

**BIS EQUITY FINANCE
PROGRAMMES
QUALITATIVE REVIEWS OF:
A) UKHTF AND B) THE
BRIDGES FUND**

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1 EXECUTIVE SUMMARY

Introduction

Although only a small proportion of companies seek equity finance, including venture capital, (estimated to be 1-2% of small and medium sized enterprises (SMEs)) it is an important source of funding for young, innovative companies with the potential for high growth. Partly as a result of a number of market failures, however, viable SMEs with growth potential have been experiencing problems in raising capital investment in amounts too large for business angels and too small for traditional private equity funds. Commonly referred to as the 'equity gap', this became exacerbated over the last decade or so as investors sought to minimise risk by supporting companies at a later stage in their development.

Given the importance of SMEs to the economy and the links between equity capital, innovation, and economic growth, the Department of Business, Innovation and Skills (BIS) and its predecessors initiated a range of hybrid venture capital schemes to increase the supply of this form of funding. This included the introduction of the Community Development Ventures Fund in 2002 and is commonly known as Bridges Ventures Fund I (Bridges Fund I). Alongside this, there were also concerns, as set out in the 2000 Myners Report¹ that institutions in the UK were not investing sufficiently in the wider Venture Capital asset class. In order to encourage more of this activity, the UK High Technology Fund of Funds (UKHTF), was launched in 2000, In 2010, BIS commissioned ekosgen and Baldhu Consulting to undertake a qualitative assessment of the UKHTF and Bridges Fund I to complement an ongoing econometric study. This report brings together the findings from the evaluation.

The evaluation has assessed the effectiveness of each Fund against its initial objectives and for the extent to which wider economic benefits have accrued. In relation to these the study has examined the extent to which the two Funds increased the supply of equity finance, the impact they had on recipient

¹ HM Treasury (May 2000) *The Myners Review of Institutional Investment*. London: HM-Treasury.

businesses and their impact on fund managers. The evaluation has also examined the factors affecting the financial performance of each Fund and the nature of exit arrangements.

The evaluation combined several research methods, drawing on primary and secondary evidence. Twelve in-depth qualitative interviews were undertaken with fund managers from the two schemes, as well as Capital for Enterprise and the British Venture Capital Association. Twenty six qualitative interviews were undertaken with businesses that had received investment from one of the two Funds. Alongside primary research, key documents and policy literature were reviewed to ascertain the aims and objectives of each Fund and their performance. Wider academic and policy literature was also summarised to set the research findings within the broader market failure context and to determine the factors affecting fund performance.

The temptation to compare the results of the UKHTF with Bridges should be avoided. The funds have different objectives, invested at different times, employ different delivery models and operate in different areas of the market.

Market Failure and Policy Responses

1.1 The UK private equity market trebled in size between 2003 and 2007 when £11.9 billion was invested.² However, this growth did not lead to the wider availability of finance to small firms in the UK. The equity gap increased in size whereby small firms found it difficult to raise sub £2 million investments. Instead, investors preferred to make available higher amounts of funding to companies at later stages of development. Consequently, the amount of investment going into early stage companies declined.³

1.2 The reasons for the equity gap are well documented and they relate to a number of structural problems within the private equity and venture capital markets. Investors have been reluctant to invest in early stage deals because they view the risks associated with them to be higher and the returns to be lower compared with later stage deals. For their part, early stage companies not only lack the experience to present themselves as viable investment opportunities, but they often have an aversion to equity finance as a form of investment. For these and other reasons, the level of institutional investment for the venture capital asset class has been low. Whilst there has been some increase, this was, and remains, too little for the market to operate efficiently. Recent investment data also shows that the 2008 financial crisis and the subsequent recession have compounded the equity gap.

1.3 Policy makers regard the equity gap as resulting from market failure and have sought to promote a variety of initiatives to increase SME access to venture capital funding. They

² BVCA (2009) *Investment Activity Report 2009* (Table 2a). London: BVCA.

³ Pierrakis, Y. and Mason, C., (2008): *Shifting sands: The changing nature of the early stage venture capital market in the UK*. NESTA.

have been influenced by the long-standing, high economic impact that US venture capital backed firms have had on the US economy. Keen to emulate these outcomes, successive UK (and European) Governments implemented various initiatives to promote the supply of venture capital funding. These became particularly prominent in the late 1990s, although there is a longer history of public intervention designed to stimulate the venture capital market dating back to 1945.

1.4 The Labour Government introduced its first set of equity finance schemes in the 1998 *Competitiveness White Paper*, which were designed to stimulate critical mass amongst the venture capital industry. This included the UKHTF, with Bridges Fund I being introduced in 2002 along with a further set of equity schemes. In total, BIS invested £337.9 million⁴ between 2000 to 2008 in various equity finance schemes. Although the Government experimented with various funding models they shared the common objectives of generating additional economic growth by increasing the amount of equity finance available to SMEs and many had the remit of demonstrating to private investors that robust returns could be made from investing in the equity gap. It is worth noting that the objectives of the latest funding mechanism, the Enterprise Capital Fund programme, recognises that the equity gap has structural foundations and that there is a need for long term Government intervention. There is a recognition that the problems of the equity gap will not be solved through demonstrating financial returns alone. Turning to equity finance under the Coalition Government, policy announcements and proposals indicate that this is an area where the Government will continue to intervene.

The Operation of the UKHTF

1.5 The UKHTF was launched to encourage institutional investors to invest in high technology venture capital funds in the UK. The Government's £20 million commitment enabled a further £106 million to be raised. The Fund invested into nine underlying funds.⁵ The Fund of Funds Manager was responsible for selecting the underlying fund managers with the selection strategy based on achieving a diversified portfolio to minimise risk. The Fund of Funds Manager relied on industry knowledge, contacts and networks to select underlying fund managers with due diligence being undertaken to make the final choice.

1.6 Investment decisions made by the UKHTF Fund of Funds Manager were made on a commercial basis with the intention of maximising the financial return. There was variation in the underlying funds regarding the extent to which their investment strategies targeted specific types of companies, with some having a stage or sector bias whilst others were more generalist.

1.7 The Government helped to define the investment parameters, but as reported by the Fund of Funds Manager, did not influence investment decisions.

1.8 Institutional investors investing in the UKHTF were encouraged to do so by the subordination offered on Government funding. However, there is a consensus amongst underlying fund managers that at the time the High Technology Fund was established, the private equity market was saturated with available finance to invest. As the UKHTF was intended to invest in the best possible underlying funds, it is perhaps unsurprising that the

⁴ NAO (2009) *Venture Capital Support to Small Businesses*. Report by the Comptroller and Auditor General.

⁵ In alphabetical order, these were: Accel Europe; Add One; Advent PE Fund III; Amadeus; Merlin Bio. III; Merlin Biosciences; MTI 4 Ltd; Quester Venture; and Scottish Equity II.

underlying funds felt that they would have raised investment without the Fund. As a result, they believe that the Government intervention, at that particular point in time, did not increase the supply of finance because they experienced no difficulties in attracting private investment. Overall, from the evidence, it appears that whilst the UKHTF was successful in attracting new investors as per its initial objective, with so many investors looking to invest in the underlying funds, ultimately, the Fund had little impact on the supply of equity finance. It is important to acknowledge, however, that fund managers emphasise that the need for some form of Government intervention is imperative now as there is a shortage in the supply of equity finance.

1.9 The underlying funds of the UKHTF received a high number of enquires from potential investees with the typical underlying fund receiving around 300 a year. Underlying fund managers considered propositions submitted in various formats and often worked up a business plan with the entrepreneur when the fund was seriously considering making an investment. A two-stage approval process for investment decisions was adopted with the final decision made by an Investment Committee. On average, this took between 3–6 months and cost up to £20,000 on external fees or somewhat more for complex technology investments (this excludes the time given devoted by the in-house team and their costs). These costs are consistent with those reported in a separate study commissioned by BIS regarding the equity gap. That study found that due diligence could take between one to three months (excluding the deal structuring) and costs ranged from £20,000–£50,000 for a straightforward deal up to £70,000–£80,000 for a technically complex business.⁶

1.10 Underlying fund managers from the UKHTF reported that post investment support comprised a further major component of their role, which was regarded as resource intensive. All fund managers reported that post investment support began with strengthening corporate governance and management arrangements as few investee businesses had senior management teams and/or boards in place with the skills and capacity to run a successful business. This was particularly the case for very early stage companies and those that had no previous experience of running a business. Along with changing the composition of management teams, fund managers also appointed at least one non-executive director to the investee's board of directors. Non executive directors were either recruited or comprised senior management team members from the fund itself. Post investment support across all funds has been confined to strategic decisions or at key points of company development. Non executive directors have added value to investee companies by drawing on their experience of managing previous businesses whilst fund managers have added value by making use of their own networks. For example, a number of fund managers had links into and relationships with large companies and sought to utilise these to enable investees to sell to them and/or for future trade sales.

The Operation of Bridges Fund I

1.11 Bridges Fund I was introduced in response to a recommendation made by the Social Investment Task Force in October 2000.⁷ The Task Force reported that many entrepreneurs in disadvantaged communities found it difficult to access finance. Looking to the US, it was felt that widening the scope of venture capital investment can help regenerate deprived areas

⁶SQW (2009) *The Supply of Equity Finance to SMEs: Revisiting the Equity Gap*. London: BIS.

⁷ Social Investment Task Force (2000) *Enterprising Communities: Wealth Beyond Welfare. Report to the Chancellor of the Exchequer*. London: Social Investment Task Force.

and help investors achieve social, as well as financial, commitments. To address this market failure, it identified new mechanisms to encourage private investment, one of which was the creation of a community development venture capital fund. As the first of its kind in the UK, Bridges was established in 2002 with £20 million from the UK Government and £20m raised from the private sector.

1.12 Investment decisions made by Bridges Ventures were driven by three key considerations: (a) meeting the Fund's eligibility criteria; (b) the potential of each opportunity to generate good commercial returns; and (c) their potential to secure wider social and regeneration impacts on local areas. EU state aid restrictions constrained Bridges Fund I to making small investments.

1.13 There is a perception that Bridges Fund I would not have been able to attract institutional investment without Government investment because private investors were highly sceptical about the likely returns that could be achieved through investing in SMEs in deprived areas. They were only persuaded to invest in the Fund following the Government's initial investment of £20 million and because £9.8 million of this was subordinated.

1.14 Bridges Fund I received an average of 360 business plans a year from companies seeking finance and it invested in a total of 28. Primarily, it worked with companies who had submitted some form of business plan, even if this was fairly sketchy. A two-stage approval process for investment decisions was adopted with the final decision made by an Investment Committee. On average, this took between 3–6 months and cost up to £20,000 on external fees (this excludes the time given devoted by the in-house team and their costs). Overall, the Fund Manager devoted significant time and resources to the investment process and this comprised a core component of the investment team's workload.

1.15 The Bridges Ventures Fund Manager reported that post investment support comprised a further major component of the investment team's workload and one that was regarded as resource intensive. Post investment support began with strengthening corporate governance and management arrangements as few investee businesses had senior management teams and/or boards in place with the skills and capacity to run a successful business. Bridges also appointed at least one non-executive director to the investee's board of directors. Non executive directors were either recruited or comprised senior management team members from the Fund itself. Post investment support was confined to strategic decisions or at key points of company development. Non executive directors' added value to investee companies by drawing on their experience of managing previous businesses whilst fund managers have added value by making use of their own networks.

The Role of Capital for Enterprise

1.16 In the first eight years of operation, publicly backed equity finance schemes were supervised by officials in BIS and its predecessors. This changed in April 2008 when the Department established Capital for Enterprise Limited as a wholly-owned company to oversee its venture capital funds programmes and deliver finance measures in support of small businesses. It collects financial information from fund managers about portfolio performance, valuation and investment activity. With regards to the UKHTF, this information is collected from the Fund of Funds Manager. It also monitors the work of fund managers and there has been some learning in the way in which it deals with under performance. New terms have been introduced in fund agreements to "re-balance" the relationship between investors and

fund managers. The new terms are seen as 'subtle' instruments to manage fund manager performance and are reported to be a more effective way of managing performance.

Fund Management Fees

1.17 Fund managers of large commercial funds tend to receive a management fee of around 2 percent of the amount raised plus profit share referred to as 'carried interest'. As the government schemes are smaller, on some occasions, a higher management fee has been awarded. More recently, building on experience from the Regional Venture Capital Funds (and not UKHTF or Bridges Fund I), Capital for Enterprise has changed its preferred management fee arrangements so that they better reflect the actual costs of management, particularly in the funds' post investment periods.

UKHTF Activity and Performance

1.18 The nine underlying funds varied in the total amount they raised ranging from £89 million to £348.6 million. The UKHTF comprised less than 10 percent of the total investment raised by seven underlying funds. Between them, the underlying funds invested in a total of 245 companies, with the number invested by each fund ranging from 10 to 41. The average investment per company was just under £7 million; although this too encompassed a wide spread ranging from a low of £1.9 million to a high of £10.6 million. The vast majority of investments were made in early stage and start-up companies.

1.19 The latest monitoring data for the UKHTF is for performance up to 30th June 2010. At the time the data was compiled, none of the underlying funds had achieved a surplus. Even though each portfolio included at least a couple of highly successful companies, to date, these have not compensated for the losses incurred by other investments. There are a core set of primary factors that have been the most influential on fund performance and these are relevant to virtually all the funds. There are a second set of factors which vary in their level of influence on each fund – for some they have been very significant and for others less so or not at all.

1.20 It has been the combination of the core factors playing out together that explains the under-performance against initial expectations of the underlying funds rather than a single factor on its own. The following narrative emerges for each fund:

- The underlying funds primarily made their investments over the period 2000–2002 when the prices for companies and deals were, in hindsight, unanimously reported to be "very high". This had two knock on effects: (a) investing too much in a company that failed meant the fund was left with a big gap to fill when write offs occurred and (b) the fund managers experienced difficulties in raising additional funds to provide follow on investment to companies.
- The lack of exit opportunities and follow on investment led to one or more of the following scenarios in each fund: (a) it hampered the growth and development of companies; (b) it led them to raise funds from elsewhere and, in the process, diluted the fund manager's investment; (c) as fund managers did not have sufficient funds, they ceased investing in the "weaker" companies to enable them to invest in the stronger ones, which in turn, meant they had a high number of write offs compared to the number of write-offs expected to occur in any type of venture capital fund.

1.21 Drawing on interview findings, it is possible to identify five secondary factors also affected performance. These include: (i) investment decisions which did not perform as well as anticipated with the benefit of hindsight; (ii) size of the fund and lack of finance to make follow on investments in portfolio companies; (iii) the impact of the dotcom crash; (iv) changes in the pharmaceutical industry; and (v) changes in the management teams of some underlying funds.

Bridges Fund I Activity and Performance

1.22 The Government's £20 million contribution was split between Fund A (70%) and Fund B (30%) and this was matched equally by other investors. A total of 29 companies received investment, which averaged around £934,000 each. Just under half the investments were made in early stage and start up companies.

1.23 The two Bridges Funds (A and B) are recording as being in surplus, as at 31st March 2010. Given that Bridges' mandate is to invest in businesses that operate within the most disadvantaged areas of England, this overall performance is highly respectable.

1.24 One of the reasons for the apparent commercial success of Bridges is that as a generalist fund, it was able to spread its risk. Good investment decisions have also contributed to success and there have only been a small number of write-offs; so under-performing businesses have not been a drag on the rest of the Fund. The investment strategy has also contributed to success in the sense that the Fund specifically chose to invest in a number of "consumer champion" type businesses or those offering value for money, a strategy aptly suited to customers living in deprived areas. A major factor contributing to the commercial success of Bridges Fund I is that a large part of its portfolio comprises property-backed businesses, arguably reduced the risk level of that part of the portfolio. However, the downturn in the commercial property market will have had a negative impact on the returns from the fund.

The Business Perspective

1.25 The qualitative interviews conducted with businesses revealed they were made aware of the underlying funds invested in by UKHTF or Bridges by their accountant or advisor. The research findings, however, also indicate an element of serendipity with entrepreneurs meeting venture capitalists at the right time and place. This appears to have been particularly pronounced in the technology market where entrepreneurs and venture capitalists attended sector specific events and then followed up on ideas discussed at events.

1.26 Most of the respondents had sought alternative forms of investment before turning to equity finance. Indeed, one of the key themes that emerged from the interviews with businesses was that venture capital continues to be perceived as finance of last resort.

1.27 Respondents identified post investment support as a key strength of equity finance. A few of the high technology companies reported that this form of finance is more willing to invest in pre-turnover companies, help them take their product to market or help them reach a suitable point to secure further investment to achieve this objective. Respondents identified three weaknesses associated with venture finance: (i) the company receives a small number of investments within one round rather than a single capital investment; (ii) entrepreneurs need to concede some loss of control over their business; (iii) it is an expensive way to access investment.

1.28 Respondents were able to raise subsequent rounds of follow on investment with the initial funding acting as a catalyst in securing future investment. This is because the initial investment grew the business sufficiently to require another round, and also the presence of a large investor gave other investors confidence to invest in further rounds.

1.29 Respondents found the investment process to be fairly straightforward. The decision as to whether or not to accept an investment offer was influenced by the personal relationship with the fund manager. Other factors that encouraged respondents to choose the UKHTF backed fund or Bridges Ventures I offer included the fund manager's knowledge and experience of their sector, reputation and their location.

1.30 With regards to post investment support, respondents reported that the fund had appointed a non executive director to the company board. They reported that the non executive director provided a balanced opinion on business decisions and acted as a sounding board for ideas. Businesses also valued the fund manager's sector and financial knowledge. Overall, the majority of businesses reported the post investment support struck the right balance between 'hands on' and 'hands off' involvement, although it should be acknowledged that the study did not interview businesses that were written off.

The Impact of UKHTF and Bridges Fund I

The Economic Impact of UKHTF and Bridges Fund I

1.31 The interviews with businesses found that most of them had introduced a new product or service as a direct result of the investment they received from the UKHTF and, to some extent, from Bridges Ventures. Additionality was high with respondents stating they would not have been able to innovate without the investment received. New innovations enabled respondents to enter new markets.

1.32 Virtually all the respondents reported that they had increased employment since receiving investment from the UKHTF or Bridges Ventures. In part, this is because the investments were made in early stage ventures and so employment levels began from a low base. Most of the businesses interviewed in this study now employ between 10 and 50 staff representing growth of over 10 percent in total for almost all businesses.

1.33 Increased turnover has been a further way in which businesses have benefited from the investment received, although as with employment, for some, this represented an increase from a low or non existent base. There are several examples of businesses moving from pre-turnover stage to turnover of several million pounds per annum. Where turnover growth has been low, this has often been due to investment in early stage technologies where commercialisation can take a decade or longer. The extent to which turnover outcomes are attributable to the funds varies, from start-up businesses in deprived areas relying on a single Bridges investment (high attribution) through to high growth technology businesses undergoing several syndicated funding rounds (lower attribution).

1.34 There were other ways in which businesses benefited from the investment they received. A number of them reported that the funds increased their profile and/or credibility amongst other investors, which led to follow on investments. Businesses receiving investment from Bridges reported that the Fund enhanced their credibility with potential customers. In addition, most respondents reported that post investment support from fund managers or their representatives had strengthened corporate governance and management techniques.

The Social Impact of Bridges Fund I

1.35 Bridges Ventures compiles a Social IMPACT Scorecard, which is reported to investors alongside financial returns. The scorecard is built upon standard regeneration measures and pre-agreed company-specific metrics provided by the investees. Respondents reported they provide employment to people from deprived communities or backgrounds. In addition, the employment created by the investee generated multiplier benefits through spending in the local economy from the earnings received. A small number of respondents also reported that they use local suppliers, which increases the multiplier effect.

The Impact on Fund Managers

1.36 The UKHTF and Bridges Funds have also impacted on fund managers. Bridges Ventures raised a second fund, but it was only able to do so because of the Government's involvement in the first. In effect, the first Bridges Fund legitimised the concept of social investment because it allowed Bridges Ventures to create a track record of that kind of investment from which the investors in Bridges Ventures' second fund could gain comfort. The UKHTF Fund of Funds Manager also raised a second € 70 million technology fund, although its success in doing so does not appear to be directly attributable to the role of the Government in the same way as Bridges Ventures. The Fund of Funds Manager has been trying to raise a third technology fund but has found it very difficult within the current economic climate.

1.37 As well as being able to raise follow on investment, there are other ways in which the UKHTF has impacted on the Fund of Funds Manager. For example, they identified several ways in which the criteria for managing and selecting underlying funds have now changed.

1.38 The study found evidence that the venture capital industry is maturing. The underlying fund managers identified several ways in which they had changed their portfolio management practices as a result of ongoing experience and rather than a direct result of UKHTF. First, they have developed strategies to reduce the risk of write-offs; second they are more likely to make several investments in a company and to link these to milestones. Third, they are more likely to pull out of an under-performing company faster than they were before. Fourth, fund managers try to ensure their portfolio is better balanced between the number of investments made in very early stage and not so early stage companies. Finally, there has been much debate within the industry regarding the suitability of venture capital as a form of investment for life-science companies particularly those at seed and early stage stages. There is anecdotal evidence that fund managers investing in the life-sciences are no longer considering investing in businesses at the proof of concept stage or even those that have reached phase one or two.

Increasing the Supply of Equity Finance

1.39 There is some evidence that the Bridges Fund I helped increase the supply of equity finance to a market that did not exist before it was established. It made investments available to companies that could not raise other forms of finance. It also acted as a catalyst for the management team to raise another fund, and has contributed to the growth of the community development venture market more widely. The role that the UKHTF played with regards to increasing the supply of equity finance is much more equivocal. There is a consensus that the rationale behind the Fund was right, but the timing was wrong. The Fund was introduced during the dotcom bubble when the supply of equity finance was high – overpriced

investments hindered its performance and ultimately its ability to make a significant contribution to increasing the overall supply of venture capital.

Stimulating the Private Market

1.40 It was intended that the UKHTF and the Bridges Funds would attract new investors by demonstrating that good financial returns can be made from investing in companies experimenting with new technology or located in disadvantaged areas. However, two key factors have hampered the growth and development of the venture capital market and there is a consensus amongst fund managers that market is now in major difficulty. Currently, it is extremely difficult to raise new funds and this is primarily attributed to the lack of commercial returns, which in turn, has undermined investor confidence. The difficulty in raising new funds is having knock-on effects on the industry in several ways. First, there is a shift towards supporting later stage investments. Second, the equity gap has become more pronounced. Third, the industry has experienced a loss of fund managers. Taking all these developments together, fund managers believe that the industry has gone back 10 years. Many fund managers believe the quality of investment opportunities has now increased and that they and investors can benefit from investing in times of recession when asset prices are low.

1.41 Another important effect from Government supported programmes such as Bridges and UKHTF is the development of the wider infrastructure and community. The study has not found any evidence of new investor networks being established as a result of the two Funds – this was not a specific objective of these programmes. However, a common thread running throughout the stakeholder and business interviews is that the industry is built on personal relationships and networking. For example, Fund of Funds Manager's selection of underlying funds will be informed by their previous knowledge of the managers. Fund managers often rely on each other to find out about investment opportunities either for the purposes of co-investment or because the investment opportunity is not suited to their fund but maybe for a different one.

2 INTRODUCTION

2.1 Although only a small proportion of companies seek equity finance, including venture capital, (estimated to be 1-2% of small and medium sized enterprises (SMEs)) it is an important source of funding for young, innovative companies with the potential for high growth. Partly as a result of a number of market failures, however, viable SMEs with growth potential have been experiencing problems in raising capital investment in amounts too large for business angels and too small for traditional private equity funds. Commonly referred to as the 'equity gap', this became exacerbated over the last decade or so as investors sought to minimise risk by supporting companies at a later stage in their development.

2.2 Given the importance of SMEs to the economy and the links between equity capital, innovation, and economic growth, the Department of Business, Innovation and Skills (BIS) and its predecessors initiated a range of hybrid venture capital schemes to increase the supply of this form of funding. This included the introduction of the Community Development Ventures Fund in 2002 and is commonly known as Bridges Ventures Fund I (Bridges Fund I). Alongside this, there were also concerns, as set out in the 2000 Myners Report⁸ that institutions in the UK were not investing sufficiently in the wider Venture Capital asset class. In order to encourage more of this activity, the UK High Technology Fund of Funds (UKHTF), was launched in 2000,

2.3 In 2010, BIS commissioned ekosgen and Baldhu Consulting to undertake a qualitative assessment of the UKHTF and Bridges Fund I to complement an ongoing econometric study. This report brings together the findings from the evaluation.

The Aims of the Evaluation and Research Methods

2.4 The evaluation has been designed to assess the effectiveness of each Fund against its objectives. It has assessed a series of key issues relating to the supply of equity finance, the impact on recipient businesses, improvements in the operation of financial markets and any outcomes experienced by fund managers. The evaluation has examined factors affecting the financial performance of each Fund the nature of any exit arrangements and views about the need for further government intervention.

2.5 The following research methods were used:

- **A Review of Programme Documentation and Monitoring Data** – The study reviewed the key documents and literature relating to each scheme in order to ascertain their aims and objectives, whilst monitoring data and annual reports were assessed to examine fund activity and performance. Wider academic and policy literature was also summarised to set the research findings within the broader market failure context and to determine the factors affecting fund performance.
- **Qualitative Stakeholder Interviews** – The study undertook 12 qualitative interviews with fund managers from the two schemes. This comprised one interview with the Fund of Funds manager from UKHTF and the nine underlying fund managers. Two interviews were undertaken with Bridges, comprising the fund manager and a Board

⁸ HM Treasury (May 2000) *The Myners Review of Institutional Investment*. London: HM-Treasury.

member. In addition, one interview was undertaken with Capital for Enterprise, the agency responsible for monitoring the performance of all government sponsored venture capital schemes. Finally, one interview was undertaken with the British Venture Capital Association (BVCA).

- **In Depth Telephone Business Interviews and Case Studies** – The study undertook 26 teledepth interviews with businesses using a stratified sampling technique. The interviews explored the motivations for accessing funds, their engagement with the fund manager and the benefits associated with this, along with the wider impacts arising from the investment received. The nature and scale of additionality was also explored, and for Bridges recipients, the social impacts were ascertained. The study team undertook follow-up research with five businesses in the form of detailed case studies. The case studies were selected in discussion with BIS.

The Structure of the Report

2.6 This report brings together interim findings from the evaluation. It is structured as follows:

- **Chapter 3** provides an overview of recent trends within the private equity market, illustrating that the decline in venture capital activity has created an equity gap. It then outlines the way in which successive UK Governments have responded to this.
- **Chapters 4 and 5** detail the way in which the UKHTF and Bridges schemes were administered by fund managers. They outline the investment strategy adopted by each, the investment process, the nature of post-investment support provided by the fund manager and the impact of this on the businesses.
- **Chapter 6** identifies the types of businesses supported by each fund along with the financial performance of the two schemes to date. This analysis is based on a combination of financial data and interviews with stakeholders, which provide a qualitative assessment of performance.
- **Chapter 7** presents the experience of businesses that have received investment from UKHTF and Bridges by drawing on the qualitative interviews undertaken as part of this study together with survey findings from a study undertaken by the National Audit Office in 2009.⁹ The chapter explores the motivations for accessing venture capital funding and the additionality associated with this, the investment processes, the nature of post investment support and the way in their business benefited from this.
- **Chapter 8** focuses on the impact of the two funds on the commercial performance of businesses, as well as the extent to which they increased the supply of equity finance and their impact on the operation of financial markets.
- **Chapter 9** presents the study's conclusions and recommendations.

⁹ NAO (2009) *Venture Capital Support to Small Businesses*. London: House of Commons.

Terminology

2.7 Private equity is an important form of finance accessed by around 2 percent of SMEs.¹⁰ It provides medium to long term finance to companies not quoted on the stock exchange in return for an equity stake in the business. Venture capital is a subset of private equity, with venture capital favouring young high growth potential sectors including high technology sectors. As they are early on their development, they have limited collateral and trading income, which means conventional loans are not usually available to them.

2.8 By contrast, private equity funds typically invest in more mature and established companies to support their growth and development and/or eliminate inefficiencies. The finance can be used for various purposes such as expanding working capital, to make acquisitions, to strengthen a company's balance sheet, or to buy out other shareholders (i.e. management buy-outs and buy-ins).

¹⁰ IFF Research (2009) *Finance Survey of SMEs*. London: BIS.

3 MARKET FAILURE AND POLICY RESPONSES

3.1 The UK private equity market is one of the largest in Europe, trebling in size between 2003 and 2007 when £11.9 billion was invested.¹¹ However, this growth has not led to the wider availability of finance to small firms in the UK. In particular, the lack of institutional commitment to create and support venture capital created a hiatus of funding for young, innovative, high-growth companies seeking capital investments in amounts too large for business angels and too small for traditional venture capital funds – a phenomenon widely termed as the ‘equity gap’.

3.2 This chapter sets out the nature of the equity gap, why this is problematic, and the way in which successive UK Governments have responded to this. The final section comprises a brief review of the literature focusing on factors determining fund performance.

The Equity Gap

3.3 The roots of the UK venture capital industry go back to 1945 with the creation of the Industrial and Commercial Financial Corporation (ICFC), which later became known as 3i. However, the industry only really started to take off in the 1970s with the arrival of experienced venture capital managers from the United States drawing on US capital. These early venture capital firms primarily financed buyouts and business expansion activities, partly because opportunities to fund start up companies were scarce.¹²

3.4 Statistics on investment activity collected by the British Venture Capital Association (BVCA) show an increase in the value of investments by 152 percent from £4.7 billion in 2001 to £12 billion in 2007.¹³ Although this increase was experienced at all financing stages, it was most pronounced at the later stages where investments increased by 175 percent for MBOs/MBIs and 132 percent at the expansion stage. The increase in venture capital investments was much lower at 11 percent.

3.5 Further analysis of investment figure shows that the aggregate growth in equity investments did not lead to the wider availability of equity finance for early stage companies or those seeking finance below £2 million. As shown in Table 2.1 the proportional amount of investment going into early stage companies fell by more than half from 8 percent in 2001 to less than 4 percent in 2007. In part, this is because private investors switched to investing in later stage businesses where they perceived the risks to be lower. In particular, there has been an increase in funding for management buy-outs and management buy-ins. Their share of total investment increased from 57 percent in 2001 to more than 75 percent in 2004 and remained above 60 percent up to 2007.¹⁴

3.6 As shown in Figure 2.3, aggregate growth in equity investment has driven up deal sizes for later stage companies. Larger private sector funds do not undertake more

¹¹ BVCA (2009) *Investment Activity Report 2009* (Table 2a). London: BVCA.

¹² Clarysse, B. et al., (2009) *Benchmarking UK Venture capital to the US and Israel: What lessons can be learnt?* Report prepared for the BVCA.

¹³ This increase is not entirely linear as there was a decline a decline in activity in the immediate aftermath of the ‘dot-com’ collapse.

¹⁴ Pierrakis, Y. and Mason, C., (2008): *Shifting sands: The changing nature of the early stage venture capital market in the UK*. NESTA.

investments than smaller funds; rather their investments are larger. Average size deals increased from £3.6 million in 2001 to £9 million in 2007.¹⁵ Since, deal sizes and investment stage are related, this reinforced a shift to later stage deals, contributing to the equity gap.¹⁶ In parallel, detailed analysis of sub-£2 million investments shows that, whilst the number of companies receiving venture capital increased from 2001–2007,¹⁷ average deal sizes decreased. Further, there was an increase in the number of investments of less than £500,000.¹⁸

3.7 In summary, there is some evidence that the size of investments have been skewed towards a large number of relatively small investments and a small number of large investments. Lower deal sizes suggest firms are under-invested, which may mean later stage investments require larger amounts per deal than early stage ones. Further, venture capital firms that receive too little money perform worse than innovative companies that have not accessed this type of finance.¹⁹ However, some caution needs to be undertaken with this analysis as it is largely drawn upon statistics produced by the BVCA. These include investments made by Government initiatives (such as Enterprise Capital Funds) and, therefore, could be a factor in influencing the figures.

3.8 It is also important to acknowledge that, over the last decade, a large proportion of the growth in venture capital investment has been driven by publicly backed investments. In 2002, deals involving publicly backed funds counted for over 20 percent of all deals while their share doubled to over 40 percent by 2009. Public funding is particularly prominent for early stage funding, accounting for 68 percent of all early stage investments in 2008 and 56 percent in 2009. This compares to 20 percent in 2000. The decline in 2009 partly reflects the end of new investments by some government backed funds (e.g. Regional Venture Capital Funds), and also wider economic conditions.²⁰

3.9 Arguably, between 2000 and 2007 the private equity market grew at the expense of the venture capital market. As discussed later, the Labour Governments introduced a variety of measures to increase the supply of finance to SMEs and support the venture capital industry, including the two schemes evaluated by this study. Before examining the reasons as to why the equity gap exists and why policymakers have been keen to address this, it is important to report on the impact of the recession and financial crisis on the equity industry and the implications this raises for the equity gap.

¹⁵ BVCA Various Investment Activity Reports. London: BVCA.

¹⁶ Pierrakis, Y and Mason, C. (2008) *Shifting Sands: the Changing Nature of the Early Stage Venture Capital Market in the UK*. London: NESTA.

¹⁷ The increase has not been entirely linear as the number of companies receiving investment has been somewhat volatile.

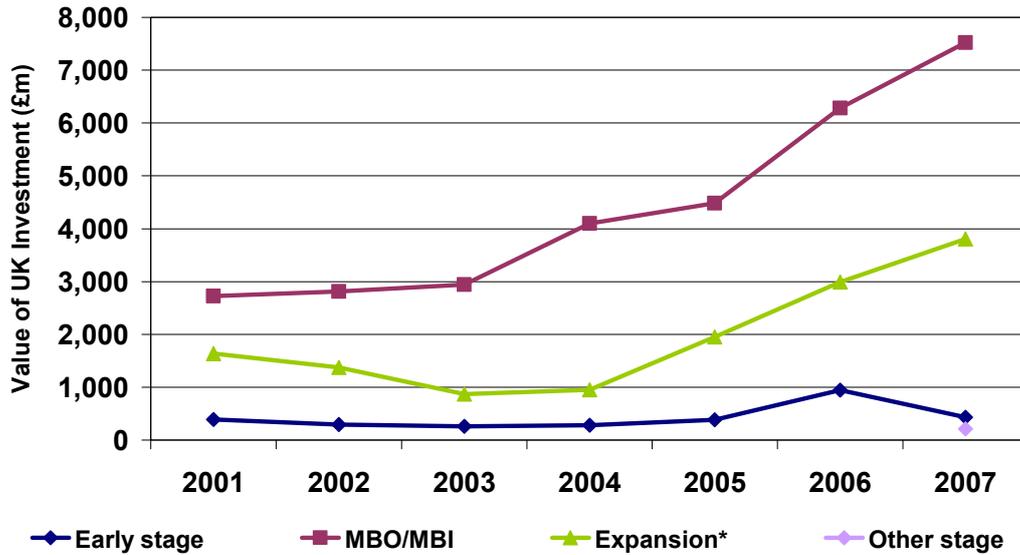
¹⁸ Pierrakis, Y. and Mason, C., (2008): *Shifting sands: The changing nature of the early stage venture capital market in the UK*. NESTA.

¹⁹ c.f. Clarysse, B. et al., (2009) *Benchmarking UK Venture capital to the US and Israel: What lessons can be learnt?* Report prepared for the BVCA.

²⁰ Pierrakis, Y (2010) *Venture Capital Now and After Dotcom Crash*. London: NESTA.

Figure 2.1: Value of UK Investment - Financing Stage

Source: BVCA Private Equity and Venture Capital Report on Investment Activity 2003, 2006, 2009



* From 2006, includes replacement capital

Table 2.1: Percentage of UK Investment by Financing Stage

Stage	2001	2002	2003	2004	2005	2006	2007
Early stage	8.2%	6.6%	6.5%	5.3%	5.6%	9.3%	3.6%
MBO/MBI	57.4%	62.7%	72.3%	76.8%	65.8%	61.5%	62.8%
Expansion*	34.4%	30.7%	21.3%	17.9%	28.6%	29.3%	31.8%
Other stage	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.8%
Total	100.0%						

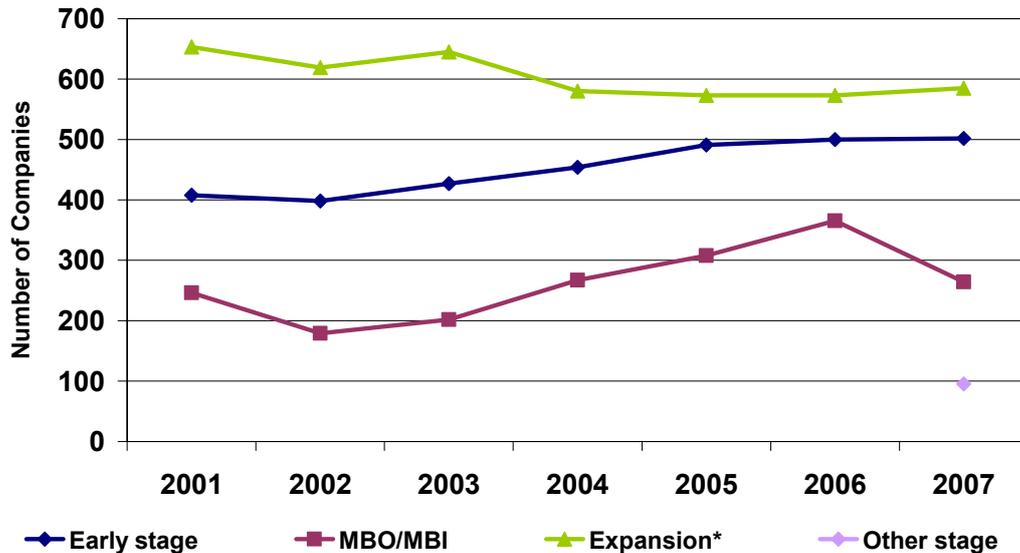
• BVCA Private Equity and Venture Capital Report on Investment Activity 2003; 2006; and 2009.

* From 2006, includes replacement capital

** Total from 2005 represent number of investments due o changes in BVCA counting methods.

Figure 2.2: Companies Receiving Investment - Financing Stage

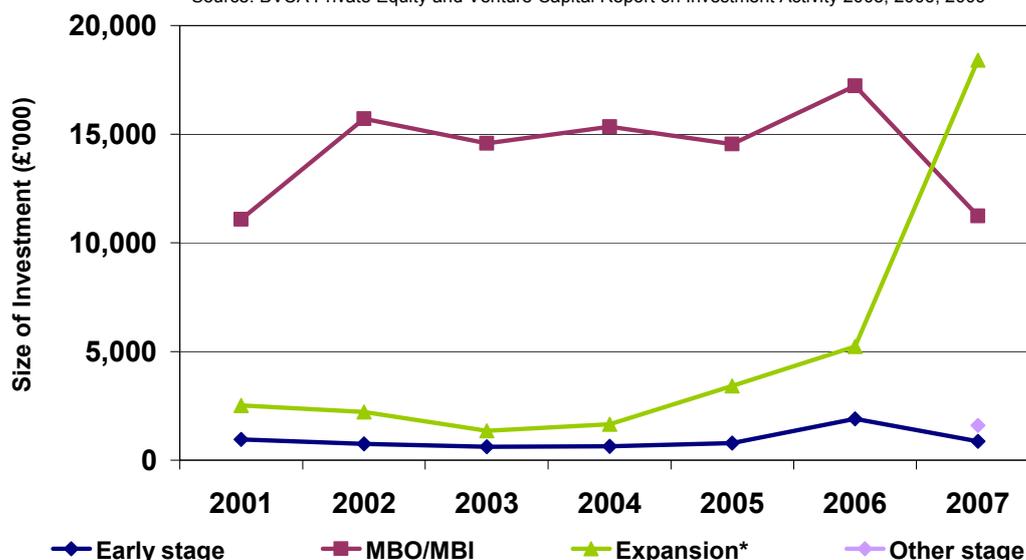
Source: BVCA Private Equity and Venture Capital Report on Investment Activity 2003, 2006, 2009



* From 2006, includes replacement capital

Figure 2.3: Average Size of Investment - Financing Stage

Source: BVCA Private Equity and Venture Capital Report on Investment Activity 2003, 2006, 2009



* From 2006, includes replacement capital

Recent Trends and the Impact of the Financial Crisis

3.10 The recession has had a significant impact on the private equity market with recent data showing that investment levels have fallen below historical norms. The slowdown in activity has affected all areas of the private equity industry, from deal activity to time to exit. Commentators note that investors are managing and enhancing existing portfolios rather than making new investments. The decline in investment activity can be illustrated by the following:

- **Fundraising:** In 2009, this was at its lowest level in the past ten years. There was a reduction in over 50 percent in both the number of funds being established and total investments. Only 11 funds were able to raise capital in 2009 compared with 22 in 2008.²¹
- **Investment levels:** Aggregate investment fell by 75 percent from nearly £12 billion in 2007 to less than £3 billion in 2009. Over this period, venture capital investment experienced a less substantial (but still noticeable) decline of 32 percent from £296 million to £434 million (see Table 2.2).
- **No of companies:** The total number of companies receiving investment fell from 1,330 in 2007 to 834 in 2009 (a decline of 37.3 percent). Of this number, only 388 received venture capital investment (a fall of 22% from 502 in 2007).
- **Deal sizes:** The average amount invested fell by nearly two thirds from £9 million to £3.5 million with average deals sizes for venture capital falling moderately from £865,000 to £765,000.²²
- **Exits:** Whilst the number of exits had been decreasing each year since 2006, this dropped even further following the 2008 recession. Only 74 successful exits were made in 2009 compared to 200 in 2006 (excluding write offs). Similarly, whilst the

²¹ Pierrakis, Y (2010) *Venture Capital Now and After Dotcom Crash*. London: NESTA.

²² BVCA Private Equity and Venture Capital Report on Investment Activity 2009, tables 4 and 6.

time to exit investments has been increasing across the world, the recession increased the time to exit even further, reaching an historic high of 7.4 years in 2009 (from 3 in 1998). This reflects the difficulties facing investors in funding suitable exit options. Without clear exit options and appropriate returns on investments, investors have less capital to commit to new funds and invest in new companies.²³

3.11 Investment figures clearly show that the financial crisis has made it difficult for companies at all stages to raise equity finance and the problems faced by SMEs may well have become more accentuated.

Stage	2007		2008		2009	
Early stage	434	3.6%	359	4.2%	296	10.0%
MBO/MBI	7,520	62.8%	3,133	36.6%	1,067	36.1%
Expansion*	3,806	31.8%	3,178	37.1%	1,328	44.9%
Other stage	212	1.8%	1,886	22.0%	266	9.0%
Total	11,972	100.0%	8,556	100.0%	2,957	100.0%

BVCA Private Equity and Venture Capital Report on Investment Activity 2009

3.12 Even without the financial crisis, recent reports have highlighted persistent structural problems within the private equity and venture capital markets, providing evidence of a continual need for government support to equity finance schemes. A recent report commissioned by BIS²⁴ suggests SMEs are experiencing an equity gap for investment amounts ranging from £250,000 up to £5 million, which is below the minimum investment level that most private sector funds are willing to consider. In the case of sectors requiring complex research and development or large capital expenditure, the upper boundary of the gap is estimated to be considerably higher at £15 million. The report also states that the parameters of the equity gap relate to first round funding and that UK companies may experience under investment at later stages of their development.

3.13 A different funding gap was also identified by the Rowlands Review²⁵ which concluded that there was an undersupply of finance for established medium growth potential companies that required growth capital ranging from £2 million to £10 million. The undersupply is believed to be structural, resulting from investors choosing to finance higher risk/return profiles and greater deal size. Whilst the funding gap was masked by the availability of cheap finance during a buoyant economy, the financial crisis revealed and compounded an underlying problem.²⁶

Reasons for the Equity Gap

3.14 The reasons why some viable SMEs with growth potential can experience problems in raising capital is well documented. They relate to a number of features and market failures on both the demand and supply side, resulting in fund managers making fewer, larger and later stage equity investments.

3.15 On the demand side, there are two main reasons for the equity gap:

²³ Pierrakis, Y (2010) *Venture Capital Now and After Dotcom Crash*. London: NESTA.

²⁴ SQW (2009) *The Supply of Equity Finance to SMEs: Revisiting the Equity Gap*. London: BIS.

²⁵ Rowlands Review (2009) *The provision of growth capital to UK SMEs*. London: BIS.

²⁶ Rowlands Review (2009) *The provision of growth capital to UK SMEs*. London: BIS.

- **Lack of investment readiness:** Venture capitalists invest in a small proportion of opportunities that are presented to them. In part, this is because early stage companies often lack the experience to present themselves as investable opportunities due to poor business plans or inadequate business skills. This constrains their ability to secure investment.
- **Aversion to equity:** Despite needing finance, many entrepreneurs are unwilling to concede control. They believe that the objectives they have for their business conflict with those of venture capitalism. The EU has noted that 'entrepreneurs can be reluctant to dilute their ownership or cede a share of control to equity investors and instead try to borrow or accept limits to the firm's growth.'²⁷

3.16 On the supply side, the main reasons for the equity gap are as follows:

- **Early stage deals are high risk and cost more:** Investing in early stage businesses often entails higher risk because they tend to have unproven business models, less experienced management staff, and fewer tangible assets. This requires a rigorous pre-investment assessment of the company involving the employment of accountants, lawyers and industry specialists. Many of these costs are fixed and thus represent larger proportion of the investment compared to larger later stage investments in both investor time and their potential for return.²⁸
- **Poor performance:** Investors often made very low returns when financing early stage high technology companies in the mid 1980s. These returns were low for several reasons including poor quality investment decisions as the industry had little knowledge of making technology investments, as well as the long recession of the 1990s. This created a poor perception of the returns that could be made and led to an exodus of investors from the venture capital market.²⁹ The track record of early stage deals has shown little improvement of the 2000s with the rate of return from venture capital investments lower than private equity funds. Between 1996 and 2005, three year average net returns of UK private equity markets were 21.2 percent compared to -2.4 percent for venture funds.³⁰
- **Remuneration of fund managers:** Later stage and buyout deals have provided better returns and personal remuneration for fund managers so that there is less incentive for them manage venture capital funds. Historically, fund managers received a management fee of 2 percent plus profit share referred to as 'carried interest'.³¹ Carried interest represents a significant financial incentive and can be maximised through closing larger deals.³²
- **Investor yield:** When making capital investments, institutional investors will be assessing their prospects of either generating a high capital gain return or an

²⁷ c.f. NESTA 2007: page 2

²⁸ NESTA (2007) *Making Money at the Early Stage: The Challenge for Venture Capital in The UK*. London: NESTA

²⁹ BIS (2009) *The Enterprise Fund – High Technology Venture Capital Intervention*. Draft ROAME Statement.

³⁰ BVCA (2006) *Investment Activity Report 2006*.

³¹ Typically, this is 20% of the capital gain after investors have had their capital returned to them and a minimum rate of return.

³² Rowlands Review (2009) *The provision of growth capital to UK SMEs*. London: BIS.

acceptable level of annual yield. However, venture capital (and equity) investments are generally illiquid, do not provide annual yield and rely on an exit event to release large capital gains. As a result, institutional investors perceive the levels of risk and illiquidity that venture capital offers not to be compensated by the returns available.³³

3.17 In light of the above, institutional investors have often been reluctant to provide venture capital funds. The aggregate level of equity investment has seen significant growth but for the reasons outlined above, this has not led to the wide availability of venture capital funding for SMEs. Whilst there has been some increase in the level of institutional investment for this asset class, this remains low for the market to operate efficiently. The question now arises as to why policymakers regard this as market failure and important for the state to intervene.

The Economic Importance of Venture Capital

3.18 Policy makers regard the equity gap as being undesirable as it constrains the growth of viable businesses and have sought to promote a variety of initiatives to increase SME access to venture capital funding. This is, in part, influenced by the long-standing disproportionate impact that US venture capital backed firms have had on the US economy. There is extensive evidence showing that venture-capital backed firms out-perform those that do not receive venture capital funding. Although US venture capital firms comprise a tiny proportion of business start ups each year, averaging 800 or so out of two million, they have been responsible for major economic impacts in the form of employment, sales and profits. In 2000, companies backed by venture capital generated 11 percent of all US sales and 13 percent of profits, employed 6 percent of the nation's workforce, and comprised one third of the total market value – that is more than \$2.7 trillion. In short, a significant proportion of all value generated by start ups in the USA has emerged from those backed by venture capital.³⁴

3.19 Similar observations have been made in the UK regarding the contribution of venture capital to the economy. Between 2002 and 2007, the growth in the number of people employed in venture capital backed companies was 6 percent annually, compared to a national average of 1 percent. Venture capital backed firms also achieved sales growth of 12 percent a year over five year period (2002–2007), a higher rate than the FTSE Mid-50 250 companies, which achieved growth rates of 5 percent per annum.³⁵

3.20 Recent research has shown the importance of a small number of high growth firms that are vital to the UK economy. NESTA's 2009 research summary³⁶ analysed the records of all UK companies between 2002 and 2008 and showed that the 11,000 business that generated annual average employment growth of at least 20 percent over a three year period were responsible for creating around half of all net employment growth. NESTA's new and updated summary shows that, despite the recession, high growth firms continued to expand and accounted for a disproportionate share of job creation. Half of all new jobs between

³³ Rowlands Review (2009) *The provision of growth capital to UK SMEs*. London: BIS. page 15

³⁴ NESTA (2008) op. cit.

³⁵ BVCA (2009) op. cit.

³⁶ NESTA (October 2009) *The Vital 6 per Cent. How High-Growth Innovative Businesses Generate Prosperity and Jobs*. London: NESTA.

2007–2010 were created by high growth firms with ten or more employees.³⁷ NESTA's research shows that innovation is the fundamental factor.

3.21 For UK firms, being innovative is strongly associated with high growth, with innovative businesses growing twice as fast, both in terms of employment and sales, as non-innovative ones.³⁸ Indeed, NESTA's Innovation Index shows that two-thirds of UK economic growth in the past twenty years was the result of innovation.³⁹ Research has also shown that for firms to be innovative, they need access to finance, including venture capital. As a result, NESTA states that enabling access to finance, including venture capital, is one of the key ways in which Government can remove the barriers to innovation.⁴⁰

Policy Responses

3.22 The US experience demonstrated that a well functioning venture capital funding system generates substantial positive spill over effects on the rest of the economy. As a result, every major economy, including the UK, has implemented initiatives to stimulate the venture capital industry and promote access to venture capital funding.

3.23 The UK has a fairly long history of policy initiatives designed to stimulate the venture capital industry, dating back to 1945. Government intervention became more pronounced in the late 1990s for three main reasons. First, there was increasing awareness of the equity gap as a result of several studies and research reports (e.g. the Myners Report).⁴¹ Second, the Labour Government was keen to support the development of SMEs and high-tech industries in order to meet wider macro economic of achieving national growth and increasing productivity. Third, the 1997 Labour Government was heavily influenced by New Economy thinking, which argued that the basis of competition had changed and was increasingly driven by knowledge and intangible assets. Since firms based on intangible assets have less collateral to put up for loans, they are particularly suited for equity investments.⁴² Against this context and following on from a range of policy interventions introduced in the 1980s by the Conservative governments, the Labour Government initiated a range of additional measures as set out in the 1998 *Competitiveness White Paper*.

3.24 The 1998 White Paper introduced a range of measures which, for the first time, were designed to stimulate critical mass amongst the venture capital industry. Alongside the £270 million Enterprise Fund, Regional Enterprise Fund, the Government introduced the High Technology Fund of Funds. At this point, policymakers believed that the equity gap affected investments up to £500,000 and there needed to be additional support for investments in High-tech firms. Further assessment in 2003 indicated a gap between £250,000 and £2 million⁴³ and a further set of hybrid funds were introduced, including ECFs and Community Development Ventures – Bridges (the rationale for which is discussed in chapter five). More

³⁷ NESTA (March 2011) *Vital growth. The Importance of High-Growth Businesses to the Recovery*. London: NESTA.

³⁸ Mason, G., Bishop K., and Robinson, C. (October 2009) *Business Growth and Innovation: The Wider Impact of Rapidly Growing Firms in UK City-Regions*. London: NESTA.

³⁹ BIS and NESTA (2010) Annual Innovation Report.

⁴⁰ NESTA (March 2011) *Vital growth. The Importance of High-Growth Businesses to the Recovery*. London: NESTA.

⁴¹ HM Treasury (May 2000) *The Myners Review of Institutional Investment*. London: HM-Treasury.

⁴² NESTA (2009) *From Funding Gaps to Thin Markets: UK Government Support for Early-Stage Venture Capital*. NESTA Research Report September 2009.

⁴³ HM Treasury and Small Business Service (2003) *Bridging the Finance Gap: Next Steps in Improving Access to Growth Capital for Small Businesses*. London: HMSO.

recent studies indicate the equity gap ranges from £250,000 to £5 million.⁴⁴ The Rowlands Review identified an additional gap in the supply of growth capital finance ranging from £2 million to £10 million for more established businesses looking to grow.⁴⁵

3.25 Over the period 2000 to 2008, BIS invested £337.9 million⁴⁶ in various equity finance schemes and, in the process, experimented with various funding models including the Fund of Funds approach, direct investment and co-investment. Arguably though, they share three common objectives. First, to increase the amount of equity finance to SMEs and, second, to demonstrate to institutional and private investors that robust returns can be made from investing in the equity gap (thereby supporting the development of the private venture capital industry). Third, set against the need to generate commercial returns, the government schemes have been concerned with contributing to economic growth through creating jobs, increasing productivity and supporting innovation. The aims and objectives of the two schemes evaluated within this study are detailed in chapters four and five respectively.

Factors Affecting Fund Performance

3.26 This section primarily draws on a study commissioned by the Small Business Service in 2006 regarding the factors determining the performance of early stage venture capital funds.⁴⁷ The study undertook a wide review of the literature to identify factors affecting the financial returns realised from venture capital funds. The most prominent findings are summarised below. Before turning to these, the following points should be acknowledged:

- The internal rate of return (IRR) of an average venture capital fund does not usually turn positive until the eighth year of the fund's life (the so-called 'J-curve' effect), which means that it is only at the very end a fund's life that excess returns are realised.
- Returns from venture capital funds have been subject to wide swings since the formation of the modern venture capital industry. For instance, whilst 30 percent annual return was fairly typical for a US fund during the 1970s and early 1980s, this level of profitability was rarely achieved between 1984–1996.
- There is empirical evidence showing a big gap between the best performing venture capital funds and the rest. The Economist noted that the top quartile of US funds produced an annual rate of return of 23 percent, whilst the bottom quartile earned the investors only 3 percent (1980–2001).
- There is common understanding amongst academics, industry interest organisations, business press and practitioners that the US venture capital industry systematically and significantly outperforms the European venture capital industry. The reason for this are explored below.

⁴⁴ SQW (2009) *The Supply of Equity Finance to SMEs: Revisiting the Equity Gap*. London: BIS.

⁴⁵ Rowlands Review (2009) *The provision of growth capital to UK SMEs*. London: BIS.

⁴⁶ NAO (2009) *Venture Capital Support to Small Businesses*. Report by the Comptroller and Auditor General.

⁴⁷ Small Business Service (2006) *Factors Determining the Performance of Early Stage High-Technology Venture Capital Funds – A Review of the Academic Literature*. London: Department of Trade and Industry.

The Characteristics of Portfolio Companies

3.27 Research shows that companies receiving investment in key sectors or industries are more likely to perform better than others. In particular, at least until recently, investments in the new economy sectors such as biotech and internet yielded the greatest returns. The developmental stage of the company has also shown to be important, with the highest returns in the UK market have been generated by later stage investments.

The Characteristics of Venture Capital Funds

3.28 The following characteristics of venture capital funds are seen to play a role in determining fund performance:

- **Structure:** Venture capital firms structured as limited partnerships with a finite life and substantial profit sharing are considered to be more successful than other legal structures.
- **Specialisation:** Venture capitalists who specialise on a certain investment stage and/or sector build up 'hard to imitate' knowledge are more likely to perform better than those without a specialised portfolio.
- **Persistence and brand:** Commonly referred to as the 'persistence effect'. Here is strong empirical evidence showing that fund managers who outperformed the industry with one fund are likely to outperform the industry with another, and vice versa. Established venture capital firms, with developed brand recognition, tend to achieve higher returns.
- **Fund Size:** There is empirical evidence showing that larger funds tend to yield higher returns. They are able to make larger investments at first round and have the reserves to follow companies through expansion stage when they require significant funding. However, there are disadvantages to running a large fund and the data suggests that they should not grow too large or too fast.

3.29 To conclude, large fund sizes, a limited partner structure and experience of the market all correlate with strong performing funds.

Portfolio Management and Exit Process

3.30 Some studies have shown the skills and competencies of fund managers are the most important success factors, particularly in terms of providing added value to portfolio companies. Further, fund managers that are not averse to replacing the management teams of portfolio companies or founding entrepreneurs can have a positive impact on performance and exit.

3.31 There are five key types of exits with studies showing that bringing portfolio companies to the public markets not only gives higher returns but can enhance a fund manager's reputation. Another important factor is the capability and discipline to abandon non performing investments sooner rather than later.

Exogenous Factors

3.32 Institutional and environmental factors have an indirect effect on fund performance. Studies that have examined performance in relation to business cycles show that funds that

are raised in boom times are less likely to raise follow on funds, thereby implying that they are likely to perform poorly. A factor that seems to have major impact on the performance of venture capital markets is the allocation and level of funds. Several studies have shown that raising investment in boom times has a negative impact on performance.

Summary

3.33 The UK private equity market experienced significant growth over the early part of the decade. Statistics on investment activity collected by BVCA show an increase in the value of investments by over 150 percent from £4.7 billion in 2001 to £12 billion in 2007. However, the aggregate growth in equity investments did not lead to the wider availability of venture capital finance for early stage companies or those seeking finance below £2 million. The proportional amount of investment going into early stage companies fell by more than half over the same period. The evidence suggests that, private investors switched to making larger amounts of investments in later stage businesses where they perceived the risks to be lower. This created a hiatus in funding for early stage, high growth companies seeking capital investments in amounts too large for business angels and too small for traditional venture capital funds.

3.34 Influenced by the experience of the US where venture backed firms have had a disproportionate impact on the US economy, UK policymakers promoted a variety of initiatives to increase the supply of equity finance to SMEs, that is, address the equity gap. Specifically, the Labour Government's 1998 White Paper introduced a range of measures which, for the first time, were designed to stimulate critical mass amongst the venture capital industry. In 2000, the £20 million UKHTF was launched and two years later, the UK's first community development venture capital fund was established – the Bridges Fund, managed by Bridges Ventures. Again, the Government provided £20 million of cornerstone investment.

3.35 Over the period 2000 to 2008, the Government invested £337.9 million in various equity finance schemes and, in the process, experimented with various funding models including the Fund of Funds approach, direct investment and co-investment. Nonetheless, all shared common objectives of increasing the supply of equity finance to SMEs and attracting institutional investors to the venture capital market.

3.36 Investment figures show the Government has become an important provider of equity finance. The financial crisis and the recession have created a downturn in the private equity industry. The difficulties that SMEs are facing in raising investment would be even greater if the Government was not a co-investor of equity finance. Indeed, both investment figures and recent research show that, despite Government intervention over the past decade, there are structural inefficiencies within the financial ecosystem that warrant ongoing public support.

4 THE OPERATION OF THE UKHTF

4.1 Qualitative interviews were undertaken with the fund managers from UKHTF and with Bridges Ventures as well as Capital for Enterprise. The interviews explored wide ranging issues from investment strategies to the factors affecting fund performance. This chapter focuses on the UKHTF whilst chapter five focuses on the operation of the Bridges Fund. Both chapters cover the investment process, focusing on deal flow source, conversion rates, investment readiness and post investment support. This chapter also sets out the way in which underlying fund managers for UKHTF were selected and how their performance is monitored. It begins by outlining the aims and objectives of the UKHTF.

The Aims of the UKHTF and the Selection of Underlying Fund Managers

Fund Aims

4.2 The UKHTF was launched as a return driven, Government sponsored initiative to encourage institutional investors to invest in high technology venture capital funds in the UK. The impetus for the Fund came from one of the conclusions of the Myners Report, which stated that UK pension funds should invest more in the private equity asset class. To give funds enough critical mass to employ teams and secure returns, it was deemed that the Government would need to cornerstone £20m to establish a Fund of Funds.⁴⁸ Thus, the High Technology Fund of Funds was created and it had four aims:

- Raise a fund of at least £105 million, including the Government's £20 million investment;
- Provide returns to investors of 15% or more;
- Stimulate interest for institutional investors to invest in UK venture capital in particular in early stage high-technology businesses;
- Initiate relationships to encourage direct investment from venture capital.

4.3 The Government's £20 million commitment enabled a further £106m to be raised from 23 institutional investors, increasing the total size of the Fund to £126.1 million.

Fund Structure

4.4 The UKHTF used a Fund of Funds structure and offered government subordination to institutional investors that had not previously invested in the target fund type. In addition, as with other public-backed equity schemes, the Fund was structured as a limited partnership.

4.5 As a result of learning from funds such as UKHTF and the Bridges Fund, the design and structure of more recent publicly funded equity schemes has changed. In the earlier initiatives, the Government sought to reduce the risk for the private investors whereas later schemes have been designed to enhance the overall return of the fund (e.g. Enterprise Capital Funds). Experience has shown that when the government subordinates to private investors, they do not become interested in fund performance until it is performing very poorly. In the newer funds, the Government prioritises a return on its investment before

⁴⁸ Clarysse, B. et al., (2009) *Benchmarking UK Venture capital to the US and Israel: What lessons can be learnt?* Report prepared for the BVCA.

investors so they have an interest in monitoring performance and the selection of the fund manager (see below).

The Selection of the Underlying Fund Managers

4.6 The UKHTF Fund of Funds Manager was responsible for selecting the underlying fund managers. The Fund Manager's selection strategy was based on achieving a diversified portfolio to minimise risk. The aim was to attract funds investing in a wide range of technologies, such as health-care, clean-tech, software and so on, as well as ensuring that between them, the funds would invest in companies at different stages of development ranging from prototype to early revenue.

4.7 With regards to the process of selecting fund managers, a competitive tendering process was not considered necessary. The Fund Manager primarily relied on industry knowledge, contacts and networks. Existing funds and/or those responsible for managing them were approached and asked if they would like to become part of the UKHTF. (This is confirmed by many of the underlying fund managers who reported that they were approached to be part of the UKHTF.) When the response was positive, the Fund of Funds Manager devoted significant time and resources to undertaking due diligence on the fund managers and/or funds.

Selecting Underlying Fund Managers

We didn't advertise – managers didn't submit a proposal to get money from us. We've been in the industry for a number of years so we knew a lot of the managers. Our role was to do the due diligence to decide which of the managers we were going to back...So we had an idea of where we wanted to put the money and who we wanted to interview. It wasn't really a situation where groups pitched to us, the ball was much more in our court and more proactive from our side and that worked quite well.

4.8 The due diligence focused on three key issues: fund manager's previous experience; the structure of the fund and its investment terms, and the fund management team and its rewards and remuneration terms. The Fund of Funds Manager used the same process for selecting underlying funds for the UKHTF as it did for purely commercial venture capital funds. The Government did not play a role in the selection process. The only criteria that it set was that the funds should predominately invest in hi-tech companies and that these should be based in the UK. The Fund of Funds Manager valued the full control that it was given to select the underlying fund managers.

Investment Strategies

4.9 The stage of company development and industry sector were the key criteria underpinning investment strategies of the underlying funds of the UKHTF. However, there was variation between fund managers as to the extent to which they were seeking to operate very specialised funds or those that were comparatively generic. By way of illustration, whilst one fund manager targeted early stage companies based in the UK in the internet related technologies sector, another chose to invest in companies at all stages, operating in one of several technology sectors and based in the UK or Europe.

UKHTF Investment Strategies

We said we would invest in a balance of early and developing stage companies, they would all be SMEs, but it would vary from start up funding all the way through to more growth equity type funding and that is very much how it came to pass. So within the sector, which was quite tight, we gave ourselves a fair amount of freedom to invest on an opportunistic basis.

4.10 There was agreement amongst fund managers that investment opportunities needed to demonstrate strong potential for commercial return and, in the case of early stage companies, commercialisation of technology and a viable route to market. Fund managers tended not to base investment decisions on the quality of management teams because they could address this post-investment (see below).

4.11 A few of the fund managers reported that, partly as a result of their involvement with the UKHTF, their investment strategies for subsequent funds have changed. They have moved towards what they term to be 'balanced portfolios', that is, investing in all phases of early stage development, across a number of sectors, both in the UK and internationally.

4.12 More widely, fund managers reported that, as a result of poor performance and the financial crisis, even those venture capitalists that used to invest in early stage are not doing so often now. If they are, they are moving towards the later phase of early stage, with very few considering seed or proof of concept investments. Increasingly, the aim is to invest in companies closer to revenue stage rather than "scientific ideas" as one respondent stated.

The Impact of the UKHTF on Investment Strategies

So another thing we've changed is...now we're balanced across all stages and we have slightly changed the mix of sectors... so now we genuinely try to balance all three. We balance by stage...we invest across several sectors, and finally we invest 50% in the UK, a little in Israel and the rest across Europe. You can't do something for thirteen years and not learn some lessons and change your mind about some things.

The classic biotech investing model wasn't working so we changed the model. So, in the third fund, we were looking to put more money behind a smaller number of companies, but more importantly, we wanted to try and find companies where they would start generating revenue relatively quickly... For want of a better word, we wanted to invest in "real" businesses where the technology had been worked on for a number of years before rather than investing in scientific ideas.

Government Restrictions

4.13 There is consensus amongst the underlying fund managers of the UKHTF that, aside from state aid rules, there were no further restrictions attached to the Fund. Accordingly, they had the freedom and flexibility to develop their own investment strategies and make decisions without government intervention. This was regarded very positively and identified as the model for future government interventions.

The Absence of Government Restrictions

The fact that some of Capital Dynamic's money in X [i.e. Fund] was government money didn't even cross my radar screen and it hasn't been an issue whatsoever in our dealing with companies. Therefore, I would say that this is the ideal way to do it because the public money was seen as private money. It didn't influence the investments we made and, if you believe in markets, this is the way for the government to be supportive.

4.14 Whilst government restrictions did not hinder investment strategies, interviews reveal good quality investment decisions were hindered by the state of the private equity market between 1998–2002 and the technology bubble. During that period, the availability of funding was very high, investors had been securing good returns from investments made in the 1990s, and there was a huge supply of technology and internet companies seeking finance. Fund managers reported that they were under pressure to invest as much and as quickly as possible. Opportunities were not always assessed rigorously as they are today. See the quotation below.

The Influence of the Private Equity Market on Investment Decisions

We never saw as many deals as we saw during 2000. So did we lack the opportunities to invest in? Absolutely not. Were we possibly blinded by the array of possibilities? Did we have the ability to select the best deals? Simply the swarm of opportunity probably prevented selection of the best deals. The market was out of whack in a big way... My answers to your questions would all be different if we were talking about money going in five years later.

Attracting Private Investors

4.15 To some extent, there is a difference of opinion between the Fund of Funds Manager and the underlying fund managers as to whether an equity gap existed in 2000. The Fund of Funds Manager believes there was a gap in the market where institutional investors were reluctant to invest in early stage technology companies. The subordination rule encouraged them to invest in the UKHTF where they might otherwise not have done so. Although returns were not guaranteed, risks were minimised, which institutional investors found attractive.

4.16 By contrast, there is a consensus amongst underlying fund managers that at the time the High Technology Fund was established, the private equity market was saturated with available finance to invest. Three issues emerge from this. First, none of the fund managers experienced difficulties in attracting private investment; indeed, some capped their funds voluntarily to avoid them becoming far larger than they could manage. Second, the availability of finance and its sheer scale increased prices for deals and companies, which subsequently had a knock on effect on fund performance (see chapter six) with one respondent citing this as the “downfall” for the whole fund. Third, it was not necessary for the government to become involved in the market because of the availability of finance at that time, although fund managers all stress that this is not the case now. The venture capital market is seen to have ‘collapsed’ as it is virtually impossible for fund managers to raise new funds. Further, there has been a reduction in the total number of fund managers, which is seen as a problem because they tend to regard each other as co-investors and important sources of deal flow rather than competitors.

The Availability of Funding in 2000 and Attracting Private Investors

So at that time we originally went out on a fund that was £ 200 million and it was clear within weeks that we had raised more, we increased it 250 and then there was still excess demand so we decided to put a hard cap at 300 million on it. So to be brutally honestly did the UK High Technology Fund make a significant difference to the fundraising in 2000? The answer is no. Even though £20 million was a significant contribution, we would probably have found it somewhere else had they not brought the money in. Now you roll forward a few years and it is totally a different story.

I would say the funds probably could have been raised [without the UKHTF]. We are talking about circumstances in the year 2000. Remember back then, there was a technology bubble and, in actual fact, that was [Fund X's] downfall because there was lots of people wanting to put money into that sort of stuff...there was lots of money around at the time and when you got the High Technology Fund it

didn't change anything, the money was already there. Now the situation is quite different, it would actually make a difference.

The fund was raised in 2000 and it was heady days and a lot of money was being thrown at the industry...The total fund was originally scheduled to be 160 with a so-called card maximum of 200 and we had to go back to the investors to get consent to allow it to be increased above that and we raised 235. So, was that money helpful at the time? No, because, with the benefit of ten years of hindsight, we did not need the money then....

There was quite a lot of interest from institutions at the time because there was a feeling that they needed to put a bit more money into venture capital as part of their portfolio than they had previously.... So there was quite a lot of money, which obviously drove up prices for the sort of deals you really wanted to do because there was far more competition.

Actually if you look at the wall of money that was raised in Europe ten years ago in technology, it was probably the biggest bulge of fundraising ever done in the European venture scene. So this Fund was possibly launching at the most competitive time to be in technology...

Now this Fund was launched at a time, to be brutally honest, when it wasn't needed... I would be surprised in 2000 that there was a single fund that took money from the UK High Technology Fund that wouldn't have been raised anyway. Compare that to now and the impact that the Innovation Fund is having, we probably wouldn't have raised our Fund so there they [government] put X million to work and we now have a £75 million fund – a leverage of 5 times and the majority of that money will be invested in the UK.

The Investment Process

Enquiries and the Conversion Rate

4.17 Underlying fund managers of the UKHTF reported that they received a high number of enquiries from businesses seeking investment, with one fund receiving 3,000 one year. Fund managers received enquires directly from businesses, as well as referrals from corporate finance houses, other venture capitalists, and entrepreneurs they had backed in the past. Indeed, the last two sources were seen as providing the best quality opportunities. In contrast to Bridges, one fund manager reported that it tended not to consider referrals from corporate finance houses in much detail because their fees for making the introduction were too high.

Enquires

We received an awful lot of deals, you get them through a lot of different channels...generally we read everything we get, although most of them are not worth a second moment's consideration...so the majority of deals that we do will come through our network and that will be from other venture capitalists or from entrepreneurs that we have met or that we have backed in the past.

The deal flow was very significant actually, there were a lot of enquiries, there were a lot of companies coming through and we were quite selective... But getting a flow of deals is not a problem, selecting is the key art. You need to make sure you get the right population coming at you, through a bit of marketing, attending conferences, being a person of good reputation in your profession and for your skill.

4.18 Most fund managers stated that they assessed every single enquiry or referral they received in case they missed a major or lucrative opportunity. Although initial assessment of each enquiry was undertaken fairly quickly because it was evident which opportunities were unsuitable, the total volume of enquires meant this was a fairly time consuming task. Following the initial screening, potential opportunities would be examined in more detail by an investment manager/teams and a decision taken as to whether to explore it further. This

stage would result in a further screening out until an investment manager would find an opportunity he/she thought was important to consider in much more detail. Opportunities discussed and assessed to be highly viable would result in detailed proposals being submitted to an Investment Committee. It would give approval for due diligence to be undertaken or make a decision not to proceed further. Fund managers reported that, on average, due diligence took between two to six months depending on the stage of company and complexity of technology, costing between £15,000–£20,000 on external fees. These costs are consistent with those reported in a separate study commissioned by BIS regarding the equity gap. That study found that due diligence could take between one to three months (excluding the deal structuring) and costs ranged from £20,000–£50,000 for a straightforward deal up to £70,000–£80,000 for a technically complex business.⁴⁹

Due Diligence

We will do commercial, market and people diligence and technical and financial diligence which is probably the lightest of the lot. All this can cost up to £20,000 and take between three and six months.

4.19 Fund managers reported that few businesses were investment ready. Consequently, they devoted a significant amount of time in helping them develop a detailed, credible business plan that could be submitted to an Investment Committee.

4.20 Overall, the investment process from initial enquiry through to final closure was lengthy and time consuming, although this is not unusual for the industry as a whole. At each stage, the fund manager and/or company opted out from the process and decided not to proceed further. Hence, a typical fund manager would have received about 300 enquires, examined 20 of them in detail, submitted eight proposals to the Investment Committee and then invested in four. In reaching these decisions, there was often a lot of debate within investment teams as to which opportunities to pursue.

Post Investment Support

4.21 Underlying fund managers from the UKHTF reported that assessing business opportunities and making investment decisions comprises one part of their role. Arguably, a more important part comprises post investment support to contribute to the growth and development of investee businesses. Post investment support was regarded as fairly resource intensive, although the level of support given varied as to the developmental stage of the company.

4.22 All fund managers from the UKHTF reported that post investment support began with strengthening corporate governance and management arrangements. There was agreement the management and leadership skills amongst investee businesses were not high and few had senior management and/or boards in place with the skills and capacity to run a successful business. This was particularly the case for very early stage companies and those that had not established previous businesses. Very often, their first task entailed changing the composition of the senior management team, including replacing the existing chief executive, which proved to be a challenging process.

⁴⁹SQW (2009) *The Supply of Equity Finance to SMEs: Revisiting the Equity Gap*. London: BIS.

Post investment support – Strengthening Corporate Governance

One of the tasks for the venture capitalist is to make sure you've got the right person or right team at each stage. Part of our job means managing the expectations of the existing founder CEO and getting him to step back from the company. Very often it means replacing the founder CEO with somebody who has the skills to run a company, which can be a difficult process.

So the guy with the very good idea very is often the scientific guy; he may have some business experience but not enough...so you need to plug in the experience...So of the thirty or so companies that we invested in... we changed the Chief Exec in all of them....

4.23 Several fund managers also reported that it was necessary to change the composition of the management team as the company progressed or moved to the next stage. The skills needed at early stage to managing high growth were seen to be different and they viewed their role as finding and securing managers with the right skills appropriate to the stage of company development. It was also noted that fund managers are able to exert considerable influence over the strategic direction of a company by changing its chief executive and, in so doing, this decision could influence the extent to which they made a positive or negative return on the investment.

The Influence of the Fund Manager through CEO Appointments

Changing the head of an organisation is quite dramatic because that's a lot of change you're effecting through that decision alone. And then, very often, the choice of who the next CEO will determine whether you're going to continue investing in the business for another three years or whether you're exiting in the next six months because the nature of the person you would hire. So changing the CEO is often the moment where you can have the most input on the strategic direction of a business and that's where you as a fund manager can have the most influence.

4.24 Partly as a way of strengthening governance and partly as a way of protecting their investment, fund managers from the UKHTF appointed at least one, if not two, non-executive directors to the investee company's board of directors. Non executive directors were either recruited or comprised senior management team members from the fund itself.

4.25 Post investment support has been confined to advising the management teams when making strategic decisions or at key points of company development. It is extremely rare for fund managers to have become involved in operational delivery. Fund managers' added value primarily lies in drawing on experience from running or managing previous businesses. They appear to have added most value to investee business through their networks and knowledge of the industry, again a finding endorsed by the business interviews. A number of fund managers have links into and relationships with large companies in the sector and have sought to utilise these to enable investee companies to sell to them and/or for future trade sales. Most fund managers are in weekly dialogue with investee companies, although this increased if the company was experiencing difficulties or expanding in some way.

Post investment support – Adding Value

We don't get involved in an executive role in the company; what we bring is knowledge and networks. In the life science sector we have relationships at board level in every one of the major pharmaceutical companies so that allowed us to introduce potential buyers and make them aware of our portfolio companies

We're genuinely hands on...It's not our job to just pick companies and put money in, it's actually to then help those companies develop and to add value to them... X plays a big part through his connections within Government and the NHS etc. He's able to make introductions for companies that they wouldn't

necessarily be able to get themselves...actually, we've been instrumental in an awful lot of companies' success just by making connections and networking.

Investment managers will be spending many days a month on each company, as much as a week a month. When a company is either very excited or very troubled, they might be spending half their time working on that company. So that will involve things like helping them open a market, helping them refine the business strategy, helping them source a new Chief Exec or CFO, helping negotiate a merger with another business, helping them raise money, or whatever.

Managing a Hybrid Venture Capital Fund

4.26 Fund managers did not report any particular challenges associated with managing a hybrid fund compared to a purely commercial one. In part, this is because the UKHTF has not been restrictive and fund managers have had the same freedom and flexibility to operate as with a commercial fund. Indeed, their positive experience, coupled with the current state of the market means that all fund managers believe it is essential for government to continue to intervene in the market.

Summary

4.27 The UKHTF fund manager made investment decisions on the basis of making a commercial return along Government criteria they to invest in funds that were investing in technology businesses and operating in the UK (although even then they were given dispensation to invest in a fund that had a European remit). None of the fund managers, believed their investment decisions were constrained by government restrictions.

4.28 Fund managers that received investment from the UKHTF did not find it difficult to attract institutional investors in 2000 because of the availability of finance at the time. However, they emphasise that the situation is very different now and there is greater need for government intervention.

4.29 Considerable fund manager time has been spent in assessing investment opportunities and providing post investment support. Both aspects of their role are resource intensive, but not unusual for the industry. None of the fund managers reported that their experience of the pre or post investment process was different to a purely commercial fund.

4.30 There is some evidence that fund managers have found it difficult to make follow on investments in portfolio companies, which they reported could hinder firm development and consequently fund performance.

5 THE OPERATION OF THE BRIDGES FUND

5.1 This chapter focuses on Bridges Fund I and explores the investment process, deal flow source, conversion rates, investment readiness and post investment support. It begins by outlining the aims and objectives of the Bridges Fund and the way in which it came to be established

Establishing the Bridges Fund and its Aims

The Rationale behind Community Development Venture Capital – the Bridges Fund

5.2 The Bridges Fund was introduced in response to a recommendation made in a report produced by the Social Investment Task Force in October 2000.⁵⁰ The Task Force was established at the request of HM Treasury in April 2000 to assess ways in which the UK could achieve a radical improvement in its capacity to create wealth, economic growth, employment and improve the social fabric in its poorest communities.

5.3 The Task Force reported that many entrepreneurs in disadvantaged communities found it difficult to access finance because it was perceived that their financial returns were not sufficiently attractive for lenders and equity providers. It was concerned that policy initiatives such as regional venture capital funds were not focusing on investment shortfalls in what it termed 'under-invested' communities. To address this (and other market failures), the Task Force identified new mechanisms to encourage private investment, one of which was the creation of a community development venture fund – subsequently known as the Bridges Fund. In making this recommendation, the Task Force was inspired by the contribution of the venture capital sector to the UK economy. It believed that the successful principles of venture capital – namely, long term equity investment, business support to the entrepreneur and backing high growth companies – could be applied to community investment in order to generate both economic and social gain.

Raising Investment

5.4 Following the recommendation of the Task Force, the Bridges Fund was established, the UK's first community development venture capital fund. Bridges Ventures was founded by Sir Ronald Cohen of Apax Partners, Tom Singh of New Look and 3i. A range of institutional investors and high net worth individuals contributed to the Fund, raising a total of £20 million. The Government matched this and by September 2002, the Fund had raised £40 million. A proportion of the Government's matched investment was subordinated in that the Government took the first risk and its return was capped.

The Aims of the Bridges Fund

5.5 The overarching objective of the Bridges Fund was to show that successful businesses could be created and developed in deprived communities. The Fund was established to:

⁵⁰ Social Investment Task Force (2000) *Enterprising Communities: Wealth Beyond Welfare. Report to the Chancellor of the Exchequer*. London: Social Investment Task Force.

- Contribute to long term economic growth through additional output (GVA) or improvements in aggregate productivity.
- Increase the supply of equity finance available to businesses in, or linked to, disadvantaged areas and have a positive impact on the wider financial infrastructure
- Increase the economic performance of recipient businesses.
- Provide venture capital finance and support to businesses with good growth potential, and those that will have a beneficial impact on employment, services and products that benefit the community and or supply chains
- By 2002, establish two viable funds of at least £40 million, which will invest in the 25% most deprived wards in England, with at least 50% of the funding provided by the private sector.
- Demonstrate to private investors that commercial returns can be achieved by investing in early stage growth businesses

5.6 More broadly, the Bridges Fund was designed to help inspire the growth of a significant community development finance sector across the UK. It was envisaged that this would bring substantial flows of investment into some of the most deprived communities in the UK.

5.7 In terms of its structure, Bridges Ventures is a private investment company that is majority-owned and managed by its Executive Directors and the Bridges Charitable Trust.

Investment Strategy

Investment Criteria

5.8 Bridges Ventures designed its investment strategy after researching the US market where there is a longer history of community development venture capital. The research highlighted the approach of targeting social impact and financial returns but that it was crucial for the manager to be very clear when decisions were being made on social versus commercial criteria. Otherwise, a fund manager could “fall between the two” and achieve neither strong financial returns nor positive social impacts. This approach was developed and applied to the Bridges Fund. Hence, in selecting propositions, potential businesses were first required to meet at both of the following two eligibility criteria: First, they had to be located in the 25% most deprived wards in England and second, they had to be linked to those areas in at least one of the following three ways: (a) employing at least 35% of employees from the deprived areas; (b) at least 50% of their spend on suppliers being to suppliers located in the deprived areas; (c) deprived areas had to comprise their core market. Any business propositions that did not meet the social impact criteria were screened out immediately; the Fund Manager wanted to ensure that investee companies had as strong a connection to deprived areas as possible.

5.9 For businesses that met those social criteria, Bridges Ventures would then focus on commercial considerations and investments were made in those companies deemed to have high growth potential. Here the Fund Manager developed a particularly distinctive approach. It backed businesses considered “appropriate” to the target area. Many were those offering low-cost products and services. ‘The Gym’ is a good example of this. It provides low cost

health and fitness facilities attracting local people across the socio-economic grouping, including those in groups C–E. The purpose built, low cost gyms were the first of their kind in the UK and, the company has been able to establish itself as a market leader.

Bridges Investment Strategy

We screened out all propositions that didn't meet the social criteria [because] we wanted businesses to have positive impact on areas as they grew. We wanted to avoid business renting a cheap place in deprived areas and not having any connection to them. If business propositions did meet the social criteria, then we focused on the commercial criteria...on SMEs with potential to grow, because if they don't grow, they can't employ people or have an impact on local supply chains.

5.10 Investment decisions were based as much on commercial viability as they were for meeting the social impact criteria. Indeed, the two were seen to be inextricably linked, the underlying assumption being that investing in companies with limited growth potential could not create employment opportunities or induce other social and economic impacts on the areas in which they were located. Further, investing in such companies would not generate sufficient returns for investors and this would not encourage them to invest in a similar fund again.

5.11 The Bridges Fund did not restrict investment to specific sectors or stages of company development and this is reflected in its portfolio (see chapter six).

Government Restrictions

5.12 The Bridges Fund was established to invest in businesses located in the 25 percent most deprived areas within England. Indeed, the Fund's investment team shared the Government's objective of using the Fund to optimise social and economic impact and the team contributed to the development of the eligibility criteria. As the Fund's social mission is regarded as its main purpose (and its most distinctive feature), the eligibility criteria was not regarded to be restrictive or adversely influence the number, type or quality of investment decisions. However, the state aids conditions that were applied to the fund did mean that the Bridges Fund was restricted to very small deal sizes

Bridges Ventures – Social Impact Criteria Not Restrictive

The investment team and the fund managers are mission driven. We wanted to apply the mission because that was the whole point of the Fund. We wanted the social impacts as much as the Government did so we didn't try and wriggle out of the criteria or invest on the fringes.

Attracting Private Investors

5.13 There is a perception that the Bridges Fund would not have been able to attract institutional investment without Government investment. The Fund Manager reports that institutional investors were highly sceptical about the merits of investing in SMEs in deprived areas. They were only persuaded to invest in the Fund following the Government's initial investment of £20 million and because £9.8 million was subordinated as this reduced their risk.

5.14 Private investors were also somewhat reluctant when investing in the Bridges Fund because it was the first community development venture capital fund and there was no track record showing that positive returns could be made. Also, the investment team had no prior experience of making such investments. However, Bridges Ventures noticed a discernable

change in private sector attitudes from Fund I to Bridges Fund II. With a healthy portfolio and two successful exits, private investors were willing to invest in the second Fund without Government intervention.

Bridges Ventures – Government Investment a Catalyst for Private Investment

At the time, the idea that you could invest in SMEs in deprived areas was met with scepticism. So, I can clearly say that we would not have raised private investment if the Government's commitment had not been there. The Government's money was very catalytic; a tranche of it was subordinated, which reduced risk and potentially enhanced return for private investors. So, the combination of the structure of the Fund and the very fact that the Government was putting money in enabled us to attract private investors. Because the return profile was seen to be poor, the private sector wouldn't have backed Bridges Ventures without Government money.

The Investment Process

Enquiries and the Conversion Rate

5.15 Bridges began fund raising in May 2002 and had completed this by September. Partly as a result of its marketing campaign and partly as a result of referrals from personal connections, by December 2002 it had received 208 business plans from entrepreneurs seeking finance. As the Fund became more established, it received an average of 360 plans a year with corporate finance becoming an important source of referral. From the total number of business plans received, 28 investments were made. Bridges did not assess enquiries in any other form, nor did it have the resources to help entrepreneurs develop a business plan. Those businesses that were interested in seeking equity finance but did not have a formal plan were signposted to where they could obtain support.

5.16 Bridges adopted a two-stage approval process for investment decisions. For potentially viable propositions, a paper was sent to the Approval Committee to obtain consent to spend resources on exploring the opportunity further and undertaking due diligence. As with the high technology funds, Bridges found that few entrepreneurs were investment ready. The investment team devoted significant time to developing realistic business plans and/or assessing the skills and capability of the executive team. If the results of due diligence were favourable, the proposition was sent to the Investment Committee for a decision on whether to proceed with the investment and to agree the terms and conditions of this. This process generally took between three to six months and cost around £20,000 on external fees

Post Investment Support

5.17 Partly as a way of strengthening governance and partly as a way of protecting its investment, Bridges Ventures appointed at least one, if not two, non-executive directors to the investee company's board of directors. Non executive directors were either recruited or comprised senior management team members from the fund itself.

5.18 The Bridges Fund Manager reported that post investment support began with strengthening corporate governance and management arrangements. Management and leadership skills amongst investee businesses were not deemed to be high and few had senior management and/or boards in place with the skills and capacity to run a successful business. This was particularly the case for very early stage companies and those that had not established previous businesses.

5.19 Post investment support by Bridges Ventures has been confined to advising the management teams when making strategic decisions or at key points of company development. It is extremely rare for the Fund to have become involved in operational delivery. The Fund Manager's added value primarily lies in drawing on experience from running or managing previous businesses. Members of the Bridges Ventures Board have extensive experience of running high growth businesses.

Summary

5.20 Investment decisions made by Bridges have been driven by three key considerations: (a) meeting the Fund's eligibility criteria; (b) the potential of each opportunity to generate good commercial returns; and (c) their potential to secure wider social and regeneration impacts on local areas. Considerable time has been spent in assessing investment opportunities and providing post investment support. Both aspects of this role are resource intensive, but not unusual for the industry.

6 FUND ACTIVITY AND PERFORMANCE

6.1 This first part of this chapter provides an overview of the types of investments made by the UKHTF and those by Bridges Fund I, setting out the size and make up of each and the characteristics of investee companies. The second part provides a commentary on the financial performance of each fund in turn and the factors that have contributed to this by drawing on qualitative interviews with fund managers. The final part sets out the role of Capital for Enterprise with regards to monitoring the performance of funds and fund managers.

Overview of UKHTF Fund Activity

Fund Size

6.2 The UKHTF raised a total of £126.1 million, of which the Government contributed £20 million. Of the amount raised £124.2 million was committed into nine underlying funds. Out of the nine underlying funds, Quester and MTI 4 raised the most investment from UKHTF. Aside from them, UKHTF comprised less than 10% of the total investment raised by the other seven funds. Accel Europe, for example, raised £340 million from private investors and £8.62 million from UKHTF, which represented 2.5% to the total size of the Fund. The UKHTF was fully committed to underlying funds by 2002.

Table 6.1: UKHTF Portfolio Size by Investor (£m), June 2010

Fund	Date Committed	% of UKHTF	UKHTF	Other Investors	Total Raised	% of UKHTF of Total Raised
Quester Venture	2001	16.1%	20.00	69.0	89.0	22.5%
MTI 4 Ltd	2000	16.3%	20.19	104.0	124.2	16.3%
Scottish Equity II	2000	8.1%	10.00	110.0	120.0	8.3%
Add One*	2000	8.3%	10.25	141.0	151.2	6.8%
Amadeus	2000	12.3%	15.27	228.0	243.3	6.3%
Merlin Biosciences*	2000	10.3%	12.79	191.0	203.8	6.3%
Advent PE Fund III	2000	16.1%	20.00	300.0	320.0	6.3%
Merlin Bio. III*	2002	5.7%	7.09	114.0	121.1	5.9%
Accel Europe**	2000	6.9%	8.62	340.0	348.6	2.5%
Total	-	100%	124.21	1,596.0	1,720.2	7.2%

Source: Capital Dynamics, Interim Review – Fund Profiles, June 2010

*Fund profile is presented in EUR, converted to GBP using Bank of England exchange rate on 30 June 2010 (EUR 1 = GBP 0.8186)

**Fund profile is presented in USD, converted to GBP using Bank of England exchange rate on 30 June 2010 (USD 1 = GBP 0.6684)

Investments

6.3 As shown in Table 6.2, the UKHTF invested in a total of 245 companies. The number varies by fund, ranging between 10 (Merlin Bio. III) and 41 (Accel Europe). This variation does not appear to correlate with the total amount committed in each fund. The average investment per company was just under £7 million, although this encompasses a wide spread ranging from a low of £1.9 million (Quester Venture) to a high of £10.6 million (Merlin Bio. III).

6.4 The number of company sales and write offs are also detailed in Table 5.2. The highest proportion of sales have been made by Scottish Equity II and Accel Europe, although this still represents less than 20% of their respective portfolios. Together with Quester Venture, Accel Europe has also written off, proportionately, the highest number of companies from its portfolio. Overall, five of the funds each have a portfolio that is at least 75% active. Even Accel Europe, which has the highest proportion of all exits in some form of other, is currently managing over 50% of its existing portfolio. These proportions are high given that some funds have been in operation for almost 10 years and, in part, they reflect the lack of exit options reported by fund managers.

Table 6.2: UKHTF Portfolio by Number of Business					
Fund	Total	% Sales	% Write offs	% Active	Average Investment (£'000)
Accel Europe**	41	18%	27%	55%	7,810
Advent PE Fund III	40	10%	13%	77%	7,477
Amadeus	31	13%	0%	87%	6,901
Scottish Equity II	31	18%	8%	75%	3,343
Quester Venture	29	6%	28%	67%	1,946
Merlin Biosciences*	23	15%	7%	78%	6,977
MTI 4 Ltd	22	16%	16%	68%	4,448
Add One*	18	14%	17%	69%	5,965
Merlin Bio. III*	10	10%	0%	90%	10,569
Total	245	14%	13%	73%	6,965

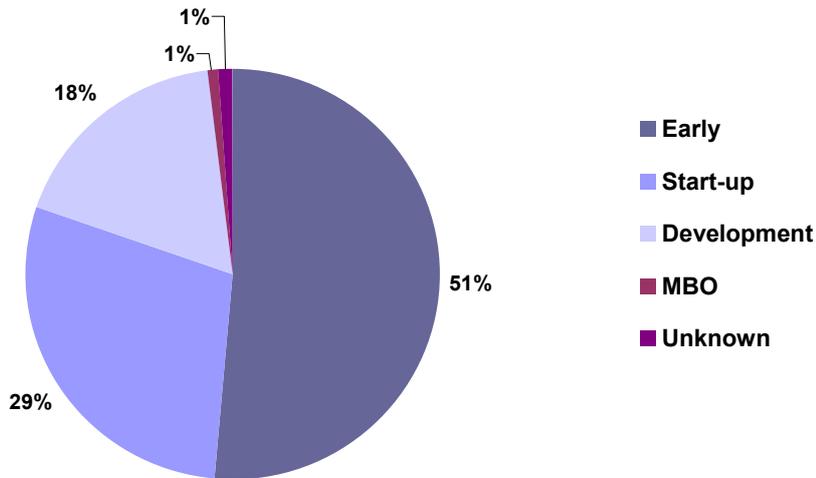
Source: Capital Dynamics, Interim Review – Fund Profiles, June 2010 and Monitoring Data, June 2010
 *Fund profile is presented in EUR, converted to GBP using Bank of England exchange rate on 31st June 2010 (EUR 1 = GBP 0.8186)
 **Fund profile is presented in USD, converted to GBP using Bank of England exchange rate on 31st June 2010 (USD 1 = GBP 0.6684)

Investee Characteristics

6.5 Over half the companies that received investment from the UKHTF were early stage (51%), a further 29% were start-ups and 18% were established businesses. See Figure 6.1.

Figure 6.1: UKHTF Investments - Stage of Investment

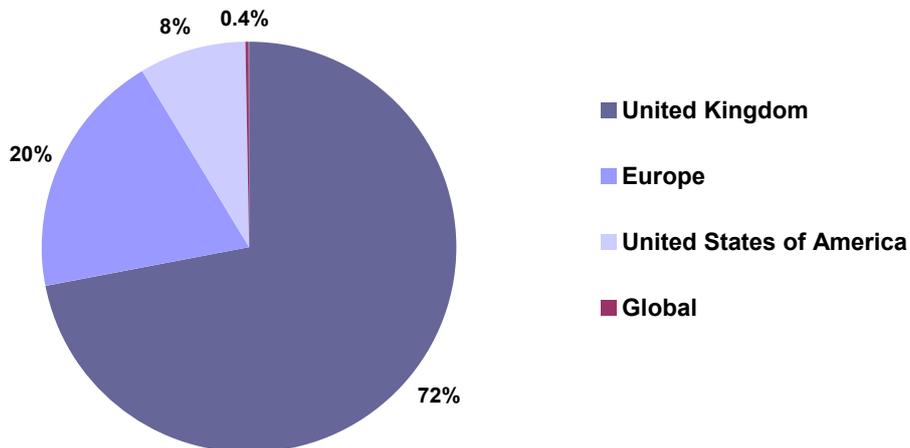
Source: Capital Dynamics and Capital for Enterprise Monitoring Data, June 2010



6.6 Nearly three quarters of investments were made in companies located in the UK (72%) and a fifth in Europe, see Figure 6.2. The funds with the lowest proportion of investments in the UK include Add One (18%) and Accel Europe (41%). The majority of investments in the UK are located in England (85%), of which nearly three quarters are based in the South East or East Anglia (73%).

Figure 5.2: UKHTF Investments - Location of Investment

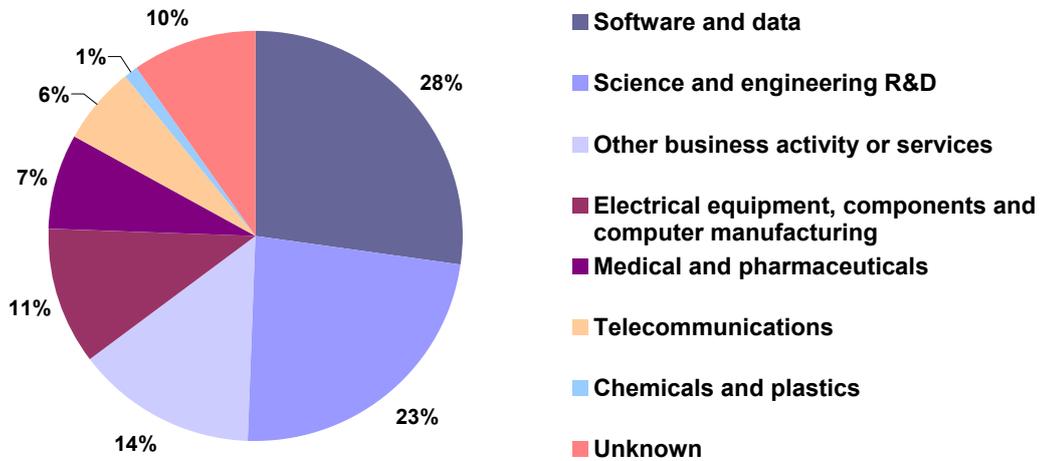
Source: Capital Dynamics and Capital for Enterprise Monitoring Data, June 2010



6.7 Fund monitoring data uses Standard Industrial Classification to categorise the sector of companies financed through the UKHTF. This shows that over half a quarter operate in software and data processing, and a further fifth in science and engineering R&D (23%).

Figure 6.3: UKHTF Investments - Sector of Investment

Source: Capital Dynamics and Capital for Enterprise Monitoring Data, June 2010



Overview of the Bridges Fund Activity

Fund Size

6.8 Government contribution to the Bridges Fund is split between Fund A (70%) and Fund B (30%), totalling £20 million and matched equally by other investors. Hence total commitment across the two funds comprised £40 million.

Table 6.3: Bridges Portfolio Size by Investor (£m)

Fund	Date Committed	Govt. Commit	Other Investors	Total Raised	% of total Fund
Fund A	2002	14	14	28	70%
Fund B	2002	6	6	12	30%
Total	2002	20	20	40	100%

Source: Capital for Enterprise, Equity Quarterly Report, July 2010

Investments

6.9 As show in Table 6.4, the average investment made by the Bridges Fund has been £934,500. Nearly a quarter of investments have been written off (24%) and 14% have been exited.

Table 6.4: Bridges Portfolio by Number of Business

Fund	Total	Exits	Write offs	Active	Average Investment
Bridges	29	4	7	18	£934,500

Source: Capital for Enterprise, Equity Quarterly Report, July 2010

6.10 The Bridges Fund has invested primarily in early stage and start-up companies as shown in Table 6.5.

Table 6.5: Bridges Portfolio by Stage of Investment		
	Number of investments	% of investments
Early stage	9	31%
Start-up	5	17%
MBO	5	17%
Development	4	14%
Property-backed	4	14%
Expansion	1	3%
Property-backed start-up	1	3%
Total	29	100%

Source: Capital for Enterprise, Equity Quarterly Report, July 2010

6.11 To be eligible for investment from the Bridges Fund, businesses must be located in or have links with the 25% most deprived wards in England as measured by the Index of Multiple Deprivation. The most investments have been made in companies based in London followed by the West Midlands. See Table 6.6.

Table 6.6: Bridges Portfolio by Location of Investment		
	Number of investments	% of investments
London	9	31%
West Midlands	7	24%
Yorkshire and Humber	4	14%
North East	2	7%
North West	2	7%
South East	2	7%
East Midlands	1	3%
East of England	1	3%
South West	1	3%
Total	29	100%

Source: Capital for Enterprise, Equity Quarterly Report, July 2010

6.12 As shown in Table 6.7, Bridges Ventures has invested in companies operating across a range of sectors, the most common termed to be the consumer related sector.

Table 6.7: Bridges Portfolio by Sector of Operation		
	Number of investments	% of investments
Consumer related	8	28%
Services	5	17%
Industrial	4	14%
Communications	3	10%
Health and medical	3	10%
Electronics	1	3%
Energy	1	3%
Financial services	1	3%
Manufacturing	1	3%
Total	29	100%

Source: Capital for Enterprise, Equity Quarterly Report, July 2010

Overview of UKHTF Fund Performance

6.13 The UKHTF was committed over the period July 2000 to August 2002 and had each of the underlying funds had operating between 8 and 10 years at the time the data was compiled. As at 30th June 2010 none of the underlying funds had achieved a surplus and although there have been some large winners, with the potential for more, the returns from these are not expected to be of sufficient magnitude to offset losses. The interim pooled average internal rate of return at 30th June 2010 was minus 8.3 per cent. The factors affecting fund performance are set out below.

Factors affecting Performance of the UKHTF

6.14 The Fund of Funds Manager and the underlying fund managers are disappointed with the performance of their respective funds even though each of them includes at least a couple of companies that have been highly successful. Unlike the theory underpinning venture capital, these successes have not compensated for the losses incurred by other investments. That said, nearly three quarters of investments are still live, and therefore there is a possibility of some improvement in the future as the economy recovers. There are a core set of primary factors that have been the most influential on fund performance and these are relevant to virtually all the funds. There are a second set of factors which vary in their level of influence on each fund – for some they have been very significant and for others less so or not at all.

6.15 There was unanimous consensus amongst all fund managers about the core factors influencing the performance of their respective funds. It has been the combination of these factors playing out together that explain under-performance rather than a single factor on its own. A common narrative emerges from each interview and it can be summarised as follows.

- The UKHTF invested in funds over the period 2000–2002 and the underlying funds also primarily made their investment within the first few years of operation. With hindsight the prices for companies and deals at this time are now unanimously reported to have been “very high”, largely driven by the level of competition. Indeed, the influence of the market seems to be the main reason that funds were committed so quickly; there was no government obligation for fund managers to do so.
- Paying high prices at the beginning had two knock on effects. First, investing too much in a company that subsequently failed meant fund managers had a big gap to fill when write offs occurred.
- Second, from 2003 onwards, the opportunities for exiting funds virtually ceased. This meant fund managers could not raise additional funds to provide follow on investment to companies needing to grow. The lack of exit opportunities also meant that companies remained in the portfolio for much longer than the fund managers had anticipated and longer than what they had based their investment strategy on.
- The lack of exit opportunities and follow on investment led to one or more of the following scenarios in each fund: (a) it hampered the growth and development of companies; (b) it led them to raise funds from elsewhere and, in the process, diluting the fund manager’s investment; (c) as fund managers did not have sufficient funds,

they ceased investing in the “weaker” companies to continue to enable them to continue to invest in the stronger ones, which in turn, meant they had a high number of write offs.

High Pricing and Influence on Fund Performance

We had this big fund and in a number of cases we put too much money to work at too high a risk and we ended up losing quite a lot of it so that created a hole in the fund. When you look at the number of successful companies coming through, it should have been enough to fill that hole and give a decent return to investors, but then you are bitten by the price that you paid at the beginning. If you pay too high a price and you are then trying to exit into a market where that value is far harsher, it is very difficult to generate the gains to fill that gap. I think you have got a culmination of both those things ... We may just about get investors their money back on this but I think we need a lot to go right for that to happen.

I think some cases we definitely overpaid at the beginning. I think in others we put too much money into companies with too high a risk, so that meant when we had a write off, there was too big a hole to fill from the more successful companies.

For that vintage, early 2000s, I would say it was definitely the high pricing and the high competition [affecting performance] and then the fact that the exit markets went away so fund managers had these companies for a lot longer than they thought. Investors have a herd instinct actually. You should really go into market when returns are poor because you are buying at the low price, there is very little competition and so you can get some good price deals. That was the problem here, investors went in at the peak of the market because there was all the hype and, actually, a better return is probably available now.

The portfolios haven't performed as well as we would have liked even though there are some companies with excellent technology in there... I think the problem was genuinely within the industry at that point in time. The managers had quite a lot of money to invest and a lot of these companies required a lot of money so they carried on putting large amounts of money in and then the exit markets went away; there weren't any opportunities for floatation nor were other investors coming in to buy them. So the companies had to stay in the portfolio for a lot longer than originally anticipated which meant they needed further money. But, by this time, the managers had run out [of money] because they've got a closed pot of funds – it isn't a bottomless. So, as the fund managers ran out of money to make follow on investments, they had to make a choice of writing off the weaker companies to fund the stronger ones, so you had a high write-off.

UK high-tech fund should have invested more slowly... I wasn't around at the time so I don't know what the requirements were, but the underlying funds made all this investment very quickly, pretty much in the same vintage, and they all paid too much for all the stuff in their portfolios.

6.16 Five secondary factors have also affected performance. The first relates to investment decisions which did not perform as well as anticipated with the benefit of hindsight. A couple of fund managers reported that the size of their respective fund was too small to invest in the technology it chose to support – companies required much more investment than they could provide. Other fund managers reported that they should not have invested in particular sub sectors because the market was not interested in the technology.

Investment decisions and Impact on Fund Performance

From a fund that was not that huge, it wasn't appropriate to back some segments within our field. In retrospect, one would have made some of those judgements differently. I mean, had one analysed the position of semi-conductors in Europe, one would have said, "Look for goodness sake let's just steer clear", we didn't... So, I think there were segment misjudgements...

I think in some cases mistakes were made in judging individual technologies, which were either before their time or were too likely to be overtaken by some competing technology... and some things were in a too early stage even for a fund with our general positioning. You just need too much money even for something which, by general standards, is not huge on capital consumption, you need too much money to get there and if you start too early, you're just never going to make it.

6.17 Lack of finance comprises the second secondary factor affecting fund performance. Several fund managers reported that they lacked access to finance to make follow on investments in portfolio companies. Investors have been unwilling to provide additional finance because of a combination of low returns to date and the current economic climate. At the same time, portfolio companies have been finding it very difficult to access finance from banks.

Lack of finance and Impact on Fund Performance

So we've had a liquidity issue within Fund X, maybe if we'd had another £10 million we could easily be looking at higher multiple. It was just that the whole credit crunch came, there were various debts in the companies and basically the bank pulled all from below us. So effectively you've got an illiquid fund and companies that are still growing, still cash hungry, so therefore you will lose them, which, unfortunately, is what happened.

6.18 The impact of dotcom crash represents the third secondary factor affecting fund performance. As one fund manager responsible for an IT-related fund reported, the fund had invested in companies that were in a telecommunications supply chain, which meant their goods and services were no longer needed when the internet bubble burst. The fund did not have sufficient finance to maintain investment whilst potential exit options were limited to five or six large companies purchasing the portfolio companies, which did not occur.

Impact of the dotcom crash on Fund Performance

The bursting of the internet bubble had the biggest effect on this Fund because what we saw accompanying the internet bubble was a massive wrap up of communication companies in capacity and technology. A lot of the companies that we backed were developing technologies to take advantage of that capacity or enlarge it so when the internet fell apart, the capacity just wasn't used. So that meant the telecoms companies largely went into a five year puddle where they didn't buy or develop anything so it was very difficult for our companies to persuade them that their technology was worth buying. If they couldn't persuade them their technology was worth buying, they were out of money. For us, you got to a point when there is only so much money you can put in to keep a company going.

6.19 Specific to the life sciences sector, changes in the pharmaceutical industry is the fourth of the secondary factors affecting performance. A fund manager investing in life-science companies reported that macro-developments within the pharmaceutical industry had directly affected the performance of the fund. At the time investment decisions were made, the fund invested in pre-trial companies because the pharmaceutical industry was interested in buying companies that had completed phase 1 trials. Over the following five years this changed as the industry focused its interest on companies completing phase 2 trials. This meant the fund had to retain companies longer in the portfolio than expected, which meant some were written off even though they would have been commercially viable in the long run.

Changes in the pharmaceutical industry and impact on Fund Performance

The market changed within the life science sector. ... When we started investing in this Fund, the market was attributing fairly significant values to companies and products that completed their phase one trials and so we tended to invest on that basis.... But, that market really changed and suddenly it was only interested in something that had phase two and even phase two B trial results. That meant we suddenly found ourselves with companies that we were having to back for far longer that we had originally anticipated – we were hoping that we would be able to back them through phase one and then exit or get a lucrative partner and deal with the major pharmaceutical company and that really didn't happen at all. So we found ourselves in a position where we could choose to fund through to phase two trials, which is expensive, or writing it off, and somebody took the option to write off because it just wasn't practical for us and the rest of the investment syndicate to go to the next stage.

6.20 Finally, a couple of the underlying funds changed management teams and this instability, along with a loss of knowledge about the portfolio, is seen to have affected performance.

6.21 In essence, the research findings show that it has been the combination of factors playing out together that has meant the fund performance has not been as positive as originally anticipated. The most prominent factors that hampered performance included paying too much for deals/companies and then not having sufficient funds to make follow on investments because of a lack of exit opportunities.

Overview of Bridges Fund Performance

6.22 As at 31st March 2010, the Bridges Funds (Part A and B) were in surplus with a positive interim pooled average internal rate of return.

Factors affecting the Performance of Bridges

6.23 Given that the Bridges Fund mandate is to invest in businesses that operate within the most disadvantaged areas of England, this overall performance is highly respectable. As a generalist fund Bridges has benefits from being able spread risk, indeed, this has been referenced by Bridges Ventures as one reason for the commercial success of the Fund. Good investment decisions have also contributed to success and there have only been a relatively small number of write-offs; so under-performing businesses have not been a drag on the rest of the Fund. The investment strategy has also contributed to success in the sense that the Fund specifically chose to invest in “consumer champion” type businesses (e.g. Simply Switch) or those offering value for money, a strategy aptly suited to customers living in deprived areas; conversely, luxury products or services were not backed. A positive by-product of this was that investee companies were fairly recession resilient. Finally, a significant factor contributing to the commercial success of Bridges Ventures is that part of its portfolio comprises property-backed businesses, which helped reduced the risk level of that part of the portfolio.

The Role of Capital for Enterprise

6.24 In the first eight years of operation, publicly backed equity finance schemes were supervised by officials in BIS and its predecessors. This changed in April 2008 when the Department established Capital for Enterprise Limited as a wholly-owned company to oversee its venture capital funds programmes and deliver finance measures in support of small businesses. The Department's rationale for establishing a separate delivery organisation was based on an identified need to professionalise Government interventions in the SME finance

market.⁵¹ It was established to undertake two key functions on behalf of the Department; firstly to monitor and report on the performance of the existing funds and, secondly, to act as an investor in new funds.

Monitoring the Performance of Fund Portfolios

6.25 Capital for Enterprise collects financial information from fund managers about portfolio performance, valuation and investment activity. With regards to the UKHTF, this information is collected from the Fund of Funds manager. The level of information required by the Department has increased for new programmes such as the UK Investment Innovation Fund where it has become interested in specific investment decisions. This is partly attributed to the involvement of several government departments in the design and establishment of the Fund.

6.26 Monitoring fund performance has improved over the years and this is attributed to more timely information given by fund managers, a higher level and standard of reporting, and regular communication between them and Capital for Enterprise. Capital for Enterprise has moved away from relying on the formal advisory committees as the primary mechanism for finding out about fund performance. It has encouraged fund managers to highlight and discuss issues as and when they emerge, as illustrated in the quotation below.

Communication and Identifying Challenges Early One

So we have informal meetings with our managers and we have a relationship where we expect them to get on the phone and tell us if there is a problem. ...we don't want to wait for the six monthly formal advisory committee or the report which is almost a quarter out of date anyway.

Managing and Monitoring Performance of Fund Managers

Monitoring the Performance of Fund Managers

... generally, what we do with any fund is we manage it; we keep an eye on it to make sure it is doing what it is supposed to be doing – we are there to help support the managers (Capital for Enterprise).

6.27 The quotation above captures the general way in which Capital for Enterprise manages and monitors the work of fund managers. It seeks to provide constructive support, yet it is rigorous in ensuring that fund managers are performing their roles and responsibilities effectively. Primarily, it uses informal approaches to address under performance, often working closely with investors. Indeed, private investors have turned to Capital for Enterprise when they are dissatisfied with fund manager performance, although not for Bridges or the UKHTF.

6.28 Over the years, there has been some learning in how to deal with or minimise under performance. Capital for Enterprise reports that new agreements are much better developed, they are clearer about the roles and responsibilities of each party and balanced more in favour of investors. For example, ten years ago Limited Partnerships tended to rely on a 'divorce' clause, whereby the manager could be removed by investors, to ensure that the manager stuck to the terms of the agreement however this was something of a "nuclear option because if you get rid of the manager half way through a fund, you risk losing a lot of value and because it is such disruptive thing it's not very effective in dealing with more minor

⁵¹ National Audit Office (2009) *Venture Capital Support to Small Businesses*. Report by the Comptroller and Auditor General.

disagreements". In trying to "re-balance" the relationship between investors and fund managers, Capital for Enterprise has introduced new terms into fund agreements. An example of this is that Fund managers will lose their fee on investments made outside the remit of the fund; they are unable to receive any carried interest on that investment and, if a loss is made, this has to be borne by the fund manager's share of carried interest. These terms are conditions are seen as more 'subtle' instruments to ensure fund manager performance.

Fund Management Fees

6.29 Fund managers of large commercial funds tend to receive a management fee of around 2 percent of the amount raised plus profit share referred to as 'carried interest'. As the government schemes are smaller, on some occasions, a higher management fee has been awarded. More recently, building on experience from the Regional Venture Capital Funds (and not UKHTF or Bridges), Capital for Enterprise has changed its preferred management fee arrangements so that the fees following the end of the investment period of funds better reflect the size of the portfolio that needs managing rather than being a percentage of the original and these now reflect the amount committed or number of investments and not the total size of the fund.

6.30 Fund managers also obtain fees from investee companies for initial transaction costs, ongoing monitoring and appointments of any non-executive directors. There is variation as to how these fees are distributed. Some fund managers directly receive these fees in which case their management fee should be lower to reflect this additional income. In other cases the fees are for the benefit of the partnership. CfEL do not prescribe any particular treatment but seek to ensure there is transparency with regards to all fees received by fund managers and that fees are not excessive.

Summary

6.31 The Government made a cornerstone investment of £20 million in the UKHTF, which raised over £100 million from institutional investors. The Fund invested in nine underlying funds which have between them invested in 245 companies, primarily at the early stage. Around half the investments were made in software and data processing companies or those operating in the natural sciences and engineering R&D. To date, the UKHTF has not performed as strongly as investors and fund managers would have liked. Fund performance has not been helped by the recent financial crisis, low valuation rates, limited exit options and constrains in making available follow on funding.

6.32 The Government invested £20 million in the UK's first community development venture capital fund, which secured an equal amount of match funding from private investors. Two funds were established and between them they invested in 40 companies, primarily located in London and the West Midlands. The Fund's financial performance to date indicates it has achieved one of its key objectives, which was to show that successful businesses could be created and developed in deprived communities.

6.33 The temptation to compare the results of the UKHTF with the Bridges Fund should be avoided. Investments were made at different periods, and the underlying UKHTF funds were restricted to high technology investments, which tend to be higher risk especially compared to a generalist fund with greater opportunity to spread risk such as Bridges.

6.34 Capital for Enterprise's main involvement with the UKHTF and Bridges centres on collecting monitoring information about fund performance and some wider intelligence about the market, which it finds very valuable. Capital for Enterprise was not involved in the design or structure of the funds or selecting fund managers. However, Capital for Enterprise has applied lessons from these and other earlier schemes to the way in which it oversees new funds.

7 THE BUSINESS PERSPECTIVE

7.1 Businesses that have received equity finance provide important insights about their motivations for seeking this form of finance and the impact it had on them. This chapter draws on findings from 26 interviews undertaken with businesses that received investment from the Bridges Fund and one of the nine underlying funds of the UKHTF. For simplicity, we use the term UKHTF respondents to refer to businesses that received investments from one of nine underlying funds into which the UKHTF invested. A total of 17 interviews were undertaken with those supported by one of the nine underlying funds and nine from the Bridges portfolio. The interviews were undertaken during January and February 2011.

7.2 Alongside these findings, the chapter also draws on the results of a survey undertaken by the National Audit Office (NAO), which was conducted in 2009 and directed at businesses receiving equity finance from several Government sponsored schemes. The study has been able to access the raw data results and isolate responses by each fund. The NAO study consulted with 35 businesses that received investment from a fund supported by UKHTF and 6 that received investment from Bridges.

7.3 This chapter focuses on the reasons why businesses sought equity finance, the strengths and drawbacks of doing so, and their views on the post-investment support they received. Chapter eight focuses more directly on the impact of the investment.

Awareness and Motivation

Awareness

7.4 Results from the NAO indicate that most businesses became aware of the funds through professional or personal contacts. These results are similar to the findings from the qualitative interviews undertaken by this study. Respondents stated that they became aware of Bridges Ventures or one of the underlying UKHTF funds through their accountants or advisors. They also drew on existing informal networks of contacts.

7.5 UKHTF respondents also mentioned that awareness stemmed from their previous experience of the venture capital market or involvement with a higher education institution. There is also an element of serendipity with entrepreneurs meeting venture capitalists at the right time and place. This appears to have been particularly pronounced in the technology market where entrepreneurs and venture capitalists attended sector specific events, on occasions knew each other before, and then followed up on ideas discussed at events.

Awareness

We found out about the fund by chance. I attended a conference in 2003 and a former colleague was at the same event, who happened to be a director at [the fund]. We discussed what each of us was doing and then [the fund] decided it would be interested in backing us. (UKHTF)

I had previous experience of using a venture capital model in another company, and we took this route to raise the expansion finance. It felt very important to have this experience and knowledge. (UKHTF)

The fund do a lot of work with universities and seed funding so we became aware of them through the university. (UKHTF)

I've been involved with the biotech sector for several years and I was aware of [the fund director] and

rated him very much. So [the fund] would have been a natural group for me to think about when considering funding.

Motivation

7.6 The UKHTF funding was used in line with the fund's objectives to finance start up and high growth businesses. The Bridges Fund could be used to finance later stage business, however funding was also most commonly used for start up capital, with a MBO cited by only one respondent. Businesses sought funding to provide working capital and in the case of the UKHTF, for prototype or product development and research. The motivations for seeking funding changed for second investments to reflect the developmental stage of the business, for instance financial support for product testing, developing global sales team or increasing staff numbers.

Motivations for Seeking Finance

We used the money to do research, develop the concept and then we piloted with a site and tested the market. (Bridges)

The money was used to start up the business having received seed funding from a university. (UKHTF)

Motivations for Seeking Finance – Further Funding Rounds

We wanted to develop an idea into a prototype, then needed the funding to get the product through the medical regulation trials and then for help with sales and marketing training. (UKHTF)

Alternatives to Equity Finance

7.7 The NAO data suggests that most Bridges and UKHTF respondents considered alternative or additional sources of finance at the time they were seeking investment from the two funds. In most cases this was other sources of venture capital as opposed to other types of finance such as loans.

7.8 To a large extent, the data aligns with the interview findings. One of the key (though unsurprising) themes that emerged from them was that venture capital finance continues to be used as a last resort. In many cases, businesses had first sought other forms of finance but after experiencing difficulties in raising the investment, they turned to venture capital. Businesses receiving UKHTF investment commonly stated the risk was too great for other finance providers. On a different note, several respondents receiving investment from the Bridges Fund reported they were attracted to the Fund because of the expertise of the Fund Manager.

Alternative Sources of Finance Considered

We looked at debt funding from the bank and it quickly became apparent that it wasn't going to be enough, so we had to look at venture capital. (Bridges)

Other options were explored. I spoke to a number of venture capital and private equity houses who had successfully invested in my other businesses ... I talked to a clearing house bank, but in the current market, that amount of debt was impossible to raise. (Bridges)

We knew it had to be venture capital in one form or another ... there is no alternative to venture capital; there is a definite funding gap for start ups. (UKHTF)

Venture capital is the only source of funds. Banks are not supportive of growth companies and venture capital fills a gap in the market. (UKHTF)

Venture capital funds will lend where others won't. (Bridges)

Strengths and Drawbacks of Equity Finance

7.9 Respondents identified access to post investment support as one of its key strengths and this is discussed later on in the chapter. A few of the high technology companies reported that this form of finance is more willing to invest in pre-turnover companies, and help them take their product to market or help them reach a point where another investor can support them with this. However, one respondent stated that within the current climate fund managers are increasingly looking for shorter term investment opportunities.

Strengths of Venture Capital

For the life sciences especially, it requires venture capital to go through the industry regulation and testing. Bank debt won't suffice as it would for a service or retail business where the revenue can be generated straight away, and funds from business angels or grants are too small. With this type of manufacturing, or manufacturing in general, there is a lot of resource intensive development work to do before profits are generated which is particularly knowledge intensive because there is a lot of new technology. (UKHTF)

We need investors that have patience, there may be slow take up and the business plan may change but continued venture capital support is critical. (UKHTF)

There is a tension between the time it takes to develop an idea and the depth of investor's pockets. The time horizon of a fund is typically ten years and that's how long the business has been going – it takes a long time to develop a product. This is a growing tension in the venture capital market and this forces businesses to be quite 'short-termist'. (UKHTF)

7.10 There were three key weaknesses of venture capital funding identified through the interviews: (i) the company receives a small number of investments within one round rather than a single capital investment; (ii) entrepreneurs need to concede some loss of control over their business; (iii) it is an expensive way to access investment.

7.11 Venture capital investments are commonly tied to milestones in the business development process. Therefore smaller amounts of capital are invested, which minimises the potential losses for the investor. This was reported to be detrimental for the business as the CEO's time is directed to seeking further finance rather than focusing on growth, which also lead to concerns as to whether the fund would be able to supply additional investment in the future. This was most commonly reported by respondents receiving UKHTF investment largely due to the high technology sector of operation and associated product development.

Weaknesses of Venture Capital – Investments Linked to Milestones

"That drip drip investment feeding is very time consuming and damages the business. It means senior directors; founders are constantly going round looking for investment, which diverts them from the business. There's no risk tolerance in the UK. Companies have to constantly meet milestones to get more funding, which inhibits the growth of business. (UKHTF)

I know for a fact that [the fund]'s been frustrated and they would have invested to a greater extent if they had access to funding. So it's been frustrating for both [the fund] and [the business] ... we've

had to constantly look for other investors and funds. (UKHTF)

My only concern was that, if the business wasn't as successful as we thought and we needed to go back for more funding, were [the fund]'s pockets deep enough? (UKHTF)

7.12 There is a perception amongst entrepreneurs that venture capital leads to some loss of control over their business and respondents stated they were concerned about fund manager's influence on corporate decision making and the post-investment relationship. Related to this, a small number of businesses reported they struggled to achieve an investment deal they were happy with.

Weaknesses of Venture Capital – Business Control

I was concerned for three main reasons: (a) giving up equity; (b) venture capital funds have a reputation that they only look out for themselves and they're not as sympathetic to business manager, that they do what is right from them rather than the company; (c) also concerned that the fund manager might take decisions that management might not agree with. But those concerns were not realised with Bridges. (Bridges)

I was conscious not to give any one a majority stake, so the venture capital funds have between 20-25% stake each. The CEO had bad experience of a previous company where the fund had a majority stake. (UKHTF)

Venture capital funds are tough financial partners and it's hard to get a deal you're happy with. I would recommend it but with the caution that it will be tough. They want to get their cake and eat it. (Bridges)

7.13 Businesses also stated that venture capital is an expensive form of finance, although they were less anxious about this than loss of control or accessing follow on investment.

7.14 Findings from the business interviews also showed some criticism of the wider venture capital market, with respondents reporting that the UK venture capital market has a higher aversion to risk than in the US, which is more accepting of investment write offs.

Variance between Application and Approved Investment

7.15 All businesses consulted as part of this study received the full amount of capital they were originally seeking from their respective fund and a minority received a higher amount. As a result, they were satisfied with the amount received.

Follow On Investment

7.16 The NAO results show that of those businesses that secured follow on investment, they primarily did so from venture capital.

7.17 In the present study, respondents received between two and six rounds of follow on investment. The initial funding was a catalyst in securing future investment. This is because the initial investment grew the business sufficiently to require another round, and also the presence of a large investor gave other investors confidence to invest in further rounds.

Importance of the Fund for Follow On Investments

The additional investment is entirely due to initial investment. I would say it has given other investors confidence to lend to us. (UKHTF)

First funding round paved the way to allow the company to achieve commercial milestones. (UKHTF)

The initial investment has helped secure more funding. Once you have a strong, large lead investor this attracts other smaller investors. (UKHTF)

"If you're having a discussion with a bank, having a venture capital fund on board gives you credibility and weight." – Business (Bridges)

7.18 The findings above are reflected in the NAO data, which also indicate that accessing additional finance was a lot easier having received the initial investment from the fund.

Likely Business Scenario in the Absence of the Bridges Fund and Underlying Funds

7.19 The NAO data shows that many businesses felt confident that they would have found the investment from elsewhere. However, in the main, businesses interviewed by this study who received investments from the Bridges Fund reported that start up or expansion activity would not have gone ahead in its absence. One respondent stated that whilst it would have been possible to establish the business without Bridges, it would not have grown as fast without the financial commitment from the Fund or the post investment support that has been provided. Only three respondents stated that they would not have been adversely affected without the availability of Bridges Funding as they would have found alternative investment.

The Impact of the Bridges Fund

Without Bridges the transaction wouldn't have gone through, there's absolute certainty about that. Without Bridges funding, there wouldn't have been any point in the bank putting in £1.25 million and the bank wouldn't have put in the whole amount. In the last few years, venture capital has been the only place to go to get investment. (Bridges)

7.20 There appears to be (more or less) an even split between businesses receiving investment from one of the underlying funds of the UKHTF. Around half that were consulted reported they were in negotiation with other venture capitalists at the same time as they were discussing a deal with the underlying fund. Others report they did not have other financial options and without investment from the underlying fund, it would have taken longer to take forward their plans.

Investment Process

7.21 The NAO findings show that the majority of businesses developed a business plan as part of the application process, which they found to be very beneficial. The majority also found the application process to be easy. This is reiterated by qualitative interviews undertaken by this study where the majority of businesses were satisfied with the negotiations and investment structure.

7.22 The decision as whether or not to accept an investment offer was influenced by the personal relationship with the fund manager. Further, on occasions the investment built on a previous working relationship between the business and fund manager.

Relationship with the Fund Manager
<i>The chemistry was good and I knew [the fund director] from before. (UKHTF)</i>
<i>It was incredibly hard at that point to get funding and so the personal relationship with [the fund] helped because I could talk about the vision I had with them in a way I couldn't with other venture capital funds. (UKHTF)</i>
<i>We had a personal contact with the Bridges, as me and another partner had worked with them before. (Bridges)</i>

7.23 Other factors that encouraged respondents to choose the UKHTF or the offer from the Bridges Fund included the fund manager's knowledge and experience of their sector, reputation and their location. One business that received investment from the Bridges Fund also reported that the social ethos of the fund fitted with their business activity.

Post Investment Support and Impact

The Fund Manager Role

7.24 The findings from the NAO survey regarding post investment support, shows the fund manager provided advice across a number of areas. In particular around the appointment of non-Executive Directors, help raising further finance and developing business plans and strategy.

7.25 The NAO data is reflected in the interview findings, with all respondents stating that the fund manager acted or appointed a non executive director on the company board. The fund manager's guidance on strategic direction, sector knowledge, the business model, recruitment and finance have been well received by businesses. Businesses reported the non executive director provided a balanced opinion on business decisions and acted as a sounding board for ideas, alongside providing support and encouragement on a personal level.

7.26 Overall, the majority of businesses reported the post investment support struck the right balance between 'hands on' and 'hands off' involvement. Respondents stated they were in contact with the fund manager on average once a month and they were satisfied with the level of engagement.

Added Value of Post Investment Support

7.27 Post investment business support is considered to be an advantage of venture capital investment. The added value that the fund manager brought to the deal in experience and connections has been well received by businesses, particularly in dealing with unexpected business situations and knowing they have a source of support should the business run into difficulties. Respondents also appreciated the fund manager's belief in the business concept at the outset.

Post Investment Support

One of the strengths of venture capital or private equity funding is that once a commitment has been made, partners have a vested interest in making the business as successful as possible. If you hit problems, it's in their interest to get you back on track. It's very different for a clearing bank where if you're in trouble they don't really help you out. They only give you money when you're doing well. (Bridges)

They have good early stage project experience. They stuck with us in the face of the unexpected. (UKHTF)

Their willingness to invest and belief in the company were the main reasons we went with [the fund]. (UKHTF)

[The fund manager] has introduced us to some big customers. (UKHTF)

Having the venture capital backing gives you access to a network of investors and makes the business look stronger financially. It gives us clout when approaching bigger clients that would not normally purchase from a small, start up company. We operate in a market that is used to small businesses but this gives us some support and clout. (Bridges)

7.28 The post investment support has added value to the business, with the majority of respondents reporting the business would be slightly behind where they are currently without the support.

Post Investment Support

Bridges offered and combined commercial and financial experience which was and has been very helpful to us given our aggressive expansion plan. (Bridges)

Summary and Conclusions

7.29 Venture capital is a key source of finance for start up and early growth businesses and is often the only option for early stage and start up businesses. Respondents are largely positive regarding their experience of venture capital despite the drawbacks for businesses associated with this form of investment. The interviews highlight the importance of networking and professional connections in making companies aware of the fund.

7.30 The post investment support has been well received by respondents and many have a strong working relationship with the fund manager who has provided valuable strategic advice and support. This support is considered to be a key strength of this form of finance. The funding has been a catalyst for securing further investment, giving other investors confidence to lend and share risk.

7.31 In contrast to the NAO survey, the respondents reported a high level of additionality with the majority reporting the business would not be in existence in the absence of the fund. This may result of the more open questions used in the current study or differences in the businesses interviewed.

8 THE IMPACT OF UKHTF AND BRIDGES

8.1 This section focuses on the impact the two funds have had on recipient businesses and the wider economy, the target areas covered by Bridges, the impact on fund managers, as well as the operation of financial markets.

The Economic Impact of UKHTF and Bridges

8.2 This section reports on the role and contribution of each fund towards innovation, turnover, profits and employment. Additional impacts identified by businesses are also reported on.

Innovation

8.3 The 2009 NAO survey found that a high proportion of investee companies had introduced new and improved products or services as a result of investment received from publicly backed equity schemes. Perhaps unsurprisingly, this proportion was highest for those receiving investment from the UKHTF. Nearly three quarters of UKHTF respondents reported that their innovation was new to the market.

8.4 These findings are supported by the qualitative interviews undertaken by this study, with the majority of businesses reporting the introduction of a new product or service. UKHTF businesses were most likely to cite one or two products brought to market, typically after several years of development. In the case of businesses that received funding from the UKHTF, unsurprisingly, new products involved knowledge intensive technologies.

Innovation for New Starts

We were entering a crowded market. Our strategy was to innovate with human and medical evidence. That is why we built the manufacturing facility [for the development of a new surgical compound now in use by surgeons in more than 30 countries]. Without the investment, we could have still been working from a lab in the university. (UKHTF)

We have introduced a new product and have sold 100m units to date. Without the fund, the project would not have gone ahead. (UKHTF)

8.5 The route taken to introduce new innovations did not vary much between companies. The majority originated within businesses, either as the core business concept for new starts or as new R&D developments within more mature companies. The added value of the investment was high, with the majority of interviewed businesses reporting that they would not have been able to launch the innovation without the investment.

8.6 A small number of investee businesses introduced innovations through taking over other businesses, although these developments were less likely to be attributable to the funding and were more likely to have gone ahead anyway.

Innovation for Growing Companies

We've developed new technology... the funding has allowed us to get the people, the software and hardware in the right place to allow this to happen. (UKHTF)

We have introduced a new product and we now operate in 40 different countries, 80% of our sales are from overseas, China is one of our biggest exports. (UKHTF)

We have revamped our product range which has gone from 100 to 300. (Bridges)

Entry into New Markets

8.7 A high proportion of businesses reported they had entered new markets as a result of the investment they had received and this was particularly evident amongst those that had introduced a new product or service.

New Markets for Existing Products

We're now expanding into the western market looking at Germany and other western European countries. We are looking to double the top line and increase employment by as much. (Bridges)

Our first site opened in 2008 and in two and a half years, a further 13 sites were opened, so expansion has been very fast. We plan to have 50 sites by 2012. (Bridges)

8.8 A further route to expansion has been through the active take-over of competitor or complementary businesses. However, expansion into these new markets would be more accurately described as 'new' for the business itself rather than an entirely new market development that the funding has in itself helped to create.

8.9 A high proportion of interviewed businesses reported that entry into new markets had been helped particularly by the active sector knowledge and networking of their respective fund managers. Added value around introductions and new opportunities was viewed as considerable and would not have been achieved through alternative routes to funding.

New Markets for New Products

We've made six acquisitions in the last two years. We now employ 105 people and in 2008, we employed 30. Turnover in 2008 was £3m and this year it's £16m. (UKHTF)

Also important was the networking that each of the fund reps undertook and fed new opportunities into the company. Greatest impact from the support probably came around sector networking knowledge rather than corporate management knowledge. (UKHTF)

Profile and Credibility

8.10 A number of businesses noted that engagement with their specific venture fund(s) had the effect of raising their business profile and/or credibility within their field among potential customers and other investors.

8.11 A high proportion of Bridges investee companies cited that their engagement with Bridges had helped to increase their profile among customers and, in particular, that it had been an effective means of promoting their corporate social responsibility. Indeed, some of them attributed entry into new markets and new sales as a direct result of the positive social image generated through the Bridges investment, for example, one company was able to raise its profile and sign up new customers to its service because it was viewed by these customers as being more socially responsible than its competitors.

8.12 Increased technical and corporate credibility was most typically reported by UKHTF businesses, but also applied to some Bridges businesses too. In highly specialised technologies, the Board input of a well-recognised industry venture fund was highly important in giving potential customers, clients and other investors' confidence in the business, and a greater chance of securing follow-on investment from other investors.

Profile and Credibility

Another benefit is that if you have a discussion with the bank, having a venture capital fund on board gives you more credibility and weight. (Bridges)

This initial investment has helped us secure more funding. Once you have a strong lead investor, this attracts other smaller investors. (UKHTF)

[The funding] helped the company to raise its profile and credibility of having a big venture capital fund backing it. Bridges helped the company against competitors – it was seen as socially responsible. (Bridges)

Management Improvements

8.13 Several businesses, particularly new start or smaller businesses, reported significant improvements to working practices and management techniques attributable to the post-investment support from Board directors representing the funds. This valuable corporate knowledge was used to help steer business growth, and give confidence in the company's ability to develop. As well as a business improvement in itself, in some cases, investees reported that it had led to increased productivity and that it had accentuated other benefits such as innovation and entry into new markets.

Managing Growth

Bridges has made us operate in a more formal manner. If the company was opened just by the management team, it would be less formal and less structured... Bridges has brought in discipline and structure, and if we didn't have that we would lose out. (Bridges)

The Board support is very, very valuable. Sector expertise, experience of dealing in corporate matters and networking intelligence. Hired business consultants just wouldn't be able to provide this level of quality input. (UKHTF)

Employment

8.14 The 2009 NAO survey found that all of the interviewed Bridges businesses and the majority of the UKHTF businesses had increased employment since receiving the funding. This study found similar findings with nearly all respondents reporting positive employment impacts. In part, this is because the investments were made in new starts or early stage ventures and so employment levels began from a low base.

8.15 Most of the interviewed UKHTF or Bridges businesses now employ between 10 and 50 staff representing growth of over 10% for almost all businesses. Two businesses that received UKHTF funding cited an increase of over 100 employees within a period of 18 months. Of those businesses reporting the highest increases in employment, two are investee businesses that have taken over other businesses and incorporated these new staff. However, there are other examples of businesses creating significant employment growth due to internal development. For example, one of the UKHTF companies launched an international sales drive which led to the recruitment of up to 50 people in under a year.

Increasing Employment

Employment before Bridges was 23 and it is now 63. All live in the surrounding deprived area. (Bridges)

New product development has necessitated increased employment. This has increased from 30-40 in 2003 to 260 today, turnover has increased from £2m to £21m. (UKHTF)

Without the venture capital fund, the product development would have taken place but we wouldn't have been able to enact the growth plan and turn the product into a viable service, with employment that comes with this. (UKHTF)

Turnover

8.16 The 2009 NAO research found that a high proportion of UKHTF businesses and all of the Bridges businesses had achieved turnover increases since receiving investment. This finding was corroborated through the latest interviews of businesses.

8.17 The high proportion of start-up and early stage businesses in the fund profiles meant that over half of the interviewed businesses began earning turnover from a low base. Four of these early stage respondent businesses have moved from pre-turnover stage to turnover of several million pounds per annum. Investments in businesses at a more mature stage have generally led to absolute increases in turnover that have been even greater. For example, one business with a turnover of several million dollars reported an increase of 20-30% through the development that UKHTF had funded.

8.18 Where turnover growth has been low, this has often been due to investment in early stage technologies where commercialisation can take a decade or longer, and this lag has been accentuated further by the effects of the 2009 recession. In these instances of long-term commercial development, more typical of UKHTF, the step up to a significant level of turnover is often dependent on a business securing one or more commercial contracts several years after the initial investment. Alternatively, other businesses have experienced low growth rates due to investment purely in working capital or running costs rather than expansion, or otherwise due to a host of reasons where growth has perhaps not been as high as was anticipated.

8.19 The extent to which turnover impacts are attributable to the funds varies, from start-up businesses in deprived areas relying on a single Bridges Fund investment (high attribution) through to high growth technology businesses undergoing several syndicated funding rounds (lower attribution). In keeping with this spectrum, a high number of interviewed businesses did not think that any turnover impacts would have been possible without the applicable fund. However, an equal number gave a moderated response suggesting that the UKHTF and Bridges Fund played their part in the business growth but alongside other key partners too. None of the businesses reported that lack of equity from UKHTF or the Bridges Fund would have simply delayed their activity, although others felt the absence of the funding would have certainly reduced the levels of turnover they currently achieve. Only two investees, experiencing rapid growth, felt that their business turnover would be at the level it is now anyway, even without the investment.

Increasing Turnover

The second round of [UKHTF] funding meant that we invested in development and got a significant deal with a pharma company. (UKHTF)

We have gone from 6-8 employees to 50 and increased turnover from \$0 to \$7.5m last year. (UKHTF)

We have increased the number of people we employ up to 60 and turnover has gone from \$0 to \$17m last year. (UKHTF)

In the absence of the venture capital fund investment, the company would have folded. (UKHTF)

The Social Impact of the Bridges Fund

8.20 This section focuses specifically on the Bridges Fund and the social and regeneration benefits it has delivered in disadvantaged areas. It is important to note at the outset that Bridges Ventures compiles a Social IMPACT Scorecard which is reported to investors alongside financial returns. The scorecard is built upon standard regeneration measures and pre-agreed company-specific metrics provided by the investees (such as reduced energy consumption, investment in training and trade with local suppliers), along with other issues relating to governance. The Bridges Ventures Social Impact Report (2009) assessed impact against regeneration and sustainability and these categories are similarly followed below.

Regeneration

8.21 As per the Bridges eligibility criteria, investee companies are expected to evidence that they have valid economic linkages to the disadvantaged communities where they operate (most deprived 25% of the country):

Economic linkages show the percentage of a company's employees, wages, suppliers and customers who are located in regeneration areas. Bridges Ventures typically targets at least 35% in at least one of these categories. (Bridges Social Impact Report 2009).

8.22 Further, the 2009 Bridges Social Impact Report found that, of all 1,300 employed by investee companies at the time, just over 500 lived in target areas and 200 were previously unemployed.

8.23 Businesses interviewed by this study similarly reported social impacts in the form of local employment creation. This employment has subsequent indirect spend benefits as employees based in the local area spend their earnings in other local businesses. As noted in the employment section above, over half of investee businesses (and this equally applies to Bridges) recognised that employment growth was attributable to securing the investment. Of note, a higher proportion would not have opened premises, and subsequently created employment, in disadvantaged areas had it not been for Bridges.

8.24 Three businesses reported sourcing from local suppliers, with one noting that this comprised the majority of their purchasing and another stating it was nearly two thirds. Local property-spend multiplier benefits have also been achieved by just under half of the Bridges businesses when they first set up in the regeneration area. In total, the 2009 Bridges Social Impact Report estimated that every £1 of Bridges investment had led to £2.50 GVA in the target areas.

Regeneration
<i>Most of the staff are from the local community and don't drive more than 20 minutes to get to work. (Bridges)</i>
<i>Most of the staff are from the local community. Most of our suppliers are sourced locally like cleaning, fit out, plumbers and electricians, etc. (Bridges)</i>
<i>We do purchase from suppliers in disadvantaged areas. We weren't encouraged to do so though from Bridges. We have taken on 7-8 people that were previously unemployed and all staff receive training. (Bridges)</i>
<i>The company was based in a regeneration area of the North East. Of 100 people in the call centre,</i>

35% were from disadvantaged areas. (Bridges)

Sustainability

8.25 The majority of the Bridges Fund investees have a strong belief in social-sustainable objectives, and advocate corporate social responsibilities. By helping these businesses to start up or grow, Bridges Ventures has enabled a wide range of benefits including environmental sustainability, local health and education – as reported through the Social IMPACT Scorecard. One respondent reported that investment in their core business activity had helped them to achieve substantive environmental benefits and that Bridges Ventures had been supportive in providing additional funding to maximise these benefits.

8.26 Elsewhere, one of the respondents emphasised how their business ethos had promoted consumer interests whilst another noted that Bridges Ventures had allowed them to provide health services at an affordable price within local deprived areas.

8.27 As well as the sustainability impacts that are attributable to investees' core business activity, several businesses have made conscious decisions and funded interventions to improve their local areas. For example, one business based in a disadvantaged area of the North East encouraged and facilitated staff time in local charity work. Also, three of the businesses reported providing training to staff, although there is no evidence to suggest that Bridges Ventures encouraged businesses to provide training that would not have done so otherwise.

Sustainability

We have supported eco friendly developments, it's another string to our bow and Bridges have been supportive. It takes more money to do it properly and they've supplied us with the extra money to do this. (Bridges)

We fit Bridges investment criteria in terms of health and social mission. We're energy efficient, the demographics of our clients fits with Bridges. Also, 75% of our sites are in disadvantaged areas which also meet Bridges criteria... [our client base] spans the whole social spectrum from social groups A-E. (Bridges)

The business believes in training for recruits and is supportive of apprenticeships, not just at a minimum wage but a proper wage. Good training shows strong support for the workforce. We believed this before Bridges. (Bridges)

10% of the workforce was previously unemployed, we've provided training – a mix of in house and external courses. (Bridges)

The Impact on Fund Managers

8.28 This section outlines the way in which the UKHTF and Bridges have made an impact on fund managers. It considers their ability to raise further funds and the lessons they learnt about fund structure and, in the case of the UKHTF, how to deal with under-performing companies.

Raising Follow on Investments

8.29 As noted in chapter five, Bridges Ventures raised a second fund, but it was only able to do so because of the Government's involvement in the first. Capital for Enterprise regards this as a "good impact" with Bridges Fund I legitimising the concept of social investment and demonstrating the financial returns that can be made.

8.30 The UKHTF Fund of Funds Manager also raised a second €70 million technology fund without Government support, although its success in doing so does not appear to be directly attributable to the role of the Government in the same way as Bridges Ventures. The Fund of Funds Manager has been trying to raise a third technology fund but has found it very difficult within the current economic climate. This issue is discussed further when considering the impact of the two funds on the market and the supply of equity finance.

Selecting Underlying Funds– Lessons Learnt

8.31 As a direct result of being involved in the UKHTF, the Fund of Funds Manager identified several ways in which the criteria for managing and selecting underlying funds has changed. These are:

- Equal weighting is given to each underlying fund with all receiving the same level of investment. As shown in chapter six, the underlying funds received different amounts of investment from the UKHTF.
- All geographical restrictions have been removed and the Fund of Funds Manager no longer confines investment to the UK. There is a perception that the funds could have performed somewhat better if they were able to invest in Europe.
- The due diligence process now focuses on the size of the fund, the investments strategy and capacity for making follow on investments. Unlike before, the Fund of Funds Manager now only makes investments if a fund reaches a minimum size, although it finds this difficult as other investors do not impose the same condition.
- Management fees are also examined much more closely at the due diligence process. The Fund of Funds Manager not only examines the management fee raised on a new fund, but also those from previous funds to ensure that the group is not making a profit from the fees it levies.

Lessons Learnt by Underlying Fund Managers

8.32 The underlying fund managers identified three key ways in which they had changed practices as result of their experience with the UKHTF. First, they have developed strategies to reduce the risk of write-offs and an under-performing portfolio. They are more likely to make several tranche investments in a company and to link these to milestones. They are also more likely to pull out of a company faster than they were before.

8.33 Second, fund managers try to ensure their portfolio is better balanced between the number of investments made in start-up and early stage companies. In particular, at the beginning of a fund's life, managers believe it is important to ensure they invest in a number of companies at the latter stages of development (albeit those still considered to be early stage). The idea behind this is that the fund should be able to exit from them without too much difficulty and produce a return for investors during the life of the fund. Experience from the UKHTF showed that, when this does not occur, the fund's finances are constrained and investors become disgruntled.

8.34 Third and following on from the above, there is anecdotal evidence that fund managers are investing in the life sciences are opting to do so primarily in companies at the later stages of development to enhance their potential of making a return. It appears there has been much debate within the industry regarding the suitability of venture capital as a form of investment for seed and early stage companies operating in some high technology sectors, such as life sciences because long gestation periods makes it difficult to achieve a return during the life of the portfolio.

The Impact on the Market

8.35 This section examines the extent to which the two funds have increased the supply of equity finance and stimulated the private market.

Increasing the Supply of Equity Finance

8.36 There appears to be little doubt that the first Bridges fund helped increase the supply of equity finance in the area of the market targeted. The interviews and the survey data from the NAO study show that the Fund made investments available to companies that would have faced significant difficulties raising the finance from elsewhere. It also acted as a catalyst for the management team to raise another fund, and has contributed to the growth of the community development venture market more widely. The growing interest in social investment and various forms of community development financial instruments can partly be attributable to the success of the Bridges Fund.

8.37 The role that the UKHTF played with regards to increasing the supply of equity finance is much more equivocal. There is a consensus that the rationale behind it was right, but the timing was wrong. As discussed in chapter four, the Fund was introduced during the dotcom bubble and the supply of equity finance was already high. As a result, the Fund was too small to make a significant contribution to increasing the overall supply of venture capital. There appears to be a consensus amongst fund managers that the Government should intervene through initiatives like the UKHTF when there is a limited supply of finance, rather like the current situation.

Stimulating the Private Market

8.38 It was intended that the UKHTF and the Bridges Fund would attract new investors by demonstrating that good financial returns can be made from investing in companies experimenting with new technology or located in disadvantaged areas. However, two key factors have hampered the growth and development of the venture capital market in the way envisaged by the Government when it designed the first set of equity finance schemes. Indeed, is a consensus amongst fund managers that the venture capital market is in difficulty, as it is proving extremely difficult to raise new funds. Primarily, this is attributed to the lack of commercial returns, which in turn, has undermined investor confidence.

Difficulties in raising new funds

Now, some of these fund managers are struggling to raise other funds because UK venture has not been successful. They haven't been able to demonstrate returns so it's very difficult to fundraise even though they've learned a lot and should be able to manage portfolios much better going forward.

If the sector had made a good return for investors then naturally they would've been happy to follow on with the sector, so it really does all come back to return... [This] is the single biggest issue affecting investors going forward... Investors have had their fingers burned so it is very difficult for them to get that confidence to go back into the market.

8.39 As discussed elsewhere, the difficulties in raising new funds is having is having knock-on effects on the industry in several ways. There is a shift towards supporting later stage investments, which fund managers view with concern because if nobody is willing to fund early stage investments, then the opportunities for funding them at a later stage do not arise. A couple of managers also expressed concern about the possibility of academics and scientists no longer being exposed to the venture capital and financial community because of the shift to later stage investments.

8.40 There is a further consensus that the difficulties in raising new funds means the equity gap has become more pronounced. Companies seeking first time investments are finding it difficult to access equity finance, whilst those in existing portfolios are finding it difficult to raise follow on funding. The loss of fund managers from the venture capital industry represents another knock-on effect. There is some equivocation as to whether this is positive or negative outcome. Some respondents believe that it is the poor performing managers that have left, leaving behind the most skilled and experienced.

8.41 Taking all these developments together, fund managers believe that that the industry has gone back ten years. The irony is, however, that many believe the quality of investment opportunities has increased. Partly because of low prices, fund managers believe that investors who are willing to finance companies now are likely to experience good financial returns going forward. Indeed, some of them thought that fund managers from the USA will take advantage of UK and European investment opportunities because they represent good value for money.

Market failure and the Difficulties facing the Venture Capital Market

We're back to the situation where a lot of new venture capital funds that started up in the early 2000s aren't going for another fund; their first fund is effectively just winding down and they won't be looking for another fund. A lot of the more traditional players actually don't have a huge amount of money... So there's not much money around at the moment... the majority of money is being used to support the existing portfolio and enhance company values, which is an incredibly sensible thing to do...

Most companies are finding that there are fewer and fewer venture funds being raised now, which means their capital is shrinking, especially when you combine that with the complete unwillingness of the banking sector to commit to anything with any element of risk. For those of us who are still in business, we are seeing companies more eager for our capital and willing to give us far better terms. The difference in the prices that we have been investing for the last five years compared to the prices that we invested in this Fund are chalk and cheese, a factor of two to three times the difference for comparable companies.

There are fewer investors now, even some of the longer term investors in venture are saying that we will sit this one out, see the returns come through and then we will invest in the next cycle. So I think its really difficult for some of managers now, even though they are all saying that there are fantastic deals around, fantastic pricing, good opportunities and very little competition in Europe. I mean, the worry is

that the US guys will start to come over because its much better value over here; and we should be doing it ourselves really.

The Development of New Investor Networks

8.42 The study has not found any evidence of new investor networks being established as a result of the two Funds. However, a common thread running throughout the stakeholder and business interviews is that the industry is built on personal relationships and networking. This goes back to the Fund of Funds Manager selecting underlying fund managers from previous knowledge of them. Fund managers tend to rely on each other to find out about investment opportunities. Businesses seek funding for new projects from fund managers that have backed them in the past. Indeed, a number of deals have occurred through chance, being at the right conference and meeting old acquaintances. Interviews with the UKHTF fund managers in particular convey the marketplace to be fairly small with most players aware of each other and, in the right circumstances, happy to collaborate.

Summary

8.43 The interviews with businesses found that most of them had introduced a new product or service as a direct result of the investment they received from the UKHTF and, to some extent, from the Bridges Fund. Additionality was high with respondents stating they would not have been able to innovate without the investment received. New innovations enabled respondents to enter new markets. The research findings also indicate that most respondents increased employment and turnover. There were other ways in which businesses benefited from the investment they received. A number of them reported that the funds increased their profile and/or credibility amongst other investors, which led to follow on investments. Businesses receiving investment from Bridges reported that the Fund enhanced their credibility with potential customers.

8.44 The UKHTF and the Bridges Fund have also impacted on fund managers. The Bridges Fund was able to raise a second fund. The UKHTF fund managers have learnt lessons from their experience. The Fund of Funds Manager identified several ways in which the criteria for managing and selecting underlying funds have changed. The underlying fund managers identified several ways in which they had changed their portfolio management practices

8.45 The first Bridges Fund helped increase the supply of equity finance to a market that did not exist before it was established. However, the UKHTF was introduced during the dotcom bubble when the supply of equity finance was high. As a result, the Fund was too small to make a significant contribution to increasing the overall supply of venture capital.

8.46 It was intended that the UKHTF and the Bridges Funds would attract new investors. However, currently, it is extremely difficult to raise new funds and this is primarily attributed to the lack of commercial returns, which in turn, has undermined investor confidence. Overall, fund managers believe that that the industry has gone back ten years. The irony is, however, that many believe the quality of investment opportunities has increased.

8.47 The study has not found any evidence of new investor networks being established as a result of the two funds. However, a common thread running throughout the stakeholder and business interviews is that the industry is built on personal relationships and networking.

9 STUDY CONCLUSIONS

9.1 This chapter sets out the study conclusions against its key research questions.

Increasing the Supply of Equity Finance

9.2 This study highlights that a recognised funding (equity) gap continues to exist for high growth firms seeking capital investments in amounts too large for business angels and too small for traditional private equity funds.⁵² This prompted the Department of Business, Innovation and Skills (BIS) and its predecessors to initiate a range of venture capital schemes, including the UK High Technology Fund of Funds (UKHTF in 2000, and Bridges - the Community Development Ventures Fund (2002).

9.3 The evaluation has found that there is little doubt that the first Bridges Fund helped increase the supply of equity finance to a market that did not exist before it was established. It made investments available to companies that could not raise other forms of finance. It also acted as a catalyst for the management team to raise another fund, and has contributed to the growth of the community development venture market more widely. The role that the UKHTF played with regards to increasing the supply of equity finance is much more equivocal. There is a consensus that the rationale behind the Fund was right, but the timing was wrong. The Fund was introduced during the dotcom bubble when the supply of equity finance was high - overpriced investments hindered its performance and ultimately its ability to make a significant contribution to increasing the overall supply of venture capital.

9.4 It was intended that the UKHTF and the Bridges Fund would attract new investors by demonstrating that good financial returns can be made from investing in companies experimenting with new technology or located in disadvantaged areas. However, currently, it is extremely difficult to raise new funds and this is primarily attributed to the lack of commercial returns, which in turn, has undermined investor confidence. This is resulting in a shift towards supporting later stage investments, a more pronounced equity gap and a loss of fund managers to the small equity sector. Fund managers believe that with an unhelpful economic market since the financial crisis the industry has regressed, despite an increased quality of investment opportunities.

Impacts on the Growth of recipient businesses and UK economy

9.5 Most of the business respondents had sought alternative forms of investment before turning to equity finance. Indeed, one of the key themes that emerged from the interviews with businesses was that venture capital continues to be perceived as a last resort source of finance.

9.6 The interviews with businesses found that most of them had introduced a new product or service as a direct result of the investment they received from the UKHTF and, to some extent, from the Bridges Fund. Additionality was high with respondents consulted as part of this review stating they would not have been able to innovate without the investment received. New innovations enabled respondents to enter new markets.

⁵²See for instance: DTI (1999) *Addressing the SME Equity Gap: support for regional venture capital funds*. Consultation Document; HM Treasury and Small Business Service (2003) *Bridging the Finance Gap: next steps in improving access to growth capital for small businesses*.

9.7 Virtually all the respondents reported that they had increased employment since receiving investment from the UKHTF or the Bridges Fund. Increased turnover has also been realised, although as with employment, for some, this represented an increase from a low or non-existent base. There are several examples of businesses moving from pre-turnover stage to turnover of several million pounds per annum. Where turnover growth has been low, this has often been due to investment in early stage technologies where commercialisation can take a decade or longer. The extent to which turnover outcomes are attributable to the funds varies, from start-up businesses in deprived areas relying on a single Bridges Fund investment (high attribution) through to high growth technology businesses undergoing several syndicated funding rounds (lower attribution).

9.8 There were other ways in which businesses benefited from the investment they received including an increased profile and/or credibility amongst other investors, which led to follow on investments or in the case of Bridges Ventures, credibility with potential customers. Post investment support had strengthened corporate governance and management techniques in many instances. Respondents were able to raise subsequent rounds of follow on investment with the initial funding acting as a catalyst in securing future investment. This is because the initial investment grew the business sufficiently to require another round, and also the presence of a large investor gave other investors confidence to invest in further rounds.

9.9 The Bridges Fund compiles a Social IMPACT Scorecard, which is reported to investors alongside financial returns. The scorecard is built upon standard regeneration measures and pre-agreed company-specific metrics provided by the investees. Respondents reported they provide employment to people from deprived communities or backgrounds. In addition, the employment created by the investee created multiplier benefits through their spend in the local economy from the earnings they received. A small number of respondents also reported that they use local suppliers.

Impacts on the Fund Managers

9.10 The UKHTF and Bridges Funds have also impacted on fund managers. Bridges Ventures raised a second fund due to the Government's involvement in the first. In effect, the first Bridges Fund legitimised the concept of social investment. The UKHTF Fund of Funds Manager also raised a second €70 million technology fund without Government support, although its success in doing so does not appear to be directly attributable to the role of the Government in the same way as Bridges Ventures. The Fund of Funds Manager has been trying to raise a third technology fund but has found it very difficult within the current economic climate.

9.11 As well as being able to raise follow-on investment, there are other ways in which the UKHTF has impacted on the fund managers. The Fund of Funds Manager, identified several ways in which the criteria for managing and selecting underlying funds has changed. The underlying fund managers identified several ways they had changed their portfolio management practices. These include strategies to reduce the risk of write-offs; making several investments in a company and to link these to milestones; and an increased likelihood of pulling out of an under-performing company faster than they were previously. They also try to ensure their portfolio is better balanced between the number of investments made in very early stage and not so early stage companies. Finally, there has been much debate within the industry regarding the suitability of venture capital as a form of investment for seed and early stage companies operating in some high technology sectors, such as life sciences

where long gestation periods makes it difficult to achieve a return during the life of the portfolio.

9.12 The study has not found any evidence of new investor networks being established as a result of the two Funds. However, a common thread running throughout the stakeholder and business interviews is that the industry is built on personal relationships and networking.

Fund Performance

9.13 The latest monitoring data for the UKHTF (30th June 2010) shows none of the underlying funds had achieved a surplus. Even though each portfolio included at least a couple of highly successful companies, to date, these have not compensated for the losses incurred by other investments. A combination of core factors playing out together explains the under-performance of the underlying funds. The underlying funds invested all of their money over the space of one or two years rather than spreading investment over a number of years. The lack of exit opportunities and follow on investment hampered the growth and development of companies. It led them to raise funds from elsewhere diluting the fund manager's investment. They ceased investing in the "weaker" companies to continue to enable them to continue to invest in the stronger ones, which in turn, meant they had a high number of write offs.

9.14 Five secondary factors also affected performance. These include: (i) investment decisions which did not perform as well as anticipated with the benefit of hindsight; (ii) size of the fund and lack of finance to make follow on investments in portfolio companies; (iii) the impact of the dotcom crash; (iv) changes in the pharmaceutical industry; and (v) changes in the management teams of the underlying funds.

9.15 The Bridges Fund, parts A and B, are recording as being in surplus as at 31st March 2010. Given that the Bridges Fund's mandate is to invest in businesses that operate within the most disadvantaged areas of England, this overall performance is highly respectable. One of the reasons for the commercial success of the Bridges Fund is that as a generalist fund, it was able to spread its risk. Good investment decisions have also contributed to success and there have only been a small number of write-offs. The investment strategy has also contributed to success - investing in "consumer champion" type businesses or those offering value for money, a strategy aptly suited to customers living in deprived areas. Also part of its portfolio comprises property-backed businesses, which helped reduce the risk level of that part of the portfolio.

Rational for Government Intervention and Policy Lessons

9.16 The recession has had a significant impact on the private equity market with recent data showing that investment levels have fallen below historical norms. The slowdown in activity has affected all areas of the private equity industry, from deal activity to time to exit though fund managers and investors can benefit from investing in times of recession when asset prices are low. That said, commentators note that investors are managing and enhancing existing portfolios rather than making new investments. Investment figures clearly show that the financial crisis has made it difficult for companies at all stages to raise equity finance and the problems faced by SMEs may well have become more accentuated. Even without the financial crisis, recent reports have highlighted persistent structural problems within the private equity and venture capital markets, providing evidence of a continual need for government support to equity finance schemes. An undersupply of finance for growing

businesses, is believed to be structural, resulting from investors choosing to finance higher risk/return profiles and greater deal size.

9.17 Institutional investors have often been reluctant to provide venture capital funds for a number of reasons: the risk and cost of early stage deals; investor yields; poor performance; lack of investment readiness; fund manager remuneration and an aversion to equity. The aggregate level of equity investment has seen significant growth but for the reasons outlined above, this has not led to the wide availability of venture capital funding for SMEs. Whilst there has been some increase in the level of institutional investment for this asset class, this remains low for the market to operate efficiently.

9.18 The evaluation has highlighted a number of lessons policy makers may wish to consider including:

- I. A continued need to **stimulate** new investment and support equity finance schemes due to current market failure provided checks and balances are put in place.
- II. The need to continue to invest in **early stage** companies with growth potential.
- III. A need to **influence** institutional investors to invest more in venture capital as an asset class by addressing some of the reasons for their reluctance (including the image of the asset class).
- IV. Capital for enterprise should continue to have a clear **oversight** of fund manager performance where public funds are invested, ensuring appropriate monitoring and fund management agreement measures are in place (e.g. to reduce the risk of write-offs and ensure a balanced portfolio).
- V. Any proposed fund **restrictions** need careful consideration to ensure the availability of opportunities is not too narrow (where they are in place they need to be monitored to ensure they are being met).
- VI. Fund managers should be made aware of the Coalition's twin objectives of **economic growth and rebalancing the economy for any new publicly backed equity scheme**. This will require setting the right parameters for the funds in the first place.
- VII. Venture capital is a **long term** prospect and timing is important. Future publicly funded schemes should encourage fund managers to avoid making investments in a compressed timeframe. This would limit susceptibility to economic fluctuations which can affect the value and performance of the fund.
- VIII. **Information** about the performance, and potential, of venture capital should be made available. An honest dialogue should be maintained with fund managers and investors to improve confidence in venture capital as an asset class.

APPENDIX 1: CASE STUDIES

Case Study 1 – Venture Capital Supports Innovation

Background

ApaTech specializes in producing synthetic bone repair material. It has operations in England, USA and Germany, and is a world leader in bone graft technologies, selling its products in over 30 countries around the world. ApaTech was spun out of Queen Mary University London in 2001 with the rights to bone materials research and IP from London and Cambridge Universities. The company retains pipeline agreements with founding inventors.

Accessing the Fund and Follow on Investment

In 2004, a chance meeting at a conference between two old acquaintances (the company chief executive and the fund manager) led to ApaTech receiving investment from one of the UKHTF underlying funds. In turn, that fund made one of its most successful investment decisions. Following that chance meeting and subsequent discussion, ApaTech raised £6.5 million, half from UKHTF and half from 3i. The investment was used for the development of physical infrastructure; a manufacturing facility was built and fitted out in the UK. It was also used for further research to develop new products, as well as to support the organisational development of the company and to recruit new staff.

ApaTech would have struggled without the funding as it was beginning to run out of capital. Another venture capitalist was interested, but reportedly, the investment proposition was not as attractive as that put forward by the UKHTF and 3i.

ApaTech had already received £3 million from 3i and so the £6.5 million comprised second round funding. The plan was that it would enable the company to become profitable. A product development delay meant the company needed a third round of funding before that happened. So, a further £2 million was raised, again, half of it from the UKHTF underlying fund.

Between 2005-7, the company received three offers of sale. However, the chief executive was convinced there was going to be a sales explosion and so persuaded the Board and investors not to sell at that point. The company raised another round of funding in 2008 – \$45 million. This was used to buy out the underlying UKHTF, build another facility, fund working capital and expand the business from 45 people to 160 across the world.

Nature and Impact of Post Investment Support

ApaTech learnt a great deal about personnel and human resource management from the underlying UKHTF. The fund manager provided valuable support with recruitment and with strengthening corporate governance. *“The fund manager’s financial experts were valuable with short and long term financial planning”*. The appointed non-executive director added value by introducing the company to others in the market. He also asked “challenging” questions to help the company implement its strategy.

Innovation and Wider Benefits

ApaTech was entering a crowded market with regards to bone grafting. However, traditional methods were not working effectively and the company developed new materials and bone graft technologies. It developed a novel silicate substituted calcium phosphate bone graft material, Actifuse. Actifuse is the first of a new class of synthetic bone graft materials that

combine osteoconductive, osteostimulatory and bioactive qualities resulting in accelerated bone growth. It mimics the body's natural bony structure and accelerates the growth of high quality bone. Actifuse is being used by surgeons in more than 30 countries around the world.

In terms of wider impacts, Actifusee is leading to better clinical outcomes than hitherto.

Awards

ApaTech has received several corporate business and research awards, including the Frost & Sullivan '2009 North American Biologics Company of the Year' as a result of its success in the US orthobiologics market. More recently, ApaTech was awarded 3rd place in the UK Deloitte Technology Fast 50 (2009), to add to being recognized as Britain's fastest growing medical technology company 3 years running 2009, 2008 and 2007 by the Sunday Times Fast Track 100 fastest growing private companies review.

Company Views of Venture Capital Funding

ApaTech has benefited considerably from venture capital funding and views it as a good source of finance. Venture capital is seen as fundamental to the success of the company. However, ApaTech is concerned that UK venture capitalists are prone to being more risk averse than those in the US.

Case Study 2 – Venture Capital Supports Award Winning Green Technology

Background / Company Details

CamSemi is a privately-held, fabless semiconductor company based in Cambridge, UK; helping customers find faster, lower cost and easier ways to design and manufacture more energy-efficient power conversion products.

CamSemi's products are based on its portfolio of patented, proprietary technologies and topologies including intelligent control architectures, RDFC and PowerBrane. These new approaches can benefit multiple markets although initially the company is targeting two major opportunities: high-volume mains power supplies and energy efficient lighting.

CamSemi has secured a number of national and international awards recognising its breakthrough technologies, cost-efficient products and ongoing commitment to the green agenda.

Accessing the Fund and Follow on Investment (awareness, reasons, how much raised)

Investment from the fund was used to develop first prototype products and commercialise the business having received seed funding from Cambridge University. The company considered a number of venture capital options at a time when access to funding was very difficult. The main reasons for choosing the fund was their willingness to invest and their belief in the company.

The company felt the fund offered a fair valuation of the business, were satisfied with the investment structure and level of funding and made good progress at each stage. They have received five rounds of funding with almost £6m coming from the fund. The fund's involvement has been very important in securing further funding, with more investors sharing the risk.

Nature and Impact of Post Investment Support

The fund manager acts as the non-executive director on the board. The level of contact has varied by the role they have played, which has changed over the years. On average they are in contact two to three times a month and meet once per month, which the business is satisfied with.

They are considered by the business to be very knowledgeable about the sector and have been particularly helpful with the financial element of the business and recruitment. The business have found the fund manager has been helpful as a mentor and offered personal support. Without this support the business would have been less able to execute in a timely manner.

Innovation or Social Impacts

The business has introduced a new product and sold 100m units to date. The business plans to expand in the mobile consumer and lighting markets, which will involve introducing a new platform product with multiple targeted derivatives.

Wider Benefits and Impacts of Fund

This growth has led to increases in employment, from 6-8 employees to 50 and increased turnover from 0 to \$7.5m in 2010. The recession has had an impact on the business, resulting in a reduction in head count twice and product development has been delayed to

save money. Without the SEPII fund support through this the business would likely not have survived.

Awards

CamSemi has been included four years running in Silicon 60 - a list of the world's most promising technology start ups researched annually by EE Times. The company was first named in 2004.

CamSemi received the 2009 Carbon Trust Innovation Award (buildings category), recognising the potential of the company's innovative products to reduce energy consumptions within buildings.

CamSemi's C2160 PSS controllers were highly commended as "New Product of the Year" in the British Engineering Excellence Awards 2009.

CamSemi and its products were highlighted in Global Cleantech 100 - an in-depth review of the world's top cleantech companies. Published September 2009 by UK national newspaper, The Guardian.

University Spin-out of the Year" in Rosenblatt: New Energy Awards 2009

Start-up of the Year 2008" in NMI's annual innovation awards and awarded to recognise CamSemi's exciting growth potential.

Named as finalist in EDN's 18th Annual Innovation Awards and the only European company focused on energy-saving technology to feature in these global awards.

Exit Strategy

There are no plans in place for exiting the fund, as the business is still growing the business is of the opinion it would be premature to withdraw from the fund.

Company views of Fund / Venture Capital Funding

At the time of first seeking finance the dot com bubble had just burst and funding from any source was difficult to find and very likely without the support of fund the project would not have gone ahead. The business still considers access to finance to be difficult and believes more could be done to help with this – especially in terms of securing working capital financing.

The business would recommend SEPII to another business but it needs to be recognised that it is increasingly difficult for Venture Capital to fund semiconductor businesses. There is a growing incompatibility between the financing required and the time it takes to go from an idea to being a successful independent global player (approaching 10 years now for semiconductors and continuing to grow) and the typical investment limits and the time horizon of a typical (10 year) VC fund. This is a growing tension in the venture capital market and forces businesses to be quite 'short-termist' and is likely to be a contributing factor to the ever dwindling number of semiconductor businesses that are successful in achieving critical mass and independence. In the companies view this is a very bad trend for the UK economy given the absolutely fundamental nature of semiconductor technology to almost all aspects of life today and the contribution that it will play in resolving a number of key societal issues.

Case Study – Venture Capital Funding a Consumer Champion

Background / Company Details

Simply Switch is a price comparison service which allows users to compare charges for household bills and switch suppliers over the telephone or online for free. The business was set up to offer information and impartial advice to help users find the best possible options for them.

Accessing the Fund and Follow on Investment (awareness, reasons, how much raised)

The two founding Directors of Simply Switch began searching for funding in 2002 to start the business and this included making direct contact with the regional venture capital funds, other smaller fund managers, seed-fund business angels and the newly formed Bridges fund. The consulted Director admitted to being nervous at the time about the option of using equity finance although the alternative option of debt was seen as an even higher risk.

In the course of discussions with potential equity funds, the Directors were impressed with the professionalism of Bridges, were satisfied with the equity offer and also saw a fit between the Bridges social ethos and Simply Switch's aims to help people save money. Simply Switch agreed to an equity investment of £125,000 in 2002 and became the Bridges' second investment. It was noted that, if necessary, investment could have been found through alternative routes but that Bridges was the best option available to them.

The business began working in serviced premises and within two years it was looking to expand its online servicing and call centre. To help with this, the business was successful in securing a further £345,000 in investments which included £200,000 from Bridges.

Nature and Impact of Post Investment Support

Two experienced Bridges executives were engaged with Simply Switch, one as a non-executive director and one as a business advisor. The fact that Simply Switch was one of Bridges' first investments meant that these two executives had relatively small portfolios by that point and could invest considerable time into the start-up phase of the business. The business found this to be very helpful, particularly in relation to raising the profile and credibility of the business and helping to bring in governance and audit mechanisms.

Innovation or Social Impacts

The investment helped the business to launch and grow its price comparison service. The company's role as a consumer champion was publicised through the Guardian newspaper among other routes. Further, the company proactively supported other social aims including an encouragement and provision for staff time to work through charities.

Wider Benefits and Impacts of Fund

From zero turnover in 2002, the company grew to a turnover of £4m within four years and employed 100 people in its call centre alone. Bridges was cited as playing a significant role in helping to achieve this growth. As well as the support from the two executive advisors, the backing of the Bridges investment helped the company against competitors as it was seen as being more socially responsible.

In relation to social impacts, the call centre was based in a regeneration area in North East England and, consistent with Bridges criteria, the company ensured that at least 35% of staff were residents of disadvantaged wards.

Exit Strategy

Simply Switch represented one of the first successful exits for Bridges with the business being sold to an external Trust for £22m in 2006. This represented a £7.5m return for Bridges from their original investment. The Director worked for an additional year for the company in line with the exit agreement. Since then, he has invested in a portfolio of other similar consumer interest and education businesses. In February 2011, following his successful experience through Simply Switch, he took up position as an Investment Director at Bridges with responsibility for underserved areas, environment, education, skills and health.

Company views of Fund / Venture Capital Funding

For early stage businesses, options were viewed as being more open in 2002. The start-up environment was perceived as being “tricky” in early 2011 requiring owners to invest their own money which is risky for a pre-revenue business. There is a recognition that bank finance certainly has a role in business growth, albeit affected by risk, and that the only opportunity for some businesses is to raise cash themselves or through personal contacts. There is support for equity investors to play a role in filling this gap although the Simply Switch director noted that a large proportion of new businesses fail and so each case for equity needs to be judged on its own merits.

There was a sense that there is “maybe” a continuing role for public investment subject to conditions. For instance, that there is less of a need for public-backed venture capital in London but that elsewhere government could step in to rebalance risk (including through subordination). It was noted however that whilst greater availability of venture capital would potentially help business growth in the UK, macro business and consumer confidence would continue to have a far greater influence.

Case Study – Venture Capital as a Springboard for Employment

Background / Company Details

Cambridge Broadband Networks (CBNL) was founded in 2000 by a combination of Cambridge-based technology veterans and researchers. The company operates in the field of high-capacity microwave radio transmission systems for voice and packet data (Internet) traffic (rather than cable-based) and manages the architecture behind this. It has become a market leader for 'Point-to-Multipoint backhaul solutions'. The company's main clients are phone network operators where point to multi-point data transfer using CBNL devices allows them to reduce their costs. More than half of the mobile phone masts in the world are connected using microwave technology.

Accessing the Fund and Follow on Investment (awareness, reasons, how much raised)

From its establishment in 2000, the company has gone through six investment rounds, a rare occurrence in the venture capital market. Round A raised \$5m drawn from several fund managers, and this included over £190,000 from one of the UKHTF underlying funds. In a subsequent round in 2003, a second underlying fund manager was also engaged and contributed just over £190,000 UKHTF. The latest Round (F), in December 2010 was worth \$16.5m.

Early on, CBNL were confident that there would be considerable venture capital interest in their business and it was a conscious decision to have so many funds engaged, backed by major financial investors (eventually covering investors from Scandinavia, UK, USA and Korea). The company was interested in engaging the first UKHTF investor because of its considerable experience with University of Cambridge and of spin-outs, whilst the second is globally respected in the technology sector.

Understandably, keeping so many investors content was a challenge but the focus amongst all has generally remained on moving the business in the same direction. It was noted that investor patience and continued support is "critical", particularly with uncertainty in anticipating speed of take-up and changes to the business plan. More recently, a greater issue facing the business has been persuading their partners to secure continuing investment for growth. Most have faced a challenging ten years and need to be reassured that technology in general is a sound investment.

Whereas venture capital in the earlier rounds was funding losses, it is now used for working capital to help generate a strong growth leading to a suitable balance sheet to exit.

Nature and Impact of Post Investment Support

With the high number of partner investors, Board representation has depended upon funding contribution. Three of the company's equity partners have permanent seats on the Board whilst smaller funds have Observer status.

The support that this represents is viewed highly favourably. The investor Board members are involved with lots of other companies and their advice has allowed CBNL to avoid making the same mistakes made by others. Also important was the sector networking that the fund representatives undertake, and the new opportunities that this brings.

Innovation or Social Impacts

The company began to roll-out its service in the emerging markets of Africa and the Middle East, but is beginning to penetrate the more mature markets of Western Europe. The market

is growing year-on-year and the company is now competing with larger well-established multi-nationals.

Wider Benefits and Impacts of Fund

In 2011, CBNL employs about 100 people, with about two-thirds based in Cambridge with other staff based in 33 countries around the world. The company's most recent turnover was \$44m and has more than doubled in size since January 2008. In the short-term future, CBNL anticipates employing 150 staff by January 2012.

The company CFO reports that without the venture capital investment, the product development would have taken place but that they wouldn't have been able to take the product to market and to have enacted the same scale of growth, including the employment that comes with this.

Exit Strategy

The company is primarily concerned on continuing growth and acknowledges that the emphasis on exit varies between investors. A seventh round (G) of investment is possible but so too are three other routes: an IPO (although this has become more difficult for technology companies in recent years); acquisition; or banks and loan finance.

Even this far into the company's development, securing a reasonable deal through bank finance was not viewed as a serious option. Aside from rare cases of funding from high net-worth individuals, venture capital was seen as the primary option until the company can make a consistent profit.

Company views of Fund / Venture Capital Funding

Anything the government can do to encourage the venture capital sector was viewed as a positive, with a recognition that it helps to generate thousands of jobs each year in the UK. This includes the potential for public-backed or fiscal incentives for venture capital investment.

Another factor is attitudes to risk. The CFO at CBNL was keen to point out that the US approach, where it has a less conservative attitude to risk, is still not established in the UK, although it had been improving. This is another area that could be encouraged through public-backed financial incentives. Further, the US was cited as having a more flexible regulatory environment which allows American companies to expand or contract more quickly and subsequently protect investments. In the UK, this is affected by regulations including EU employment law.

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