company itself. If in politics a week is a long time, it certainly is in business.

Loss of a company of course is not just a matter of loss of jobs, loss of investment; a very personal crisis is involved, career, role, "face", esteem (with colleagues, friends, family), personal possessions, including as often as not, the family house — all go. In business, particularly in small businesses, the time-scales, the urgencies, the anguishes, are of a completely different order.

The Academic who has a good product or process and *does* want quickly to make the transition to achieving success in business, in his own right, has to quickly adapt and acclimatise to the new ethic. Investors like MBVC can play a valuable role here in helping to bring together with various ingredients; in making sure the mix is right at the outset; in making sure the resulting business is used to create full "barrow-boy" understanding.

However just because the time-scales are so critical, a relatively new operation can't afford to make too many mistakes if it is not to go under, so learning on the job is a chancy business. What is needed is some form of preparatory education in at least the basic issues.

The Business Courses

But where does one turn? The ultimate paradox is that any form of course, almost by definition, tends to be run by Academics! That is not to say that the various courses run up and down the country don't play a most valuable role. Indeed they do, but in the context for which they are structured.

The trouble is very few business courses are able to recreate just what it feels like to be in a production bay on a Thursday afternoon with equipment in pieces all around you, knowing it has to be got out of the door by Friday night or the company folds. Similarly, on the marketing side with the order that is awaited and just does not come in, or comes in too late. What is the reason? Is it styling? Is it an inept approach to the market place? Is it lack of flair? . . . events rarely give you time to find out. By then it is too late.

What is needed is some form of short business course that accurately recreates the real feel for the time-scales, exposures, anguishes of the small business scene.

Even a week of skilfully made, case-history, video films, plus skilled teaching in key areas — where to go to get product styling right, how to ensure faultless reliability of the equipment, simplified ways of assessing and monitoring performance — could avoid many of the dramas and pitfalls that happen in practice and help a significantly larger number of companies to survive and grow. And with it, of course materially increase the confidence of investors like MBVC in backing a much wider spectrum of companies.

A final thought. In just the same way that most of the best businesses have underlying them a skilled fusion between the "creative" and "business" element, so it ought to be with business courses. They ought to start with the businessman/barrow boy himself creating an accurate feel for the scene and then getting the academic to use his considerable ingenuity to actually recreate the climate needed — in a classroom, in a phantom company, the equivalent of the electronic barrow, or whatever — so an accurate "feel" for events can readily be picked up and the lessons quickly learnt. We in MBVC, where it is a major problem area do our best to provide at least *some* of the input required, but it needs handling in a much more formal and properly-structured basis.

Conclusion

We in MBVC don't claim to have more than scratched the surface of the potential available in the small business field and certainly some perhaps inevitable mistakes have been made. In one case where a company got the Queen's Award for Industry, the television cameras arrived much at the same time as the liquidator, which caused a somewhat strained dialogue on the shop floor. MBVC now has investments in companies ranging in age from seven months to seventy years; from high technology (X-ray mirrors, ion sources), to industrial racking; and from the very vulnerable start-up to the mature business. The economy has not been kind, with the recession starting the very same month that MBVC was set up, but we like to think, on the analogy of the plastics company mentioned earlier, that by getting the sums right, and kept right, a company can, more or less, be made to survive and prosper whatever the adverisities hurled at it; the same being just as true for MBVC itself as for its underlying investments.

We know of no more interesting and stimulating work in contributing, in however small a way, to the challenges and success of the UK economic scene into the 1980s and beyond.

MBVC
22 Watling St.
London
EC4M 9BR **Tel 01-638-8861 × 1599**

The following is a list of companies in which MBVC have invested in the period up to 30 September 1981, taken from their company accounts. Two of these projects featured in VCR as shown in brackets. All these investments were in the form of cumulative participating preference shares, on which there are no dividends payable until the company is in cumulative profit, so putting as little strain as possible on the company's cash flow in the early, vulnerable years. When dividends do become due, the formula is usually 10% of the capital invested or 10% of pretax profits, whichever is higher. On the capital side, MBVC likes a blocking vote of at

VCR

Head Office: 2 The Mall
Clifton
Bristol BS8 4DR
Tel. Bristol (0272) 737222

London Office
63 Lincoln's Inn Fields,
London W2CA 3JU

Venture Capital Report

Half yearly index of Projects
July – December 1981

July 1981

1. Mid-page Article — **Small Firms Loan Guarantee Scheme**
by Barry Baldwin
A Partner in Price Waterhouse, London

2. Private Hospital — **£2.55 m**
A group of hospital consultants have purchased the land and have outline planning permission for a 39 bed private hospital. Their development team seeks £950,000 of equity capital to match £1.6 m of debt, and offers 100% of preference shares and 49% of voting shares to the investor(s).

3. Insulation Company — **£20,000**
An expanding company in the business of insulating domestic, retail and local authority premises, seeks to raise £20,000 to increase its marketing, and finance expansion. It offers 40% of the equity initially.

4. Mobile Floating Intensive Fish Farm — **£80,000**
An engineer has developed a new floating intensive fish farm that overcomes the drawbacks of existing fish farm systems. He has a working prototype and requires £80,000 to build the first production model. He is offering 51% of the equity.

5. Pop Group — **£20,000**
A pop group that is locally established, and whose first single record has been released in a small quantity and sold out, is seeking £20,000 to produce and promote two further singles and an album. It offers 50% of the initial profits.

6. Telephone Call Measuring and Recording Device — **Licensee**
A professional inventor has devised a low-cost machine for instantly printing out, on the user's premises, details of every telephone call made. A prototype has been approved by the Post Office, and the inventor is looking for a licensee to manufacture and market the product world wide.

7. Polishing Company — **£15,000**
The main polisher with a company making fine furniture seeks up to £15,000 to enable him to set up on his own. He offers 55% of the equity initially.

8. Salt Glazed Pipe Company — **£150,000**
One of four remaining salt glazed pipe manufacturers in the UK seeks £150,000. The Company is offering up to 49% of the equity and a preferentially secured debenture of £100,000.

9. Magnetic Home Printing Set — **£25,000**
An entrepreneur whose first magnetic printing set is now selling in 80 UK stores, seeks £25,000 to develop a larger model for which both he and major store buyers see much greater potential. He offers 20% of the equity.

10. Yacht Chartering Company — **£65,000**
An ex-RN entrepreneur seeks £65,000 in addition to his own £10,000, to purchase an existing Mediterranean yacht chartering business. The yacht will be security, and 60% of the equity is offered.

11. Take-away Food Chain — **£40,000**
An entrepreneur has a fast-food shop, and would like to expand into further managed branches, and eventually franchises. He is seeking £40,000 to establish the second take-away, and is offering 60% of the equity initially.

12. Music Board Game — **Distributor**
The inventor of a new musical board game, one of the three best-sellers last Christmas, seeks someone to take over the distribution of the game.

August 1981

13. Mid-page Article — **CoSIRA**
by Nigel Vinson, Chairman
Chairman of CoSIRA and the Development Commission

14. Data Capture Manufacture — **£175,000**
A company which manufacturers microprocessor based data loggers and other associated electronic devices seeks £175,000 to finance the production and sales of an expanded product range. 49% of the equity is offered or a controlling interest if desired.

15. Import/Export Company — **£20,000**
An entrepreneur, requires £20,000 working capital to match up to £40,000 of his own to be secured with a second mortgage, for his recently formed import/export and property agency company. He anticipates net profits before tax of over £20,000 per annum within three years, and is offering 33% of the equity.

16. Medical Electronics Company — **£40,000**
A company making medical electronic equipment seeks to raise £40,000 to remedy its position of undercapitalisation, to expand and launch two new products. It offers 30% of the equity.

17. Drive-In Restaurant — **£150,000**
An American entrepreneur has detailed plans for a large 1950's style (waitresses on roller-skates) drive-in restaurant in a rapidly expanding new town. He has outline planning consent and a site from the development corporation subject to finance. The total project cost is £400,000. He will provide £50,000, his associates £50,000, the banks £150,000, and he now seeks £150,000 as loan and equity and offers 43% of the equity.

18. Fish Farming — **£115,000**
An existing profitable Fish Farm in Southern England requires £115,000 to expand, it offers 60% of the new company.

19. Mechanical Aerosol Fog Generator — **£15,000**
An established company which produces fog generators for spreading insecticides, pesticides, deodorants, disinfectants etc., wishes to find a purchaser. The asking price is £15,000 for the products.

20. 18 Metre Windmill — **£75,000**
An entrepreneur with extensive helicopter experience has designed and tested a low-cost 18m windmill. £75,000 is now sought to match £100,000 including a £25,000 D.O.I. grant to produce a pre-production model. 50% of the equity is offered.

21. Film Production Company — **£300,000**
A film production company is seeking to raise the capital it requires over three years in order to establish itself principally in the cable, TV and video market. It is currently producing a film in Los Angeles to be filmed in Mexico. It offers up to 51% of the equity for an investment of £300,000 which could be input over three years.

22. Air Cleaning/Freshening Products — **£30,000**
An entrepreneur who has been manufacturing and selling two ranges of products, is retiring due to ill health. He is offering the patents and rights to the products for £30,000.

23. Recent History of Past Projects Portable Buildings — April 1980

September 1981

24. Mid-page Article — **New Ideas—the legal opportunities for protecting them**
by Hugh Brett, Solicitor
Hugh Brett, Editor, European Intellectual Property Review

25. Cassette Manufacture — **£150,000**
A plastics injection-moulding company seeks £150,000 to expand its cassette manufacturing. It offers 75% of the equity initially.

26. Fire Extinguisher Distributor — **Concessionaire**
An overseas company seeks to appoint four concessionaires for the United Kingdom to sell high-quality fire extinguishers. A concessionaire would require a minimum of £20,000.

27. Rechargeable Curling-Tong — **Licensee**
A successful inventor has designed and developed a rechargeable hair curling tong. He seeks a licensee to manufacture and market the product.

28. Electronic Larynx Analysis — **£80,000**
Two entrepreneurs have produced a prototype diagnostic tool for ENT consultants, enabling them to display the waveform of the larynx on a screen. They believe it will quickly become required equipment. They seek £80,000 to produce and market the device, and offer 60% of the equity initially.

29. International Communications Company — **£80,000**
A company providing a transatlantic telephone service for multinational companies, allowing them to make savings in the region of 15-20% on their normal billings, seeks £80,000 to finance expansion. They offer 25% of the equity.

30. Inflatable Catamaran — **£75,000**
An entrepreneur whose prototype inflatable catamaran holds the world speed record in its class seeks £75,000 to launch the craft commercially. 45% of the production company is offered.

31. Motorcycle Stunt Tour — **£20,000**
An entrepreneur who has been performing motorcycle stunt shows for many years for a fee, seeks £20,000 to finance a test tour of 15 shows in 1982, in which he would be the promoter and take the gate money. He offers 45% of the equity.

32. Scaffold-Board Repairing Machine — **£25,000**
A company that has been producing a scaffold-board repairing machine under contract, has developed a new upgraded model of which a number have been sold. It requires £25,000 to finance an increase in working capital, and offers 26% of the equity.

33. Ski-Pole Manufacture — **£300,000**
An inventor seeks a company with spare capacity to manufacture a range of products based on a patented telescopic expanding tube. The first product will be ski-poles, and £300,000 is needed, almost all for working capital. 75% of the equity is offered.

34. Gearbox — **£20,000**
An entrepreneur seeks £20,000 to finance stocks of his improved design of a gearbox for Formula Ford racing cars. 50 of the previous design were sold with success. He offers 40% of the equity.

35. Sound Systems Services — **£30,000**
The economic recession in the South Yorkshire/Humberside region has led to an increased demand for pub and club entertainment. An entrepreneur requires £30,000 to develop his business to provide sound and music equipment, and to service the many needs in the area. Up to 50% of the equity is offered.

36. Security System — **£100,000**
An established and well-respected company in the security system market, has developed a specialised computer-based system claimed to be more effective than any other competing product. It seeks to set up a marketing company to sell the product, which may need up to £100,000 over the next three years. It offers 50% of the marketing company.

37. Rubber-based Surfaces for Livestock — **£25,000**
A landscaping company has developed a new rubber-based underfoot surface for livestock, and seeks £25,000 to develop and market the product. Equity of up to 30% is offered, with the opportunity of active participation.

Company for Sale
38. Machine Tool Manufacture/Metal Working — **£250,000**
Offers are invited by the Receiver/Manager for the assets and business of a general engineering and plate working machine tool manufacturer.

October 1981

39. Mid-page Article — **Prospects for Small Businesses**
by John MacGregor, MP,
Parliamentary Under-Secretary of State for Industry

40. Marine Hardware Manufacturer — **£40,000**
An established company that manufactures non-corrosive marine hardware, is seeking to raise £40,000 to secure its financial base. It offers 40% of the equity initially.

41. Leisure Park Equipment Supplier — **£25,000**
An entrepreneur with experience in the leisure park industry, who has spent nearly two years building up contacts, now needs £25,000 (with an equal overdraft facility for cash flow) to promote and expand more rapidly, supplying equipment such as Landtrains, Go Karts etc. He offers 51% of the equity.

42. Microprocessor Applications Company — **£40,000**
Three young electronic engineers started a hardware-oriented company in March 1981 to apply microprocessors to industrial processes. They have now completed their first two contracts, but have been disappointed in a promise of finance. They seek £40,000 to finance expansion, and would like an active corporate or businessman investor, to whom they offer 75% of the equity initially.

43. Film Distributor — **£21,000**
A recently-formed film distribution company which has the rights to several films, seeks to raise £21,000, and initially offers 40% of the equity.

44. Photo-voltaic Cells — **£50,000**
A small company which has patiently developed a high-efficiency flexible photovoltaic cell primarily for military use, has now won orders on which the gross profit will be £100,000. Because the product is new, it cannot factor the invoices. It now seeks £50,000 to finance the production of these orders, to be repaid when the orders are fulfilled. 30% of the equity is offered initially.

45. Solid Hardwood Furniture — **£60,000**
An entrepreneur who has been making solid hardwood furniture of distinctive modern design for 3 years, now seeks £60,000 to put his business on a sound commercial footing. 60% of the equity is offered initially.

46. Clamp-on Washing Line — **£30,000**
A Dutch entrepreneur, familiar with the brackets welded onto the balconies of high-rise residential buildings in Holland for attaching washing lines, has applied for a patent on a clamp-on washing-line support. He foresees a huge demand and offers 30% of the equity for the £30,000 he needs to launch the product.

47. Medical Product Distributor — **£40,000**
A company that has been distributing a medical product range to hospitals and nursing homes for two years, has now added a further two products, and seeks £40,000 to finance its expansion. It offers 45% of the company initially.

48. Curtain Manufacturer — **£20,000**
A company that makes up made-to-measure curtains, seeks to raise £20,000 to fund its working capital requirement as it expands its services. 40% of the equity is offered initially.

49. VAT Recovery from Abroad — **£20,000**
Through his business in antiques and transport, an entrepreneur became aware that companies were not reclaiming large sums of VAT paid abroad. He has researched the subject, and intends to act as a recovery agent. He seeks £20,000 and offers 60% of the new company.

50. Variable Geometry Aerofoil Sail — **£23,000**
An entrepreneur has patents on an ingenious solid slotted reversible asymmetric aerofoil sail, which is highly efficient. He seeks £23,000, to employ British Aerospace to complete a wind-tunnel analysis of his prototype and to market the principle to the world's marine architects. He offers 25% of the design company, and 75% of the commercial company.

51. Split Vice — **£75,000**
A company that has recently launched a patented split vice for engineers, seeks to raise £75,000 to develop accessories and increase its marketing effort. 40% of the company is offered.

Company for Sale
52. Scaffold Company/Specialist fabricators — **Offers**
Offers are invited by the receiver for the assets and business of a scaffold hire and sales company and specialist engineering fabricator.

November 1981

53. Mid-page Article — **The Cranfield School of Management Course on Entrepreneurship**

by Professor Malcom Harper
Professor of Enterprise Development at Cranfield Business School

54. Pop-up Books **£30,000**

An entrepreneur whose Polish parents were in books, and who has spent all his working life in publishing and bookselling, seeks £30,000 to establish a company in Poland to manufacture elaborate pop-up books, mostly for export to the West. He offers 40% of the equity.

55. Property Training Centre **£15,000**

A property consultant with 20 years experience in property, and who for 10 years ran his own estate agency and property development company, seeks up to £15,000 to start a training centre for estate agents. He is ready to start, with £5,000 of his own, and offers 25% of the equity.

56. Railway Construction Consortium **£54,000**

A consortium which is expected to pre-qualify to tender for major overseas railway construction projects, seeks £54,000 to pay the final costs of tendering. 20% of the equity is offered, to one or more investors.

57. Graphics/Printing **£10,000**

A husband and wife team started a graphics business in 1980. She does artwork and design in rented premises, while he prints in the evening at home. The business is growing slowly, and the bank balance is rising. However, the couple are conscious of a lack of business acumen, and seek an investor who could provide this and also £10,000 to purchase some more machinery. They offer 25% of the equity.

58. Oak Furniture Producer **£5,000**

A recently-formed company producing oak furniture has underbudgeted for its start-up costs, and now seeks £5,000 to finance stocks and promote its products. It offers 40% of the equity.

59. Milkbottle Holder **£20,000**

An entrepreneur who once worked for a short time as a milkman, has patented an auto-locking milkbottle holder. He seeks £20,000 to launch the product commercially, and offers control to an investor initially.

60. Telecommunications Equipment Importer **£20,000**

A company importing telecommunications equipment from the Far East requires £20,000 to finance the orders they are receiving. 25% of the equity is offered.

Business for Sale

61. Hospital Trolley and Aseptic Furniture Manufacturer **Offers**

Offers are invited by the receiver for the assets and business of a hospital trolley and aseptic furniture manufacturer.

62. Recent History of Past Projects Packaging Co — February 1981

December 1981

63. Mid-page Article — **Venture Capital Priorities**

by Sue Palmer
Sue Palmer, Business Development Officer ICFC

64. Medical Engineering **£5.0m**

An American entrepreneur proposes to establish a company to manufacture artificial organs, based on research conducted over the last 12 years at Oxford University. £5.0m is needed over 5 years to launch the company, and of this, £3.3m may be provided by several government bodies. 38% of the equity is offered, for the remaining £1.7m required. A low-cost product by product approach may also be possible.

65. Hairstyle Previewer **£50,000**

An inventor/development engineer has invented and patented a device enabling hairdressers to show customers their own face with a variety of different hairstyles. Orders for 200 machines are being negotiated, arising from enquiries before any marketing effort has been organised. The entrepreneur seeks £50,000 to finance sales and production to serve the market he has created, and is willing to offer 40% of the equity for the capital input of £16,500 plus loan facilities.

66. Mining Comany **£350,000**

A company with tin mining rights in Cornwall seeks £50,000 initially, to carry out further tests on their mine, to establish to a greater degree of certainty, that the existing data is accurate. If the existing information is confirmed, the company will be in a position to raise more capital to carry out a mining operation. 50% of the equity is offered in return for the initial £50,000.

67. Industrial Floor/wall Cleaner **£76,000**

An engineer has developed an industrial floor/wall cleaner which uses high-pressure water and a wet vacuum action. It is light and easy to use, and may reduce cleaning times by up to 50%. £36,000 is sought to develop a production model, and £40,000 to establish an assembly line. Alternatively, a company with spare capacity could manufacture it. 25% of the development company and 95% of the manufacturing company is offered.

68. Continental Holiday Company **£50,000**

A company which sells continental holidays, had a turnover of £400,000 in 1981 and is forecasting a turnover of £1m in 1982, seeks £50,000 or more, and offers 26% of the equity.

69. Recent History of Past Projects Aquatic House — January 1979

1 September 1981

Thank you very much for your letter of 26 August, and for letting us have details of your Index of Entrepreneurial Activity for September. I have shown this to the Prime Minister, and she found it very interesting.

I look forward to seeing how the Index behaves in the coming months.

WR

J.L.A. Cary, Esq.

Econ Pol
Original
returned
to Ashworth

MR PATTISON, No 10

I attach a letter I have had from Lucius Cary giving us the first details of his index of entrepreneurial activity. I have asked him to continue to keep us posted.

As Lucius says, it is difficult to know quite what to make of such a sharp rise - but I think one can take comfort in the fact that it is a rise and not a fall!

R

DR J M ASHWORTH

28 August 1981

John Ashworth

Lucius Cary has written us an identical letter since I agreed with him that he would keep us posted. At my prompting, DoI took out a subscription to the VCR report. I have shown the PM his letter.

[illegible]
28/8

VCR

Venture Capital Report Ltd

Head Office: 2 The Mall
Clifton
Bristol BS8 4DR
Tel. Bristol (0272) 37222

John Ashworth Esq (or his successor)
CPRS
70 Whitehall
London
SW1A 2AS

26 August 1981

Dear John,

I am not certain whether you have already left CPRS, and in case not, I address this to you. In your letter of June 30 you asked me to send you or your successor details of the VRC Index of Entrepreneurial Activity (VCRIEA) for September 1 1981.

Hence this letter about the index which measures the level of funding obtained by projects covered in VCR in the period April 1979 - March 1981, and compares this with the base period.

September VCRIEA = 117.08

This compares with the June VCRIEA of 100, and therefore shows a dramatic rise of 17%, which I would be surprised to see repeated in the future.

It is as difficult to explain this rise as it is to explain rises in any other index such as the FT 30-Share index, but I think that contributing factors are:

1. The importance of being entrepreneurial and funding small business has been constantly stressed by this government, in particular by the Prime Minister herself and by her Chancellor. This emphasis, as well as the specific measures announced in the 1980 and 1981 budgets have helped to create a more positive attitude among investors towards investing risk capital.

2. The recession has driven many businessmen to take decisions which in some cases they have been putting off for years, and to reexamine their business strategies, to get out of old industries and into new ones with a future. For example, one project we published recently has found support from a textile company who had set out to find a new business and who had specified microelectronics or private medicine as being suitable growth areas.

I enclose a copy of a recent article in the Daily Mail, which, as well as giving some useful background information, gives two examples of the liviong businesses which underlie the index above. I hope this is helpful.

Yours sincerely,

Lucius Cary

J.L.A.Cary.

Don't let your good idea fail for lack of money

Daily Mail, Friday, July 31, 1981

Alec Marzano; he designed a mini rubbish skip.

A tip that is a winner

ALEC MARZANO wanted £18,000 to develop a mini-rubbish skip he'd designed which can be towed by an ordinary van or car.

'In the end I didn't get the money from a Venture Capital subscriber, but it wasn't for lack of interest.

Control

'Around 20 people responded to the feature, but most of them wanted to take over the manufacturing and I wanted to retain control.'

Mr Marzano's minitip is now in production thank to financial backing from the National Research Development Corporation.

'We've already sold 15 skips and have had inquiries from the electricity and gas boards as well as the London Zoo who want something to help clear up after the elephants!' says Alec.

FOR ANYONE WHO'S EVER THOUGHT OF SETTING UP THEIR OWN BUSINESS

A magazine that can help

TRIED the banks? Exhausted your own contacts? Looking for a shop window for your ideas?

Try the Bristol-based Venture Capital Report. The magazine cannot provide money for enterprising businessmen, but it can give their projects a wider airing.

'Before an idea is published we ask entrepreneurs to complete a lengthy questionnaire giving details of the project, the size of the potential market, cash flow projections and so on', says director Lucius Cary.

'This deters many people because they discover they haven't really thought through their ideas.'

'Over 1,000 projects landed on our desk last year, but only 100 made it into the report', adds Mr Cary.

Venture Capital Report costs £150 a year to buy and is read by over 450 subscribers.

'The largest block of readers is companies including publicly quoted firms like Shell and ICI,' says Mr Cary.

'But we also have around 100 individual subscribers, and 50 or so investing institutions like the National Enterprise Board, ICFC and the Bank of England.'

● For more details write to Venture Capital Report, 2, The Mall, Clifton, Bristol, BS8 4DR. Telephone Bristol 0272-37222.

John Gardner: he started his own cassette making company.

He finally got it taped

JOHN GARDNER is absolutely delighted with the response he got from a Venture Capital article.

'We started five years ago without a penny and built our first machine using the deposit we were paid on an order,' he says.

'It was clear we'd need some money if we wanted to expand and our accountant suggested the Venture Capital Report.

'The banks were totally useless, but after the VC report we got at least 12 inquiries from interested investors prepared to put up the £80,000 we needed.

'One wrote from Switzerland saying he'd give us the money if we gave his son a job, but in the end we got the money from a private investor who's also filled an important gap by becoming our sales director.'

Machines

Mr Gardner's company, Tape Automation, is the only UK company making machines which produce pre-recorded cassette tapes at high speed. A 60 minute tape takes just 16¼ seconds to make.

He has also developed an automatic video cassette winding machine which he believes is a world beater. 'As far as I'm aware no one else has produced one yet,' says John Gardner.

VCR

Venture Capital Report Ltd

Head Office: 2 The Mall
Clifton
Bristol BS8 4DR
Tel. Bristol (0272) 37222

Prime Minister 2

Mr Cary agreed to send us details of his index free of charge, and, at our prompting, Mr McGregor's office have taken out a subscription to his report.

WR 28/8

MT 1

William Rickett
10 Downing St
Westminster
London

26 August 1981

Dear Mr Rickett,

As promised, I enclose the details of the VRC Index of Entrepreneurial Activity (VCRIEA) for September 1 1981, which measures the level of funding obtained by projects covered in VCR in the period April 1979 - March 1981, and compares this with the base period.

September VCRIEA = 117.08

This compares with the June VCRIEA of 100, and therefore shows a dramatic rise of 17%, which I would be surprised to see repeated in the future.

It is as difficult to explain this rise as it is to explain rises in any other index such as the FT 30-Share index, but I think that contributing factors are:

1. The importance of being entrepreneurial and funding small business has been constantly stressed by this government, in particular by the Prime Minister herself and by her Chancellor. This emphasis, as well as the specific measures announced in the 1980 and 1981 budgets have helped to create a more positive attitude among investors towards investing risk capital.

2. The recession has driven many businessmen to take decisions which in some cases they have been putting off for years, and to reexamine their business strategies, to get out of old industries and into new ones with a future. For example, one project we published recently has found support from a textile company who had set out to find a new business and who had specified microelectronics or private medicine as being suitable growth areas.

I enclose a copy of a recent article in the Daily Mail, which, as well as giving some useful background information, gives two examples of the liviong businesses which underlie the index above. I hope this is helpful.

Yours sincerely,

Lucius Cary

J.L.A.Cary.

Directors: J.L.A.CARY T.W.N.GUINNESS W.H.SMITH
Registered Office: 2 The Mall, Clifton, Bristol BS8 4DR Company Registration No. 1387182 England.

Don't let your good idea fail for lack of money

Alec Marzano: he designed a mini rubbish skip.

A tip that is a winner

ALEC MARZANO wanted £18,000 to develop a mini-rubbish skip he'd designed which can be towed by an ordinary van or car.

'In the end I didn't get the money from a Venture Capital subscriber, but it wasn't for lack of interest.

Control

'Around 30 people responded to the feature, but most of them wanted to take over the manufacturing and I wanted to retain control.'

Mr Marzano's minitip is now in production thank to financial backing from the National Research Development Corporation.

'We've already sold 15 skips and have had inquiries from the electricity and gas boards as well as the London Zoo who want something to help clear up after the elephants!' says Alec.

Daily Mail, Friday, July 31, 1981

FOR ANYONE WHO'S EVER THOUGHT OF SETTING UP THEIR OWN BUSINESS

A magazine that can help

TRIED the banks? Exhausted your own contacts? Looking for a shop window for your ideas?

Try the Bristol-based Venture Capital Report. The magazine cannot provide money for enterprising businessmen, but it can give their projects a wider airing.

'Before an idea is published we ask entrepreneurs to complete a lengthy questionnaire giving details of the project, the size of the potential market, cash flow projections and so on', says director Lucius Cary.

'This deters many people because they discover they haven't really thought through their ideas.'

'Over 1,000 projects landed on our desk last year, but only 100 made it into the report', adds Mr Cary.

Venture Capital Report costs £150 a year to buy and is read by over 450 subscribers.

'The largest block of readers is companies including publicly quoted firms like Shell and ICI,' says Mr Cary.

'But we also have around 100 individual subscribers, and 50 or so investing institutions like the National Enterprise Board, ICFC and the Bank of England.'

● For more details write to Venture Capital Report, 2, The Mall, Clifton, Bristol, BS8 4DR. Telephone Bristol 0272-37222.

John Gardner: he started his own cassette making company.

He finally got it taped

JOHN GARDNER is absolutely delighted with the response he got from a Venture Capital article.

'We started five years ago without a penny and built our first machine using the deposit we were paid on an order,' he says.

'It was clear we'd need some money if we wanted to expand and our accountant suggested the Venture Capital Report.

'The banks were totally useless, but after the VC report we got at least 12 inquiries from interested investors prepared to put up the £60,000 we needed.

'One wrote from Switzerland saying he'd give us the money if we gave his son a job, but in the end we got the money from a private investor who's also filled an important gap by becoming our sales director.'

Machines

Mr Gardner's company, Tape Automation, is the only UK company making machines which produce pre-recorded cassette tapes at high speed. A 60 minute tape takes just 16½ seconds to make.

He has also developed an automatic video cassette winding machine which he believes is a world beater. 'As far as I'm aware no one else has produced one yet,' says John Gardner.

File

Econ Pol

3 August 1981

Many thanks for your letter of 16 July. It is very kind of you to agree to keep us up to date with your Index free of charge.

I have taken up your comment about the usefulness of VCR to Government within Whitehall, and I hope you will be pleased to learn that the Department of Industry are taking out a subscription.

W. F. S. RICKETT

J. L. A. Cary, Esq.

ME

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 0002
SWITCHBOARD 01-212 7676

From the
Parliamentary Under Secretary of State's Office

William Rickett Esq
Private Secretary
10 Downing Street
LONDON SW1

31 July 1981

Dear Willie,

Thank you for your letter of 17 July addressed to Anthony Willis and enclosing correspondence with Mr J L A Cary of Venture Capital Report Ltd.

Mr Cary will be pleased to learn that this Department's library is taking out a subscription for the Venture Capital Report.

Yours sincerely
Jane Gutteridge

JANE GUTTERIDGE
PRIVATE SECRETARY

FILE

(Report encl to D/Ind)

10 DOWNING STREET

From the Private Secretary 17 July, 1981

I enclose some correspondence that I have had with Mr J L A Cary of Venture Capital Report Limited.

You will see from his latest letter that he suggests that many of the projects listed in his report would qualify under the Business Start Up Scheme, and that a Government department ought therefore to take out a subscription for his report. If any department is to take out a subscription, I think it ought to be the Department of Industry. I should, therefore, be grateful for your advice as to whether a Government department should take up Mr Cary's suggestion by the end of the month.

W. F. S. RICKETT

A C S Willis, Esq
Department of Industry

VCR

Venture Capital Report Ltd

Head Office: 2 The Mall
Clifton
Bristol BS8 4DR
Tel. Bristol (0272) 37222

William Rickett Esq
10 Downing St
Westminster
London

16 July 1981

Dear Mr Rickett,

I will certainly send you the index and was never intending to charge for this.

However, we do have quite a struggle to make ends meet, and I have always thought that the Cabinet Office should have a copy of VCR to hand, so that you can test the policy options you are considering against some actual examples. How many of the projects in the July issue for example would qualify under the Business Start-up scheme ? How about a subscription?

Yours sincerely,

Lucius Cary

J.L.A.Cary

VCR

2 The Mall
Clifton
Bristol BS8 4DR
Tel. Bristol (0272) 37222

Venture Capital Report

Half yearly index of Projects
January – June 1981

January 1981

1. Insurance Recovery Agent **£20,000**
An entrepreneur with 12 years experience of insurance recoveries, wishes to raise £20,000 in order to start on his own account, and offers 30% of the equity.

2. School Furniture **£15,000**
A successful entrepreneur has a range of library furniture which is sold to schools and other institutions. He is seeking £15,000 for working capital, and offers 33.3% of the equity.

3. Tile Showroom **£25,000**
Having exclusive rights to sell several leading brands of Italian ceramic tiles in England, an entrepreneur believes that more could be made of the retail side of the market. He therefore wishes to set up a showroom, and offers 50% of the equity in return for £25,000.

4. Vehicle Landing Craft **£20,000**
A well-known firm of vehicle prototype engineers seeks £20,000 to match £10,000 of their own to prototype a low-cost rugged craft, powered by the vehicle itself, for transporting military and disaster relief vehicles. 66.6% of the equity is offered.

5. Mobile Hotel **£23,000**
An entrepreneur wishes to convert a double-decker bus to provide a mobile hotel for six couples, to be hired, for relaxed continental touring holidays, with driver. He seeks £23,000, and offers 60% of the equity.

6. DIY Construction System **£25,000**
An entrepreneur whose patented DIY construction system was launched in 1980, needs £25,000 for working capital to finance increasing orders. He has received verbal offers in excess of £100,000 to sell his company, and now seeks £25,000 for 25%.

7. Computer Shop **£10,000**
A young entrepreneur with retail experience seeks £10,000 to stock a computer shop (Apple dealership) in a near city-centre site on which he has negotiated a lease. 60% of the equity is offered.

8. Radio Controlled Cars **£10,000**
An entrepreneur has designed and developed a range of remote-controlled model cars, for sale to leisure centre operators. He seeks £10,000, and is prepared to offer up to 40% of the equity. One system has been sold.

February 1981

9. GRP Dhows — £80,000
The managing director of a boatbuilding company wishes to establish a plant in Malta to construct Arab dhows in fibreglass, for which he has some enquiries. £80,000 is sought, and 90% of the equity offered.

10. Bar and Restaurant Complex — £70,000
Two entrepreneurs require £70,000 to complete the development of a bar and restaurant complex on which they have been working. They are offering an investor 70% of the equity.

11. Desk-Top Terminal — £70,000
The ex-technical director of an electronics company has developed a desk-top computer terminal which he believes is the smallest practical unit in the world. He has received his first orders, and seeks £70,000 to launch the product. 40% of the equity is offered.

12. Automatic Chain Oiler — £10,000 Advance Royalty
A company director and motorcycling enthusiast has developed an automatic chain oiler which greatly reduces wear and maintenance requirements on motorbike chains. He is seeking assistance from a company or investor who can undertake the marketing of the device, on a royalty basis.

13. Home Coffee Roaster — £40,000
The managing director of a high quality coffee distribution company seeks £40,000 for the commercial launch of a home coffee-roasting machine. He offers 60% of the equity initially.

14. Quality Art Reproduction — £250,000
A company that reproduces paintings which are so realistic that it is possible to hang them in place of the originals, seeks £250,000 for expansion, and offers 50% of the equity.

15. Pneumatic Bin Activator — Up to £100,000
A mechanical engineer has received the first orders for his bin activator, on which he has applied for a patent. He seeks a partner with funds to enable him to grow faster. A majority of the equity would be offered to a suitable investor initially.

16. Growing House — Licensee
An entrepreneur has designed a low cost horticultural enclosure for use as an indoor garden, and which can also be used as an outdoor growing house wishes, to license the manufacturing and/or selling rights.

COMPANIES FOR SALE

17. Packaging Company — £54,000
A senior manager and a team of his colleagues wish to purchase a packaging company from the receiver. The site includes 12 acres of land freehold and a factory of 100,000 sq ft. £50,000 is required as a secured loan and £4,000 for 13% of the equity.

March 1981

18. Cassette Winding Machinery — £60,000
The only UK manufacturer of tape cassette winding and duplicating machines, established four years ago, has developed two new machines to add to its range. It forecasts a sales increase of 500%, and seeks £60,000 of working capital to finance this growth. 45% of the equity is offered initially.

19. Computer Software Package — £25,000
An experienced computer programmer seeks £25,000 to finance the development and launch of a specialist accounting computer package, and offers 60% of the equity initially.

20. Medical Projects and Services Company — £20,000
A company which provides complete medical installations and the personnel to run them seeks £20,000 working capital. It offers 50% of the equity.

21. Venture Capital Fund — £750,000
A former McKinseys consultant is establishing a company which is investing in young companies with high growth potential. He seeks £750,000 for expansion in tranches of not less than £50,000.

22. TV Film — £350,000
A team of suitably qualified people has assembled to make the 'pilot' for a TV series which will be sold initially in the USA. The aim is to establish an independent UK producer of TV films. The group has invested £50,000 already and will invest a further £50,000, and now seeks an additional £350,000. 50% of the profits are offered.

23. Controlled Droplet Sprayer — £40,000
A former technical director of McConnels, agricultural engineers, seeks £40,000 to supplement his own funds to establish a company to assemble and sell controlled droplet sprayers for fruit, particularly vines in Germany. He offers 66.6% of the equity.

COMPANIES FOR SALE

24. Toolmaking Company — £120,000
A West country toolmaking company, which specialises in the manufacture of high-pressure diecast and plastic-moulding tools, is offered for sale.

25. Manufacturer of uPVC Window/door Systems — £47,000
The managing director of a small double glazing company is retiring, and offers his company for sale. He asks £47,000, but will listen to offers.

26. Colour Separation — £45,000
As a result of a restructuring of the holding company, 100% of a company operating a colour separation scanner is for sale for around £45,000. Alternatively, an investor might form a consortium with other interested parties.

April 1981

27. Mid-page Article — The 'Big Four'
by Malcolm Craig

28. Skid-steer Loader Manufacturer — £350,000
Two entrepreneurs have an option to take over the manufacturing and marketing of a range of skid-steer loaders worldwide. They require £350,000 to finance stocks and pay the first instalment of £100,000 on the licence fee, and offer a majority of the company initially.

29. Squash Club — £90,000
A squash coach and referee is seeking £90,000 to develop a squash and leisure complex. 50% of the equity is offered.

30. Bedpan Washer — £80,000
An entrepreneur who worked for the two largest UK manufacturers of bedpan washing machines, has an improved design and seeks £80,000 to launch a company to assemble and sell this machine. 60% of the equity is offered.

31. Space-saving Furniture — £50,000
An entrepreneur has designed and built the first in a range of space-saving furniture. He seeks £50,000 to launch the product, and offers 60% of the equity initially.

32. Solar Bag — £6,000
An entrepreneur wishes to manufacture and sell a solar bag, which allows people to sunbathe on British beaches even on cold summer days. He seeks £6,000 and offers 40% of the equity.

33. Miniature Steam Railway — £225,000
A steam enthusiast accountant wishes to construct a miniature steam railway on the Isle of Wight as a tourist attraction. He needs an extra £225,000 in addition to £125,000 already under negotiation. Tranches of £25,000 each are offered for 9% of the equity.

34. Continental Holidays — £30,000
A rapidly expanding coach operator seeks £30,000 to finance the increase in its operations, and offers 26% of the equity.

May 1981

35. Mid-page Article — The Finance Bill Business Start-up Scheme
by Arthur Young McClelland Moores & Co

36. Homebuyers' Protection Plan — £50,000
A company has recently launched a homebuyers' protection plan, a package that insures the purchaser of a pre-owned house against defects in the electrical, plumbing and central heating systems for the first year. The company seeks £50,000 to launch the scheme in the Midlands, and offers 26% of the equity.

37. Pumps and Fountains — £30,000
An entrepreneur with experience in the construction industry, who has an exclusive distributorship for a German pump and fountain company, wishes to expand from dealing in custom-built fountains, to the private garden market. He needs £30,000 to buy stock, and will appoint dealers. He offers 30% of the equity.

38. Handtool Marketing and Distribution Company — £50,000
A rapidly expanding company that distributes and markets several ranges of handtools to garages in South Lancashire and Merseyside, seeks £50,000 to finance its expansion. It requires £16,000 initially, and £34,000 over two years, and offers 26% of the equity.

39. Offline Tool Pre-setting Apparatus — £20,000
A company that designs and markets a range of very accurate measuring devices based on microelectronics, requires £20,000 to expand, and to finance the launch of a revolutionary new 3D measuring machine. 26% of the equity is offered.

40. Microcomputer Dealerships £60,000

A company is entering the retail microcomputer market in the London area, and seeks £60,000 to pay for the initial stock and launching expenses. It is offering 30% of the equity initially.

41. Hotel Lodge Complex £50,000

A partnership which has successfully run a hotel for eight years is seeking to raise £50,000 in addition to their own £100,000, to build a lodge complex in the hotel grounds. They are offering 50% of the equity.

42. Design and Building Services £50,000

A company that carries out interior design and building work seeks to raise £50,000 to finance its operations and expansion, and is offering 26% of the equity.

43. Nightclub £80,000

A successful concert promoter who started from scratch in 1978, and hopes to achieve a turnover of £200,000 this year wishes to purchase the lease of a night club. The asking price is £85,000; several major breweries have expressed interest in making loans. The entrepreneur seeks £80,000 for purchase, in return for 80% of the equity initially, to be reduced when the brewery contribution is received.

44. Bottled Mineral Water Licensee

Two entrepreneurs have a naturally effervescent mineral water spring in Lincolnshire, and rather than market and distribute it themselves, would prefer to licence a company with an existing distribution network. The licensee would require £50,000 for capital expenditure.

45. Slope Rider £70,000

An entrepreneur has designed and developed a new leisure sports product for use on grass-covered hillsides. He is offering the manufacturing and marketing rights in exchange for a royalty on sales.

46. Recent History of Past Projects Ski Equipment Distribution — August 1980

Optical Measuring Transducer — May 1980

June 1981

47. Mid-page Article **Venture Capital and the Stock Exchange**

by Rowe Rudd & Co Limited

48. Information Handling System £100,000

A company which has supplied computer information handling systems for news agencies and multinational companies since 1970, has developed more modern systems and sold the first of these. It seeks £100,000 to finance an anticipated expansion in sales, and offers 30% of the equity.

49. Medical Centre £90,000

A doctor has plans for a private medical centre, capable of providing complete clinical examinations. He is seeking £90,000, and offers 80% of the equity.

50. Hinge Licensee

A new do-it-yourself hinge system for the fitting of doors to shelving systems has been invented and developed by an entrepreneur who wishes to licence the manufacture and marketing. It has a patent applied for.

51. Radiator Quick Release Bracket £10,000

An entrepreneur, who has prototyped a radiator bracket which allows the householder to decorate behind the radiator without unplumbing, seeks £10,000 in order to develop its commercial potential. He seeks a small royalty, and offers 51% of the equity.

52. Cargo Handling Equipment £30,000

An entrepreneur seeks £30,000 to finish development of an improved cargo handling system for airports and docks, for which he already has one order. 33% of the equity of his company is offered.

53. Housing Estate £80,000

An experienced builder, who has completed negotiations with a local authority to build a housing estate, has been let down by his original backer, and seeks £80,000 to be secured on the land, in addition to the £40,000 he already has. He is offering 51% of the equity.

54. Restaurant and Cafeteria Complex £500,000

A property developer has design plans for a restaurant complex to be erected in an affluent South coast resort. The cost of the development will be £500,000, and the opportunity is now for sale.

55. Serviced Offices £75,000

A company which supplies serviced offices is seeking £75,000 to increase its profitability and expand. It is offering 49% of the equity.

10 DOWNING STREET

From the Private Secretary

13 July 1981

You wrote to John Ashworth on 26 June about your "Index of Entrepreneurial Activity". John Ashworth passed me your letter, and I showed it to the Prime Minister, since we both felt it would interest her. I hope you do not mind our taking this liberty.

The Prime Minister was indeed interested. She has asked if you could possibly keep her up-to-date with movements in your Index. Given the constraints on public expenditure, would you be prepared to give us this information for love rather than money?

J.L.A. Cary, Esq.

510

Sph Azh

BF 7/7 (when Ashworth returns to London)

CF

Gen Pol

TO: MR RICKETT

30 June 1981

FROM: DR ASHWORTH

Prime Minister

Interesting. Would you like me to ask Mr Cary to keep us in touch with movements in his index given that John Ashworth will be leaving us soon?

WR 3/7

Entrepreneurial Activity

It is difficult to measure 'entrepreneurial activity' although it is, of course, central to Government policy that it be stimulated. One of the ways I have tried to find out what is happening is to commission occasional reports from my friend Lucius Cary who started what amounts to a computer based referral system designed to bring together those with money and those with ideas. I attach the latest letter I have had from him. You will see that he believes there to have been an increase in entrepreneurial activity, although not yet enough to make VCR profitable.

The Prime Minister has met Mr Cary (he was one of those invited to the January reception for inventors and entrepreneurs) and she might be interested to learn of his views.

We may have to substitute for the Index

MT

VCR

Venture Capital Report Ltd
Head Office: 2 The Mall
Clifton
Bristol BS8 4DR
Tel. Bristol (0272) 37222

Dr J.M.Ashworth
The Cabinet Office
Central Policy Review Staff
70 Whitehall
London
SW1A 2AS

26 June 1981

Dear John,

I enclose an index of projects that we have covered in the last six months for your interest: I am glad to say that more than ever are now being funded, and there is a quite noticeable increase in activity - due in large measure to government policy.

In order to measure this quantitatively, we will be publishing an 'Index of Entrepreneurial Activity', normalised to 100 on June 1st 1981. This will simply measure the % of projects published in VCR that are funded from all sources. Though imperfect it will at least be objective. The first meaningful index will be published on September 1st, and I expect it to show a small increase reflecting the fruits of government policy.

Expressed mathematically, the index is calculated as follows:

$$\text{IEA} = \sum_{M-6}^{M-30} \frac{\text{No of projects funded}}{\text{No. projects published}} \times \frac{182 \times 100}{42}$$

Please let me know if you would like to be kept in touch.

Sadly, we are unable to make ends meet at VCR, since we still only have 450 subecribers, so we will have to begin charging entrepreneurs something, probably £100 and a small commission, possibly starting in September. I very much regret having to do this, since I fear it will lessen our effectiveness, but I see no alternative.

Yours sincerely,

Lucius

J.L.A.Cary

PV

(2)

Mr Langhorne ?
Prime Minister
Econ Pol
Ag
Perhaps

PRIME MINISTER

MT

US VISIT

I should have reported sooner on my return two weeks ago from the United States. I visited New York, Boston, Cleveland, Chicago and San Francisco and was enabled to meet or call on large numbers of American businessmen, all with or contemplating industrial activity here.

2 Much of my time was spent with venture capitalists who bring together finance, marketing and entrepreneurial skills, especially, but not only, in high technology and especially, but not only, in the neighbourhood of good quality universities.

3 Entrepreneurship in America is, as you know, plentiful since a significant proportion of graduates and of managers want to set up businesses on their own. Here the proportions are probably very much less - for cultural reasons and because there appears to be a greater aversion to risk in this country on top of those discouragements (tax and over-regulation) which we have been reducing. As a result, the birth rate of new manufacturing businesses in America is probably very much higher than the birth rate of equivalent businesses here. The death rate is high too - but American entrepreneurs tend to pick themselves up and start again.

4 Nevertheless, venture capitalism has begun here. Several successful US venture capitalists are starting up here - for business as well as pro-British reasons - and there are British venture capitalists too. I shall continue to seek ways to facilitate the growth of venture capitalism here.

5 I am copying this minute to Peter Carrington.

KJ

K J

23 June 1981

Department of Industry

Ile AH

10 DOWNING STREET

From the Principal Private Secretary

22 June 1981

Dear Thompson,

US VENTURE CAPITAL

Thank you for your letter with which you sent a copy of the statement which the National Venture Capital Association presented to the House of Representatives in April.

I have shown the statement to the Prime Minister and she was very interested to read it.

Yours sincerely,

Clive Whitmore.

J K L Thompson Esq.

AH

4.

Copy to Mr Walters.

Prime Minister

JMJ 17 vi

BRITISH EMBASSY
3100 Massachusetts Avenue, N.W.
WASHINGTON, D.C. 20008
Telephone: (202) 462-1340

Mr C A Whitmore
Principal Private Secretary to the Prime Minister
10 Downing Street

Dear Mr Whitmore

US VENTURE CAPITAL

You will remember that when the Prime Minister visited Genex Corporation in Rockville, she was very interested in Dr. Glick's views on how venture capital fares in the US as compared with the UK.

I recently visited the National Venture Capital Association in Washington and picked up the enclosed statement presented by the NVCA to the US House of Representatives.

The Prime Minister may be interested in the reference to the effects of reductions in capital gains tax and alterations in the rules for incentive stock options.

Yours sincerely

John Thompson

J K L Thompson
Counsellor, Science and Technology.

8th June 1981

x-3

NATIONAL VENTURE CAPITAL ASSOCIATION
1225 19th Street, N.W., Suite 750
Washington, D.C. 20036
(202) 659-5756

STATEMENT OF

MORTON COLLINS

General Partner
DSV ASSOCIATES

and

Executive Vice President
NATIONAL VENTURE CAPITAL ASSOCIATION

before the

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS

Thursday, April 2, 1981

<u>SUMMARY OF TESTIMONY</u>

MORTON COLLINS
NATIONAL VENTURE CAPITAL ASSOCIATION

1. Achievement of President Reagan's goals for the economy requires that investment be stimulated and that consumptive spending be moderated.

2. Reduction of capital gains tax rates in 1978 has dramatically stimulated venture capital formation and investment in small business. Data presented covering 1979 and 1980 indicate nearly a ten-fold increase in activity. Preliminary estimates indicate a substantial revenue gain by the Treasury for 1979 and 1980 as a result of increased capital turnover activity.

3. Further reduction of capital gains tax rates or elimination of taxation of capital gains is recommended. DRI econometric model simulations indicate dramatically positive benefits for the economy from such action.

4. The creation of incentive stock options such as those described in the Packwood-Bentsen bill (S.639) is recommended. Such options will assist small business in attracting qualified management personnel needed for growth.

STATEMENT OF
MORTON COLLINS
GENERAL PARTNER, DSV ASSOCIATES
PRESIDENT ELECT OF THE NATIONAL VENTURE CAPITAL ASSOCIATION
BEFORE THE
COMMITTEE ON WAYS AND MEANS
April 2, 1981

Mr. Chairman and Members of this Distinguished Committee:

My name is Morton Collins and I am a General Partner of DSV Associates, which is a $25 million Limited Partnership formed in 1974 for the purpose of venture capital investing. Prior to the formation of DSV Associates, I was Chief Executive Officer of Data Science Ventures, Incorporated, a privately held corporation formed in 1968 for the purpose of venture capital investing. Since 1975, I have been a Director of the National Venture Capital Association, a trade association representing most of the organized venture capital firms in the country. I am currently Executive Vice President of the NVCA and will become its President later this month.

Prior to initiating my career in venture capital, I was the founder and Chief Executive Officer of a computer services company and before that I was a faculty member in the School of Engineering at Princeton University.

I am pleased to have been invited to testify here today and I thank the Committee for this opportunity to further explore solutions to the economic problems of the country. Today, I speak on behalf of my own organization, DSV Associates, which when combined with its predecessor has made a total of 51 investments in young high technology companies since 1968. Our sole objective is to provide equity funding and sophisticated management and technical assistance primarily to new, high risk, growth oriented companies. In addition, I speak on behalf of the National Venture Capital Association. The NVCA's membership consists of over 100 firms throughout the country which in the aggregate have approximately $4.5 billion invested in small businesses. That $4.5 billion is especially critical as it constitutes the seed capital for the technology industry of this country.

My organization is representative of the venture capital industry as a whole in what it does. While the principal focus tends to be on high technology, often more mundane areas of business are financed by the venture industry. An example of such a company is Federal Express. Federal Express, financed by the venture capital industry has beat the United Parcel Service and the U.S. Postal Service at their own game by providing a service the marketplace needed.

I am appearing here today to urge you to include in the tax reduction package two specific tax law changes:

- Elimination or further reduction of capital gains taxes; and
- Authorization of an Incentive Stock Option Plan.

We are fully supportive of President Reagan's goals including:

- Gradually reducing growth of the federal money supply;
- Reducing growth of federal expenditures in relation to Gross National Product;
- Enactment of tax incentives to encourage investment, and;
- Adoption of proposals to induce greater savings by individuals.

Achievement of these goals requires stimulation of demand for investments and moderation of consumptive spending. We question whether the tax package pending before Congress will sufficiently stimulate saving and investment and it is for this reason that we believe capital gains tax reductions and stock option provisions should be included in the tax package.

I. <u>Elimination or Reduction of Capital Gains Taxes</u>

The most compelling reason to further reduce or eliminate capital gains taxes is the need for equity capital by small business. The combination of run away inflation and record high interest rates has worked inexorably to weaken small companies. The need for new equity is immediate if these companies are to survive and grow. The current "weakness" of small companies can best be expressed through their debt to equity ratios. For the period 1961-1970, debt to equity ratios of small firms averaged 0.93 : 1; for the 1971-1975 period, the ratio increased to 2.12 : 1; and such ratios are now estimated by many to average as much as 4 : 1 and higher. This kind of balance sheet condition is often fatal particularly during periods of economic downturn.

Small businesses, when provided with adequate risk capital, can achieve remarkable things which include:

- The creation of jobs - Secretary Regan says that 85% of all net new jobs are created by small business;
- Increased research and development expenditures vital to innovation and productivity;
- Stimulation of exports important for balance of trade and stability of the dollar, and;
- Increased competition and economic diversity assuring a dynamic economy which is desired by the Congress and by the people.

Detailed survey analysis presented to this Committee by Dr. Zschau three years ago indicates that within five years, each $1.00 invested in small company equity produces each year:

- $0.70 in exports;
- $0.33 in R&D expenditures;
- $0.30 in taxes paid to the Federal Government;
- $0.05 in taxes paid to State and Local Governments.

This adds up to a total of $1.38 in benefits for all for each equity dollar invested, each and every year. On a present value basis, $0.30 a year forever is worth $3.28. Thus, when government decides to tax an equity dollar at $0.70, $0.50 or $0.20, it is deciding to accept these proceeds now instead of something worth $3.28 now. This does not even take into account the additional benefits in the area of exports, R&D spending, job creation and State and local taxes.

The 1978 Capital Gains Tax Reduction has had dramatic effects. There has been a massive capital infusion into venture capital firms who in turn have invested this capital into small businesses. In addition, more seasoned concerns have been able to raise capital in the public market which has been stimulated by the reduction. The data are as follows:

- Venture Capital firms raised:

8 years - 1970-1977	$466 million
3 years - 1978-1980	$1.789 billion

- Venture Capital firms invested:

8 years - 1970-1977	$2.935 billion
3 years - 1978-1980	$2.550 billion

- Companies with less than $5 million net worth raised:

8 years - 1970-1977	$2.202 billion
3 years - 1978-1980	$1.092 billion ($820 million in 1980 alone)

Stated another way:

- Venture Capital firms raised annually an average of:

  1970-1977 - $58.25 million
  1978-1980 - $596 million, an average annual increase of 923% over previous 8 years.

- Venture Capital investments averaged annually:

  1970-1977 - $369 million
  1978-1980 - $850 million, an average annual increase of 132% over previous 8 years.

  (Estimated Fundings and Disbursements table attached.)

In addition to the benefits for the small companies, the government has made money as well. In 1978, the Joint Tax Committee estimated that the capital gains tax reduction would cause a revenue loss to the Treasury of $2.6 billion for 1979. Treasury now estimates that there was a

$1.1 billion revenue gain in 1979 (14% more than collected in 1977 and 1978) and a $900 million gain in 1980.

Recent testimony to the House Budget Committee by Sam I. Nakagama, Chief Economist of Kidder, Peabody and Company suggested the elimination of taxes on capital investments made subsequent to March of 1981. This proposal would have the potential to immediately "unlock" the estimated $350 billion in outstanding capital investments which could generate revenue to the Treasury of approximately $42 billion at currently effective tax rates. Future benefits of such a scenerio as determined by the DRI econometric model include:

- GNP would grow at a faster rate to $4.8 trillion by 1985 compared to reaching $4.4 trillion in 1985 under current policy;

- Business Fixed Investment (in constant 1972 dollars) would grow to $197 billion in 1985 compared to $177 billion under current policy;

- By 1985, 1.6 million more jobs would be created than forecast under current policy, yielding an unemployment rate then of 6.5% compared to 7.7%.

- The federal budget deficit would be reduced in the first year by $21.5 billion, and by 1985 we would have an $89.3 billion surplus compared to a surplus of $16 billion under current policy.

(Zero capital gains model tables attached.)

II. Incentive Stock Options

The Incentive Stock Option is important in enabling small companies to attract key management personnel. Most often such personnel are critically needed when the companies are in very early stages of development and are extremely cash poor. Small companies just cannot compete with the salaries and other benefits offered by large companies.

Incentive Stock Options reward employees in direct correlation to their performance. This has the benefit of specifically motivating improvement in productivity and efficiency.

"Non-qualified" options, granted under the current law, while better than nothing, are largely useless for inducing innovation and risk taking. The employee is forced to pay tax at ordinary rates on a "phantom" profit at the time of exercise of his option. He must provide the capital in "real" dollars to pay such taxes. While it is possible to construct plans by which company loans and grants are made available to enable the employee to pay taxes, they do not work in companies that have not yet reached profitability or are cash poor. In addition, such plans are in general too complex to be communicated effectively to employees. Thus, the plan is poorly understood and much of the potential for increasing productivity is lost. This problem can be cured by a bill similar to the Jones-Frenzel bill of last year (not introduced yet in the 97th Congress) or the Packwood-Bentsen Bill S.639 introduced recently.

The Incentive Stock Option proposal is another plan which benefits both business and government. Treasury revenues are increased because corporations lose the current front-end deductions achieved with the non-qualified option law. Various groups have analyzed the effect of the Incentive Stock Option proposal on Treasury revenue. The results of these estimates show gains in the second to third year, with the magnitude of the increase reaching $30-$60 million annually by 1985.

In conclusion, I urge you to include in the tax bill provisions to reduce or eliminate capital gains taxes and provisions for an Incentive Stock Option Plan. These proposals benefit both business and government. The DRI econometric model projects dramatic effects on the economy by eliminating capital gains taxes entirely. The NVCA certainly supports this idea. It is clear from the results of the past two years that any reduction in capital gains taxes would have a beneficial impact and a revenue gain for the Treasury. The Incentive Stock Option Plan also provides a revenue gain although it is more modest. Each of these proposals specifically targets the supply side and dampens the demand side with everyone winning--small business, the employees of small business, the investing public and the Federal government.

I thank you for your attention and would welcome your questions.

jj

VENTURE CAPITAL INDUSTRY

ESTIMATED FUNDINGS AND DISBURSEMENTS
(Millions of Dollars)

Year	New Private Capital Committed to Venture Capital Firms	Estimated Disbursements to Portfolio Companies	Public Underwritings of Companies with a Net Worth of $5 Million of Less: Number	Amount
1980 (Est)	$900	$1,000	(135)	$ 820
1979	319	1,000	(46)	183
1978	570	550	(21)	89
1977	39	400	(13)	43
1976	50	300	(29)	145
1975	10	250	(4)	16
1974	57	350	(9)	16
1973	56	450	(69)	160
1972	62	425	(409)	896
1971	95	410	(248)	551
1970	97	350	(198)	375
1969	171	450	(698)	1367

Total Capital Committed to the Organized Venture Capital Industry
Estimate at December 31, 1980

Independent Private Venture Capital Firms	$1.8 billion
Small Business Investment Companies	1.4 billion
Corporate Subsidiaries (Financial and Non-Financial)	1.3 billion
Total	$4.5 billion

This pool remained static from 1969 through 1977 at some $2.5-to-$3.0 billion (with new fundings more or less equal to withdrawals).

SOURCE: VENTURE CAPITAL JOURNAL

ECONOMETRIC ANALYSIS using DRI model
Prepared by Sam I. Nakagama, Kidder-Peabody and Co., Inc.
February 26, 1981

Zero Capital-Gains Tax Proposal
With Non-Accommodating Monetary Policy

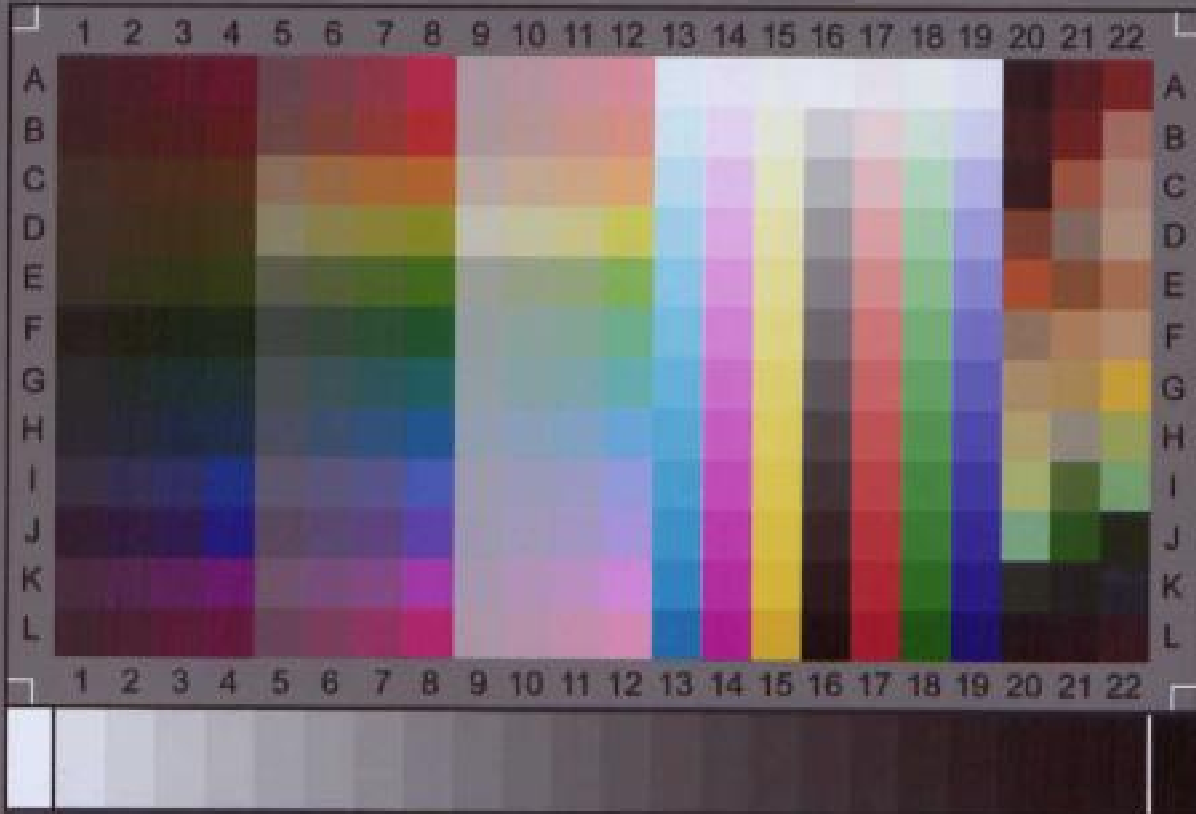
	Baseline Projections Assuming No Tax Changes					Projections Assuming Zero Capital-Gains Proposal*				
	1981	1982	1983	1984	1985	1981	1982	1983	1984	1985
Gross National Product	2,910.2	3,252.1	3,611.8	3,906.1	4,418.3	2,959.3	3,374.0	3,810.0	4,273.3	4,810.2
% change	10.7	11.7	11.1	10.4	10.8	12.6	14.0	12.9	12.2	12.6
GNP in '72 Dollars	1,485.4	1,515.5	1,547.3	1,586.6	1,632.7	1,511.1	1,560.0	1,602.2	1,649.8	1,703.4
% change	0.2	2.0	2.1	2.5	2.9	2.0	3.2	2.7	3.0	3.2
GNP Deflator (1972 = 1.00)	1.959	2.145	2.334	2.512	2.706	1.950	2.162	2.378	2.589	2.823
% change	10.4	9.5	8.8	7.6	7.7	10.4	10.4	9.9	8.9	9.0
Business Fixed Investment, '72 Dollars	153.0	158.3	163.3	169.2	176.7	156.5	169.2	179.6	188.2	197.0
% change	−3.0	3.5	3.2	3.6	4.4	−0.8	8.1	6.2	4.8	4.7
Personal Consumption Expenditures, '72 Dollars	944.0	952.2	963.1	985.3	1,004.5	966.9	985.1	1,005.8	1,033.9	1,060.5
% change	1.1	0.9	1.1	2.3	2.0	3.5	1.9	2.1	2.8	2.6
Total Employment, in millions	98.1	100.4	102.0	103.3	104.8	98.4	101.5	103.4	104.8	106.4
% change	0.8	2.3	1.6	1.3	1.5	1.2	3.1	1.9	1.4	1.5
Unemployment Rate	7.8	7.5	7.7	7.9	7.7	7.5	6.6	6.6	6.7	6.5
M2	1,779.1	1,897.3	2,032.9	2,172.4	2,310.1	1,776.0	1,914.0	2,056.5	2,173.2	2,275.6
% change	6.9	6.6	7.2	6.9	6.3	6.7	7.8	7.4	5.7	4.7
Nonborrowed Reserves	40.05	41.68	43.94	47.14	48.71	40.05	41.68	43.94	47.14	48.71
% change	−2.9	4.1	5.4	7.3	3.3	−2.9	4.1	5.4	7.3	3.3
Three-Month Treasury Bill Rate	13.19	13.75	12.28	9.54	9.43	13.15	13.33	12.51	10.74	11.02
Twenty-Year Government Bond Rate	12.29	12.06	11.71	10.74	10.65	12.27	12.35	12.39	11.81	11.91
S&P Stock Price Index (1941-43 = 10)	131.16	127.45	134.47	147.82	161.54	147.59	152.94	161.36	177.30	193.85
% change	10.4	−2.8	5.5	9.9	9.3	24.3	3.6	5.5	9.9	9.3
Federal Budget Position, NIA Basis	−54.5	−35.1	−20.0	−12.2	16.0	−33.0	7.7	37.4	48.3	89.3
Personal Taxes	299.1	339.0	381.8	426.6	475.6	308.4	352.2	390.4	451.5	514.2
% change	15.9	13.3	12.6	11.7	11.5	19.5	14.2	13.1	13.3	13.9

* Assumes capital gains tax reduced to zero on new investments without accommodating monetary policy.

Table 1
Zero Capital-Gains Tax Proposal With Accommodating Monetary Policy

	Baseline Projections Assuming No Tax Changes					Projections Assuming Zero Capital-Gains Proposal*				
	1981	1982	1983	1984	1985	1981	1982	1983	1984	1985
Gross National Product	2,910.2	3,252.1	3,611.8	3,986.1	4,418.3	2,960.1	3,370.7	3,806.3	4,295.1	4,893.5
% change	10.7	11.7	11.1	10.4	10.8	12.6	13.9	12.9	12.8	13.9
GNP in '72 Dollars	1,485.4	1,515.5	1,547.3	1,586.6	1,632.7	1,511.4	1,558.7	1,601.9	1,656.7	1,719.8
% change	0.2	2.0	2.1	2.5	2.9	2.0	3.1	2.8	3.4	3.8
GNP Deflator (1972 = 1.00)	1.959	2.145	2.334	2.512	2.706	1.958	2.162	2.376	2.592	2.845
% change	10.4	9.5	8.8	7.6	7.7	10.4	10.4	9.9	9.1	9.8
Business Fixed Investment, '72 Dollars	153.0	158.3	163.3	169.2	176.7	156.6	169.0	179.4	189.2	200.4
% change	−3.0	3.5	3.2	3.6	4.4	−0.7	8.0	6.1	5.5	5.9
Personal Consumption Expenditures, '72 Dollars	944.0	952.2	963.1	985.3	1,004.5	967.0	984.4	1,005.8	1,037.6	1,069.4
% change	1.1	0.9	1.1	2.3	2.0	3.5	1.8	2.2	3.2	3.1
Total Employment, in millions	98.1	100.4	102.0	103.3	104.8	98.5	101.5	103.4	104.9	106.7
% change	0.8	2.3	1.6	1.3	1.5	1.2	3.0	1.9	1.5	1.7
Unemployment Rate	7.8	7.5	7.7	7.9	7.7	7.5	6.6	6.6	6.6	6.2
M2	1,779.1	1,897.3	2,032.9	2,172.4	2,310.1	1,774.8	1,906.7	2,063.1	2,229.4	2,396.1
% change	6.9	6.6	7.2	6.9	6.3	6.6	7.4	8.2	8.1	7.5
Nonborrowed Reserves	40.05	41.68	43.94	47.14	48.71	39.99	41.51	44.46	48.53	50.80
% change	−2.9	4.1	5.4	7.3	3.3	−3.0	3.8	7.1	9.2	4.7
Three-Month Treasury Bill Rate	13.19	13.75	12.28	9.54	9.43	13.19	13.62	12.01	9.08	8.69
Twenty-Year Government Bond Rate	12.29	12.06	11.71	10.74	10.65	12.27	12.40	12.32	11.56	11.65
S&P Stock Price Index (1941-43 = 10)	131.16	127.45	134.47	147.82	161.54	147.59	152.94	161.36	177.38	193.85
% change	10.4	−2.8	5.5	9.9	9.3	24.3	3.6	5.5	9.9	9.3
Federal Budget Position, NIA Basis	−54.5	−35.1	−20.0	−12.2	16.0	−32.7	6.0	36.1	58.9	122.6
Personal Taxes	299.1	339.0	381.8	426.6	475.6	308.5	352.1	397.8	453.0	522.8
% change	15.9	13.3	12.6	11.7	11.5	19.6	14.1	13.0	13.9	15.4

* Assumes capital gains tax reduced to zero on new investments and accommodating monetary policy.



IT8.7/2-1993
2009.02

Image Access

IT-8 Target

Printed on Kodak Professional Paper

Charge: R090212