VENTURE CAPITAL, NEW INVESTMENT AND THE DEVELOPMENT OF STOCK EXCHANGES IN THE CARIBBEAN

BY

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Venture Capital, New Investment

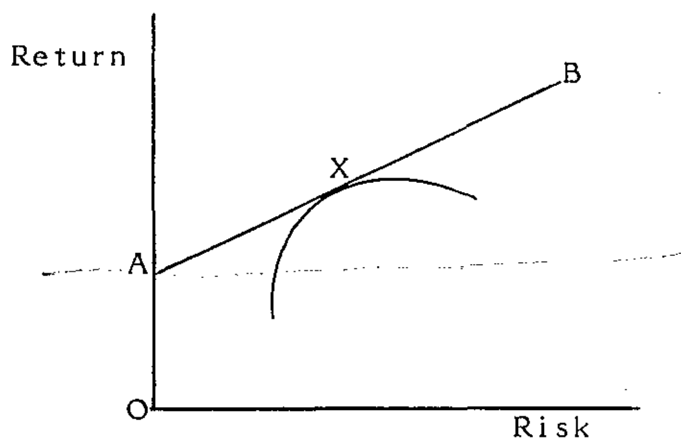
and the Development of Stock Exchanges in the Caribbean

This paper analyses the role which venture capital can play in the economic development of the Caribbean, it seeks to explain the costs which Caribbean countries pay for the absence of such regimes and examines the kind of fiscal and other support necessary for the establishment of venture capital regimes in Caribbean countries.

The decision to invest in a new project or to set up a new company is essentially based on an analysis of perceived profitability. The level of profitability desired is generally a function of the perceived risk of the undertaking. Venture capital is typically the term used to describe such equity or equity featured capital seeking investment in new ideas, new companies, new products or new services that offer the potential of high return on an investment which bears a high risk. Risk capital, as distinct from venture capital is generally defined as capital, either equity or loan, invested in a business enterprise where it is at relatively greater risk than collateralised loans to the same enterprise or at greater risk for the investor than common alternative investment opportunities.[2] All venture capital is therefore risk capital but some capital may be at high risk but may not qualify as venture capital.

Risks involved in a venture are both systematic risk and non-systematic risk. It is not possible for an investor to do anything about his beta or systematic risk though the actions of governments can effect systematic risk in so far as general economic conditions, inflation rates and generalised tax structure are altered. In a situation where the unsystematic risks are high and returns are low such ventures are off the curve of feasible options. See Figure 1. In this figure O A represents the riskless rate. Returns must be considerably higher than O A to attract risky investments. Venture capital projects which fall below this and to the right will be rejected unless higher returns are artificially created.

Figure 1



Governments may take action to alter this risk/return trade off through specific fiscal measures designed to assist specific types of investors thus altering unsystematic risks of the

investor for a limited period of time and altering the returns of investee companies through tax concessions.

Generally speaking most new ventures in sectors such as retail trade and distribution and to a lesser extent services, are not considered high risk operations. Risky operations are those which require investment in substantial equipment, fixed assets, tools, know-how and engineering and must face the uncertainty of product acceptance, marketability, appropriate pricing and where such goods are exported - foreign exchange variability.

In the Caribbean context most venture operations which might be termed venture capital operations in terms of risk, tend to be in the manufacturing and export sectors. This does not imply that projects in other sectors which exhibit some of the characteristics of venture capital should not be or are not so termed.

In terms of return, in the current Caribbean context, many existing operations in manufacturing and export industry are not at the high profitability end of the market, yet the risks are high. This explains why export ventures have tended to be slow in coming on stream. One may conclude that the conditions which give rise to venture capital do not exist in the Caribbean, that is, that risks of these ventures are high but returns are not. In Caribbean countries constrained by the need to earn foreign

exchange for their survival there is a strong case for artificially improving the potential profitability of these ventures in so doing taking some of the risks out of the ventures, so adjusting the risk return/trade off to attract venture capitalists.

In the past, Caribbean governments have paid considerable attention to the need to attract new capital by altering returns of companies in specific activities. This has been approached principally by way of incentives and tax concessions to companies. Where those concessions differ from those of a venture capital regime is that the company must be in operation in order to benefit from these concessions. The potential investor must therefore look to the profitability of the operation in order to recover his investment.

Very little has been done to alter the unsystematic risk of the investor. The rationale behind the establishment of venture capital regimes is to permit the investor or the venture capital company to recover most or all of his investment independently of the profitability of the operation of the company in which he invests, while at the same time permitting him to share in its potential returns for the duration of his investment. Specific divestment rules invariably assume his exiting the operation by way of sale of his interests thereafter, thus transferring ownership to the venturer. An examination of other venture capital regimes suggest that in order for such regimes to be

successful a whole package of tax and other fiscal support must be offered to the investor at the stage of investment as distinct from the stage of operations.

Statistics from the Caribbean show that gross capital formation in many Caribbean countries has been declining. Further private capital inflows have dwindled considerably. In Barbados for example, the past five years show negative capital flows. This compares with positive flows for the most part in the years prior to 1983. Data for Trinidad and Tobago demonstrate the same trend, while Jamaica experienced both net inflows in some years and net outflows in others. (See Table 1).

Venture capital regimes help to pool resources thus assisting in the process of domestic resource mobilisation. In the Caribbean context the highly competitive market for export products suggests the need for increased scale of operations and for more advanced levels of technology in equipment and engineering and therefore call for higher levels of equity participation. Generally, the limited savings of the owner of the company or the sponsor of the idea are insufficient to provide this level of equity base to finance large or even medium sized projects on the desired scale. The establishment of venture capital regimes provide a basis for the establishment of larger and better technologically equipped companies and thus more competitive operations.

A random sample of the gearing ratios of applicants for credit at one financial institution in Barbados for example, disclosed that gearing ratios tend to average 2.75:1. The samples selected further suggested that medium sized borrowers in the portfolio were particularly thinly capitalised. Large companies, here defined as those with market value of equity in excess of $3.0 million, had gearing ratios averaging 0.5:1. (See Table 3.) In the case of both Trinidad and Barbados new investment by existing companies tended to be invested through internally generated funds.[2] (The Trinidad survey was conducted in 1983 while the evidence for Barbados is for 1989 and includes 18 of the largest firms in the island).[3] For Trinidad it was noted that 31% of the companies surveyed used overdraft facilities to finance some proportion of capital investment. As in Barbados, firms in distribution in Trinidad and Tobago tended to have higher debt/equity ratios. It is suggested that the nature of their business lent itself to collateralising of security. Sixteen percent of firms in the sample had total debt/equity ratios in excess of 5:1 and 45% of those firms were in the distributive sector.

Normally high gearing reduces the profitability of companies since additional interest expense on high levels of debt is a charge on profits. (This is less so in regimes where interest rates are low and where dividend tax credits are generous). Adequate equity through the systematic establishment of venture capital regimes in the Caribbean could help to provide the depth

of capital needed for growing companies as under capitalisation of even promising companies can hasten bankruptcy.

Most policy makers agree that fiscal incentives relating to the operation of manufacturing enterprises are not producing the required results; that rapid technological advances have left the Caribbean behind; that stiff competition from other destinations, and a slow down in private foreign capital inflows have combined with regional trade problems to place manufacturing and export sectors under some pressure. However, Caribbean governments struggling to balance their budgets will most likely be highly skeptical of ceding further potential revenues through a scheme of tax concessions designed to increase equity in new venture capital companies. However, the Caribbean must use the surpluses of the private sector to avert the threatened viability of its foreign exchange earning sectors. Data on exports from the Caribbean show a declining trend in exports over the past 5 years for many Caribbean countries (See Table 4). Improved access to risk capital and improved profitability are essential ingredients for a turn-around.

Potential new businessmen have tended to take their chances in the less high risk retailing distribution and service sectors, where there are fewer new skills to be acquired and no new geographical markets to breach. The areas of highest growth tend to be in distribution or in production for the domestic market. In 1989 of the 4 companies which had ROCE* in excess of 20%, 3 were manufacturing principally for the domestic market. Yet paradoxically, these traditional high earning activities cannot

* Return on capital employed

survive indefinitely unless other sectors earn the foreign exchange to finance their activities. Preliminary data indicate that the foreign exchange earning sectors grow faster when the general economic growth is bouyant and collapse faster when general economic performance declines - with some lag. (Table 2 + 6). Further testing of this tentative hypothesis is necessary and its general application to Caribbean countries other than Barbados will need to be further examined but insufficient data did not permit this at this time.) Traditional activities maintain a more even performance. (Tables 6 and 7).

Demand dampening measures put in place to stem the outflow of foreign exchange in almost every Caribbean country tend to have the spin off effect of reducing the profitability of companies at the margin, many of whom are in foreign exchange earning or saving sectors. New business start-ups tend to rise when the economy is buoyant but if a proportionately higher percentage of new businesses are involved in foreign exchange using activities this growth can be short-lived as foreign exchange needs force countries to adopt demand dampening measures. For example the recession of 1981-83 was accompanied by increased bankruptcies in Barbados (see Table 5) while the 1984-88 years of positive growth were accompanied by an increase in start-ups. (This can be short lived if the areas of activities are not chosen well.) One of the most critical factors therefore in an economic turn-around is to effect a change in the structure of the industrial sector - a shift to encourage entrepreneurs to reinvest surpluses in foreign exchange

earning or saving activities. However the risk/return trade offs must be altered to attract surplus earning companies to reinvest in these activities.

Many countries have established venture capital companies to meet the need for equity capital in desired activities. In developed countries many large profitable companies opt to search for viable projects or use their funds for research and development partly because fiscal systems encourage it permitting either write-off of research and development costs or tax credits against tax payable.

In the U.S. venture capital companies have been set up in this way, many being subsidiaries of a high profit-making parent firm. In other countries they have been given official support either through a series of tax allowances or through the direct involvement of Government in the establishment of a firm to hold equity in investee companies. In the U.K. in addition to the several private venture capital companies, a company was set up by the Bank of England and the clearing banks as a vehicle for providing venture capital to small and medium sized businesses. Canada, and Quebec in particular, has paid particular attention to the establishment of a vibrant venture capital regime to encourage new and expanding companies. In Korea, a Korean Technology Advancement Corporation was sponsored by Government and another venture capital company was set up jointly with foreign financial institutons. In Australia, a programme called

Management and Investment Companies (MIC) Programme has become a model for other venture capital regimes. Government had no direct involvement but offered a regime of tax incentives for equity investors in licensed MICs. Other developing countries where such regimes have been established are Singapore, Korea, Brazil, India, Mexico and Kenya.

Traditionally the venture capital industry provides early stage finance, expansion finance and finance for acquisition or managerial buyouts. This latter is most applicable to Caribbean countries offering incentives to industry and faced with their departure when fiscal incentives expire. The second stage is usually major expansion. If further venture capital is not available at this point many businesses are stuck at this stage in their development. While this is by no means an explanation of the demise of our manufacturing sector (the reasons are many and much more complex), some Caribbean manufacturers did suffer for lack of further capital at the critical point when expansion was indicated. The survey conducted by the Central Bank of Trinidad and Tobago in 1983 indicated that 21% of the companies sampled had to either scale down or abandoned projects for lack of financing. (The survey was conducted during the boom years.)

Presently fiscal regimes in the Caribbean tend to give encouragement to investing in public rather than private companies. In Barbados for example, one of the few concessions which encourages investment of new capital is the ability to

claim up to $10,000 invested in new shares as an expense. This applies to investment in public companies only, many of which are in the business of trading. Caribbean countries could usefully extend tax concessions of this kind to include venture capital defined in a manner which suits the financial needs of each Caribbean economy.

Tax incentives to venture capital may take several forms. Among them are tax credits, tax rebates, deductions from tax payable or taxable income of amounts invested in eligible venture capital companies. In Korea and Brazil income received from investee companies is tax free in the hands of the venture capital company and in some countries payments made by the investee company to the venture capital company are still tax deductible expenses (e.g. Brazil). Investors in the venture capital vehicle may be subject to a lower tax rate and in some cases income from the venture capital company may be tax exempt - usually after a certain minimum period of investment. It has been suggested by some writers on venture capital regimes that the existence of capital gains taxes work to discourage reinvestment in high risk ventures by taking away some of the returns which companies earn through growth, so discouraging venture capital regimes. Some Caribbean countries do have in place capital gains taxes which may well be having this effect.

Venture Capital is also often required to permit a company to take the step from private to public. Private companies may

need a bridge of either equity or long term finance often to satisfy listing criteria before going public where they can then access public offerings. Many companies never get to become public companies because they lack an adequate capital base sufficient to qualify them for listing and for opening their doors to public offerings.

Stock Exchanges therefore have a role to play in the development of venture capital regimes. Stock Exchanges traditionally have not filled the venture capital vacuum since their rules require that the company must first of all be public, its asset base must be fairly large and it must be paying annual dividends. Such regimes do not favour growth companies which wish to hold on to retained earnings for reinvestment, as is essential for most venture capital companies. The private company which is young and which is interested in retaining its earnings for future growth rather than paying our dividends is not therefore accommodated.

There is also a role in the Stock Exchange market for the venture capitalist at the time of divestment. An active market for company stocks is often cited as one crucial factor which makes venture capital feasible as it provides a vehicle for investors to off load shares in investee companies when the time for disinvestment comes. Not all venture capital companies can however reach the stage of listing by the time divestment comes and they often need other vehicles to effect transfers of ownership.

Several countries have provided a vehicle to facilitate the needs of small and medium sized businesses in the exchange of shares. Many North American and European countries and some developing countries, among them Nigeria, have created special exchanges for shares of small companies. The listing requirements of such exchanges are lower e.g. - only a minimum percentage of shares need be held by the public, reporting of shareholders is less frequent and there need be no profitability record or a lower profitability record. (See Table 8). Mutual funds and special investment trusts have been in some cases authorised to invest in stocks if companies trade in these over-the-counter markets or special exchanges. The development of a special arm to the Stock Exchanges of the region or the development of an over the counter market seem indicated for Caribbean countries.

This paper is not meant to imply that venture capital companies do not exist in the Caribbean. They do. The Caribbean Financial Services Corporation is such an enterprise. It is an operation servicing the region with funding from USAID, IDB and EIB. It operates only on a limited scale, providing normally only up to 15% of net worth to any one company or up to US$500,000. Nevertheless it provides a critical service. Similarly the Agricultural Venture Trust, an organisation established by USAID, to serve Barbados and the OECS region performs a similar function. The Trust may invest up to 49% of

the equity in a corporation or up to 49% of the total capitalisation other than loans in a project involving a small farmer. These are relatively new institutions (CFSC since 1984 and Caribbean Venture Trust since 1986). While these institutions are venture capital companies they do not have access to the benefits of a venture capital regime, offering tax and other fiscal concessions as is the case in the countries cited nor is the capital funded from surplus earning domestic companies. The capital in almost all cases comes from overseas funding.

It is probably unrealistic to envisage transnational or trans-Caribbean venture capital companies in different Caribbean countries, working jointly on projects which need substantial resources, each regime being supported by a range of tax and other fiscal concessions. However large projects requiring capital, technological know how and perhaps raw materials which reside in different locations may well be candidates for the transnational venture capital company.

The above is not a formula for success of venture capital companies. The experience of venture capital regimes has been that operations need to be supported also by providing technical assistance and advisory services and by facilitating contracts between businessmen and potential overseas marketing and technical partners. The provision of capital is therefore only one part of the entire thrust, but it is a vital part. Peter

Wall in writing on the importance of venture capital regimes came to this conclusion when he wrote "A risk capital industry is a national necessity for any country which puts value on a healthy dynamic private sector."

Marion V. Williams November 1989

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Table 1

CARICOM COUNTRIES

BDS$ Million

Private Capital Flows

	Barbados	Guyana	Jamaica	Trinidad & Tobago
1983	- 13.1	-	-220.4	118.7
1984	- 47.3	3.1	239.6	-116.7
1985	- 34.3	-	110.0	- 84.2
1986	- 81.9	-	-46.8	-135.0
1987	- 12.4	-	435.2	9.1
1988	- 23.9	-	n.a.	41.9

Source: Balance of Payments Statistics - Annual Digest of Statistics, Central Bank of Barbados

Table 2

REAL GROWTH IN SELECTED CARICOM COUNTRIES

%

	Jamaica (1)	Guyana (2)	Barbados (3)	Trinidad & Tobago (4)
1982	1.1	-10.4	-4.9	n.a
1983	2.3	- 9.3	0.5	-1.8
1984	-0.9	2.1	3.6	-7.1
1985	-4.5	1.0	1.1	-3.9
1986	2.2	0.2	5.1	-3.8
1987	4.1	0.6	2.2	-4.8 P
1988	n.a	- 3.0 P	2.8	n.a

P = Provisional
(1) GDP in 1974 prices
(2) Real GDP at factor cost
(3) GDP in constant 1974 prices
(4) GDP at 1985 market prices

Table 3

GEARING OF COMPANIES - BARBADOS

Total Debt/to Equity		
Small and Medium Sized Companies[1]		Selected Large Companies[2]
Tourism	2.36	n.a.
Industry	3.07	.64
Manufacturing	1.89	.41
Small Business	2.00	n.a.
Fishing	4.43	n.a.
	2.75	.55[3]

Source: (1) Sample of companies, clients with Barbados Development Bank
(2) Calculated from data in "Performance '89" published by Arthur Young.
(3) Average for 2 categories only

Table 4

EXPORTS OF CARICOM COUNTRIES

BDS$ Million

	1983	1987	1988
ECCA	430	549	n.a.
JAMAICA	1404	1347	n.a.
TRINIDAD	4045	2793	2925
BARBADOS	510	214.5	284
GUYANA	380	418	429

Table 5

PRIVATE GROSS CAPITAL FORMATION
OF SELECTED CARICOM COUNTRIES

(in current prices)

US$'000

	Barbados	Jamaica	Trinidad & Tobago
1982	192	408	n.a
1983	186	570	1,560
1984	179	425	2,619
1985	164	392	1,911
1986	164	326	3,584
1987	200	n.a	2,811
1988	235	n.a	n.a

Sources: Annual Statistical Digest
Central Bank of Barbados

IMF Reports

Table 6

ANNUAL LIQUIDATIONS BY NO. OF YEARS IN OPERATION

BARBADOS

	0-4 yrs (4 yrs)	5-8 yrs (4 yrs)	9-12 yrs (4 yrs)	13-16 yrs (4 yrs)	Over 16
1982	5	2	4	4	10
1983	6	6	4	6	8
1984	16	7	6	8	7
1985	10	2	1	1	5
Total 1982-85	37	17	15	19	30

Source: Registrar of Companies

Table 7

% CHANGE IN EARNINGS PER SHARE 1984-88 (18 OF THE LARGEST COMPANIES IN BARBADOS)

BDS$

Trading	Manufacturing	Utilities
46	29	44
378	68	40
490	259	n.a
400	56	"
-18	4	"
83	107	"
-43	37	"
	152	"
Av. 1964	Av. 89	Av. 42

Source: Arthur Young "Performance '89"

Table 8

Second Stock Markets Facilitating Turnover of Venture Capital Portfolios 1/

Country	Stock Exchange	Year Opened	1985 Number of Company Listings	Listing Requirements 2/ Minimum Public Offer (% Total Capital)		Minimum Number of Shareholders		Minimum Capital	Years in Operation		Profitability Stipulations	
Australia	All six Exchanges	1984/85	65	-	(14%)	50	(300)	A$100,000 (A$300,000)	-	(-)	-	(-)
France	Second Marchè	1983	120	10%	(25%)	-	(-)	-(F200 mil.)	-	(3)	-	(yes)
U.K.	USM	1980	350	10%	(25%)	-	(-)	-(£200,000)	3	(5)	-	(-)
U.S.A.	NASDAQ	1971	4,136	-	(20%)	300	(2,000)	US$1 million (US$16million)	-	(3)	-	(-)
Nigeria	SSM	1985	1	10%	(25%)	100	(500)	N50,000 (N125,000)	3	(5)	-	(-)
Spain	Barcelona	1984	14	-	-	80	(100)	pta 50million (pta 200million)	-	(-)	-	(-)

1/ This term (and this table) covers only trading systems designed to provide a centralized market place for stocks, with listings requirements set lower than those of the principal stock exchanges' "full listing." Many countries however have "over-the-counter" markets and "Second Sections" with standards less than full listing.

2/ Items in parenthesis indicate standard for full listing. A dash (-) indicates there is no such stipulation. The U.S. comparator is the New York Stock Exchange. Other countries known to have or to be planning Second Stock Markets include Ireland, Malaysia, Singapore, Spain (Madrid), and India.

Reprinted from a paper on Venture Capital Activities in Selected Countries prepared by Peter Wall of the International Finance Corporation.