BIS Department for Business Innovation & Skills

BIS EQUITY FINANCE SCHEMES: SURVEY OF FUND INVESTORS

JULY 2011

The findings and interpretations in this report are those of the authors and do not necessarily represent the views of BIS

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Executive Summary

Introduction and Approach

Venture capital is a specialised form of finance typically targeted at high growth, early stage companies. These businesses often require significant capital investment up-front which can be hard to obtain from traditional sources like debt providers due to the high risk. Equity finance investors generally include pension funds, banks and high net worth individuals. There is however little research on the factors that motivate them to participate in the venture capital market, especially in Government initiated equity funds. Further, the recent financial crisis and subsequent economic recession precipitated a relative 'collapse' in the supply of venture capital in the UK and heightened the existing structural shortage of equity finance to early stage companies. This structural shortage is often referred to as the equity gap[1].

In winter 2010, the Department for Business Innovation and Skills (BIS) commissioned ekosgen and Baldhu Consulting to survey investors involved in seven of its Venture Capital Funds (VCFs)[2]. This research project was part of the wider evaluation strategy of BIS venture capital initiatives.

The main objective of the study was to explore the reasons why private sector investors choose to invest in venture capital compared to other asset classes and the factors that would encourage further investment in the future. The study assessed the characteristics of investors; set out their motivations for investing in venture capital; explored the impact of BIS equity funds on leveraging additional finance to SMEs; and investor attitudes to venture capital as an asset class. The research also explored the experiences of BIS fund managers, highlighting their perspectives on delivery and approach to raising investment from private sector sources.

The research methods comprised a combination of primary and secondary research. Primary research entailed 11 in-depth interviews with market stakeholders; 21 qualitative interviews with private investors involved in BIS equity funds; and 9 interviews with fund managers delivering BIS equity funds.

[1] The Supply of Equity Finance to SMEs: Revisiting the "Equity Gap", a report to BIS, SQW, 2009
[2] These funds included the Regional Venture Capital Funds (RVCFs), the UK High Technology Fund (UKHTF), the Early Growth Funds (EGFs), Bridges (the Community Development Venture Fund – CDVF), the Aspire Fund, the Enterprise Capital Funds (ECFs) and the UK Innovation Investment Fund (UKIIF).

A literature review summarised the emergence and development of the venture capital market over time.

Key Findings

Investor Profile

There are two broad types of BIS equity fund investors: institutional investors (e.g. pension funds, universities and charities) and business angels or high net worth individuals.

Key findings from the profile of investors and co-investors were:

- The majority of institutional investors have significant funds under management – typically over £1 billion. In general, only a small proportion (1-7%) of their total assets is allocated to venture capital. For most investors, the bulk of their venture capital investments are in the United States.
- Business angels typically invested as part of a syndicate or wider investor network.
- Investors perceive that returns on their venture capital investments in the UK are likely to be lower compared to other markets. Some institutional investors regard UK fund managers as more risk averse than their overseas counterparts, preferring to realise investments early in the life of the fund, often at lower returns.
- Some BIS fund managers have noted a shift in the profile of equity finance investors, from institutional investors to private individuals. They reported that fewer institutional investors are willing to invest in VCFs, including BIS VCFs, whilst high net worth individuals appear to have proven to be more resilient.
- The recession has generally led to a decline in portfolio values for both institutional investors and business angels, although they have since largely recovered. Business angels have reduced their overall investment activity, whilst institutional investors have tried to maintain their exposure to different asset classes.

Investment Motivations and Behaviour

Investors invest in the venture capital asset class primarily because of the potential high financial returns and to achieve diversification in their portfolios.

Additional observations on the investment behaviour of BIS investors included:

- Some investors, particularly business angels, invest in venture capital for personal satisfaction and value investing in early stage companies.
- Generally, investors do not regard BIS equity funds to be any different from commercial VCFs and have the same expectations of financial rewards. Government support does reduce the risk of investing in what is perceived to be a very risky asset class.
- The role of the fund manager is fundamental and investors reported that the quality of fund manager is more important than Government support in making investment decisions. Co-investors placed strong emphasis on the fund manager's experience of early stage businesses and their post investment monitoring of companies.
- Investors were generally satisfied with the Government coming in on a pari passu basis, however they had different views about the role of Government subordination and whether it should invest directly in the venture capital market.
- Tax incentives complemented existing Government VCFs, and the Enterprise Investment Scheme (EIS) has been an important motivator for most business angels.
- There is a general preference for larger scale VCFs to match the investment management needs of institutional investors and also to reduce the fragmented nature of existing schemes.

Impact of BIS Schemes

BIS equity funds are helping to increase the supply of equity finance, especially to companies requiring less than two million pounds. In addition:

- BIS equity funds are improving the equity capital ecosystem through co-investment funds. These also provided early stage companies with essential non-financial support.
- Fund managers and investors reported that BIS equity funds have leveraged institutional investors who would not have otherwise invested in small scale VCFs.

- A growing number of high net worth individuals are co-investing with BIS equity funds and encouraging other private investors to do so. This will be important for increasing the future supply of equity finance to businesses affected by the equity gap.

- Co-investors generally attributed the overall amount raised by the recipient company to BIS equity funds.

- Overall, the EGFs, ECFs and UKIIF have been highlighted as the most successful BIS equity funds, effectively designed and having prospects for good financial returns.

- The EIS tax scheme was also widely commended as encouraging more private investment in early stage companies.

- Overall, around 40% of institutional investors (5 respondents) and a third of co-investors (3 respondents) reported pure additionality, i.e. they would not have made their investment without BIS's support. These investors reported that BIS's involvement has reduced the risks associated with their investment. There is also some partial additionality where BIS funds have lead to a greater amount of funds invested in venture capital. However, a third of investors (including institutional investors and co-investors) reported they would have invested anyway (deadweight).

- Lessons have been learned from earlier funds which led to improvements in the design and delivery of later funds, although prevailing negative perceptions of venture capital continue to make it difficult for fund managers to raise new private investment. Nonetheless, BIS fund managers are continuing to secure new investment from private investors.

- There was consensus that Government support is necessary because of the equity gap. However, some consultees were concerned that the current focus on early stage businesses is taking place at the expense of later stage companies, which are still not large enough to attract mainstream VC.

Fund Manager Experience

Fund managers are generally satisfied with the level of Government involvement through Capital for Enterprise, which is regarded as an important source of market knowledge. Interviews also revealed:

- The benefits associated with managing several VCFs included complementary deal flow enabling cross investments in portfolio companies; reduction in operational/administrative costs; and the opportunity to develop key specialist skills.
- Fund managers have targeted a pool of potential investors and generally used their own network of contacts to identify investors. The majority of investors are '*repeaters*', reflecting the overall importance of the fund manager's track record in attracting additional private investment.
- Co-investment fund managers tended to rely on existing business angel networks to identify potential co-investors. In contrast, institutional investors tend to be specifically targeted.
- Fund managers are currently experiencing difficulties attracting private investors, although this was not the case when some of the earlier funds were launched. The poor financial track record of venture capital over the last ten years and a lack of profitable exit opportunities in the UK have led to a loss of investor confidence in this asset class.
- Fund managers remain confident that investors will continue to invest in teams demonstrating a good track record. They reported it is generally easier to raise private investment with Government involvement.
- Overall, fund managers felt it was too early to comment on performance of more recent portfolios, but were generally confident they will be profitable.

Lessons for Future Delivery

There was general a consensus that Government intervention in equity finance is valid and appropriate. That said, the interviews revealed some enhancements that they believed could potentially improve the impact of BIS equity funds. These are:

- **Strengthening the promotion of existing equity funds to attract more investors.** Investors required more market intelligence on the venture capital industry to support their investment decisions and business angels would welcome greater advice on managing different stages of the investment process.

- **Maximising the expertise of Capital for Enterprise.** Its market knowledge and expertise could be made more widely accessible to help raise the profile of Government initiated venture capital funds amongst institutional investors and angels.

- **Coupling financial support with investment readiness assistance to enhance the viability of investments.** This involves assisting investee companies to become more investment ready at different stages of financing.

- **Providing fund managers with additional support** to improve their chances of raising investment from private investors.

- **Improving engagement and dialogue between the Government and institutional investors regarding the future design and delivery of hybrid funds.** This might include strategy days/events, networking events, the development of an informal network or formal consultation through intermediaries or simply information.

- **Maximising BIS's investment** by encouraging greater private investment in BIS equity funds that are truly additional by identifying and encouraging non traditional alternative investors such as sovereign wealth funds, endowment funds and charitable foundations.

- **Continuing to support the development of effective business angel networks** as a key conduit to financing early stage companies.

- **Increasing the scale of future hybrid equity funds.** Institutional investors would welcome much larger funds (£50m or larger) to attract them into early stage financing as some of them are unable to invest below a certain threshold and do not have the expertise to make and manage a wide range of direct investments in a number of small VCFs. Larger funds would be more cost effective (in terms of spreading fixed costs) and better suited to make follow on investments.

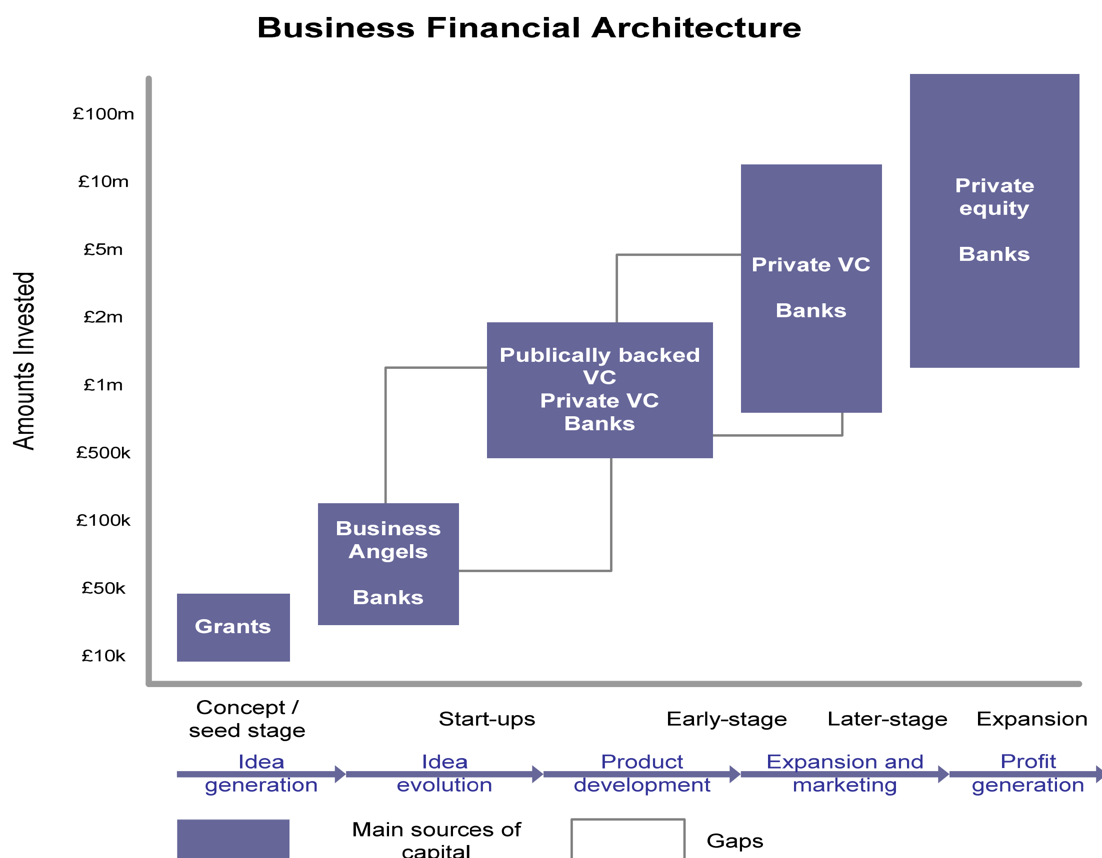
- **Maximising the use of taxation measures** to encourage private investors to invest in VCFs, making it easier for them to retain their

benefits whilst using professional fund managers (e.g. by expanding the scope of the EIS). This would allow investors to receive double benefits of tax relief and lower risk through Government investment in the underlying fund.

Introduction

1.1 Venture capital is a specialised form of finance primarily (although not exclusively) targeted at early stage companies which has the potential to offer high financial rewards. It provides an injection of capital into a business in exchange for a share of its ownership. It is primarily used for a small cohort of new or young high growth potential companies, often in the information technology, life sciences and advanced engineering sectors[3] - See Figure 1.1. These companies typically require significant capital investment up-front which can be hard to obtain from sources of debt finance that require regular repayment. Venture capitalists also offer additional support to their investee businesses, notably advice (sometimes embedded with management teams), strategic insight and networking opportunities.

Figure 1.1: SME Funding Escalator



3 Pierrakis and Westlake (2009) *Reshaping the UK Economy: The Role of Public Investment in Financing Growth*. NESTA

Source: Adapted from NESTA (2009)

1.2 In general, the majority of SMEs do not readily seek equity finance and most regard it as financing of the last resort[4]. Yet equity finance is an important source of funding for some high growth companies and for certain businesses can be a more appropriate source of finance upon which to grow a business than say debt finance[5]. This is because equity finance is able to provide significant investment upfront, especially at the very early stages of development when the risks are high, but the scope for potential returns is significant.

1.3 Investors in equity capital, ranging from institutional investors such as banks and pension funds to high net worth individuals investing their own money, have an important role supporting the growth and often survival of high growth, early stage businesses. As a result, the Department for Business, Innovation and Skills (BIS) has commissioned research to survey private sector investors to BIS venture capital funds. This research is timely given concerns of perceived gaps in the SME funding escalator, on account of many private sector venture capital funds (VCFs) withdrawing from early stage investments towards larger deal sizes for reasons including high transaction costs of making small investments (such as due diligence costs) and also low financial returns[6].

1.4 The study was undertaken by ekosgen and Baldhu Consulting during the Autumn/Winter of 2010/2011. This report presents the findings from the survey of private sector investors to BIS equity funds.

The Aims of the Study

1.5 The primary objective of this research is to understand the role and motivation of private sector investors and, in particular, what they regard to be the benefits of investing in BIS equity funds compared to other funds. The report provides a qualitative assessment of the characteristics of investors; their motivations for investing in venture capital, especially VCFs supported by the Government; the impact of publicly supported VCFs on leveraging additional funding from the private sector; and their overall attitudes to venture capital as an asset class.

1.6 The study examines the role of private investors in relation to each of the BIS equity schemes, namely: the Regional Venture Capital Funds

[4] Centre for Business Research (2008); BIS (2007) *The Annual Small Business Survey*
[5] City of London (2009) *The City's Role in Providing for Public Equity Financing Needs of UK SMEs*
[6] NESTA (2009) *Shifting Sands: The Changing Nature of Early Stage Venture Capital Market in the UK*

(RVCFs), the UK High Technology Fund (UKHTF), the Early Growth Funds (EGFs), Bridges (the Community Development Venture Fund – CDVF), the Aspire Fund, the Enterprise Capital Funds (ECFs) and the UK Innovation Investment Fund (UKIIF). Chapter 3 summarises their features and differences.

Research Methods

1.7 The study has used qualitative methods, involving a number of components:

- **Literature review** analysing reports and research on the emergence and development of the venture capital market over time. This sets the context for the research findings.
- **Stakeholder Consultations** with eleven market stakeholders, including a range of associations and sector groups, who have provided an informed view of private investor motivations and in particular how these have changed over time (see Appendix A).
- **In Depth Investor Interviews** were undertaken with twenty one investors, including institutional investors (e.g. pension funds), corporate investors, and individual investors. The interviews explored their investment activity, perceptions of, and involvement in, venture capital, experience of BIS supported VCFs and impact of recession on their investment activity. The nature and scale of additionality of private sector finance leveraged in by BIS established funds were also explored.
- **In Depth Fund Manager Interviews** with nine managers of BIS supported VCFs. These interviews focussed on the management of BIS funds in comparison with solely commercial funds; delivery challenges, particularly around raising investment; and the likely impact of BIS established VCFs (see Appendix A).

Structure of the Report

1.8 The report is structured in the following way:

- Chapter 2 presents a brief narrative of the VC market and how investor behaviour has changed over time;
- Chapter 3 presents a summary of the various BIS equity schemes including the varying sector focus and terms;

- Chapter 4 reviews the profile of investors, their role in the various schemes and the scale of their investments;
- Chapter 5 incorporates the views of investors, fund managers and stakeholders on motivations, attractiveness of venture capital, role of fund managers and Government support and the reasons why they have invested in BIS equity schemes;
- Chapter 6 focuses on the impact of BIS supported VCFs and explores their added value;
- Chapter 7 highlights the fund managers' experience, focussing on challenges raising additional investment; and
- Chapter 8 draws out the study conclusions.

2 The Venture Capital Market and Change over Time

2.1 This chapter draws on existing literature to present a narrative of the venture capital market and how investor behaviour has changed over time. Specifically, the chapter covers:

- General trends in the venture capital market over time, including the increasing trend for venture capital investors to seek larger private equity deals;
- A profile of institutional and co-investors, including the HMT tax incentive schemes;
- The equity gap and the reasons for this market failure; and
- Previous policy responses to these trends in terms of addressing the gap.

Trends in the Venture Capital Market Over Time

2.2 The UK venture capital industry started to develop in the 1970s with the arrival of experienced venture capital managers from the United States drawing on US capital. These early venture capital firms focussed activity on leveraging buyouts and expansion type deals, partly because start up opportunities were scarce.[7] With the rise of the free market politics of the 1980s, venture capital for dynamic small firms was perceived as a route to a more competitive economy and leading investment institutions chose to back fledgling venture capital firms[8].

2.3 However, during the 1980s, investors made low returns on early stage high technology companies and perceived the level of risk associated with these investments as unduly high. These returns were low for several reasons: the quality of investment decisions were poor as the industry had little knowledge of making technology investments; many investee companies were not investment ready and had little commercial and financial knowledge; and the exit options were limited.

2.4 The recession in the 1990s depressed the venture capital market as funding shifted to later stage companies and the resulting contraction affected virtually all sectors. The recession caused the failure of the London Stock Exchange's Unlisted Securities Market (USM), a stock market for smaller

[7] BVCA (2009) Benchmarking UK Venture capital to the US and Israel: What lessons can be learnt?
[8] BVCA (2008) BVCA 25th Anniversary book, Private Equity in the UK - The first 25 years.

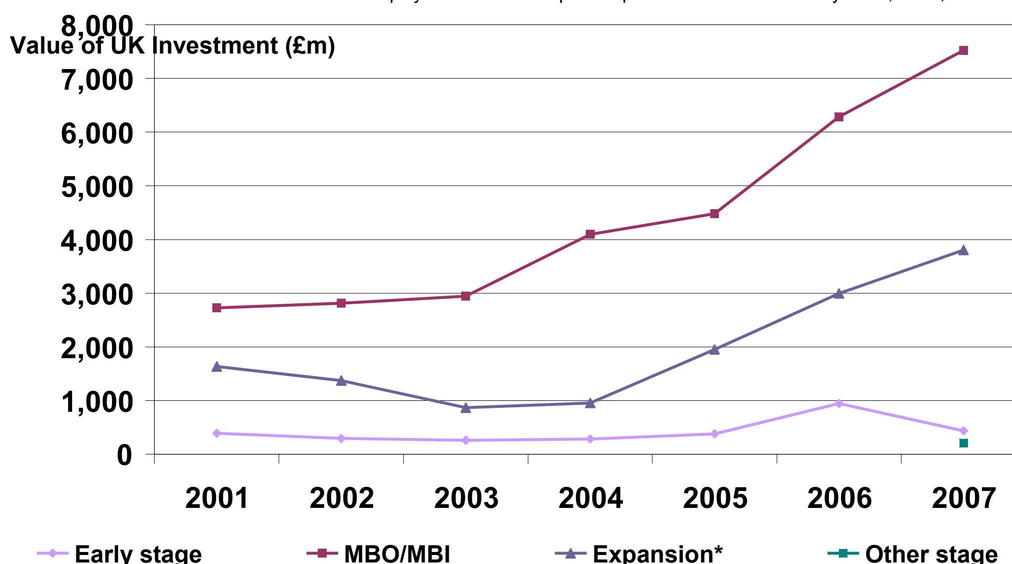
companies undergoing rapid growth, due to a lack of liquidity, and it brought an end to the first buy-out boom.

2.5 The bursting of the dotcom bubble in 2001 had a number of effects on the VC market. Many of the funds have performed poorly in the aftermath of the dotcom failures, largely because the funds were at the start of a ten year lifespan just before the bubble burst. The ICT sector suffered a withdrawal of investors and funds found it harder to raise financing for any type of investment, with venture capital suffering from a bad reputation with institutional investors. By 2005 the market had largely recovered, venture capital firms were able to raise a good level of funds and banks and hedge funds began to take an interest in the venture capital market once again[9].

2.6 The value of Private Equity investments has increased by 152% from £4.7 billion in 2001 to £12 billion in 2007[10]. This increase was most pronounced in the management buy-out (MBO)/ management buy-in (MBI) segment rather than venture capital, which has stayed relatively constant. The expansion occurred primarily in investments in the later MBOs/ MBIs (175%) and expansion (132%) business stages – see Figure 2.1.[11]

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

[9] The Supply of Equity Finance to SMEs: Revisiting the "Equity Gap", a report to BIS, SQW, 2009.
[10] This increase is not entirely linear as there was a decline in activity in the immediate aftermath of the dotcom collapse.
[11] This graph and subsequent graphs in this section omit 2008 and 2009 data to show the long run trends before the credit crunch and recession.

2.7 In 2007 early signs of the credit crunch began to emerge with venture capital activity beginning to decline and the Initial Public Offering (IPO) market starting to dry up, cutting off an important exit route for private equity. The credit crunch made it very difficult for venture capital firms to raise new funds as institutional investors were conserving their own funds. In addition the uncertainty in the economy led to VCFs finding it difficult to make valuations of companies causing a decline in new investments.

2.8 By 2009 venture capital investment in the UK fell to £296 million, a drop from the £359 million invested in 2008 and a significant decline from 2007, which saw £434 million invested.[12] The decline in deal flow has challenged venture capital firms and a greater emphasis has been placed on portfolio management and operational expertise.

2.9 A report from the National Endowment for Science Technology and Arts (NESTA) presents a pessimistic picture of the venture capital market as it emerges from the recent downturn, as the level of fund-raising has fallen since 2007 alongside the number of funds managing to raise new capital. This increases the importance of public funding as a contributor towards fundraising particularly for the early stage market.[13]

The Equity Gap

2.10 The aforementioned growth between 2001 and 2007 in the UK private equity market has not led to the wider increase in the availability of finance to small firms. Indeed, it builds on the historic focus on leveraged buyouts and expansion type deals dating back to the 1970s. In particular, the lack of institutional commitment to venture capital created a hiatus of funding for companies with high-growth potential seeking capital investments in amounts higher than business angels are able to provide, but too small for traditional private sector VCFs to consider– a phenomenon widely known as the 'equity gap'.

2.11 The split of UK investment by financing stage have largely followed similar trends over the past decade. As shown in Table 2.1, the proportional amount of investment going into early stage companies has typically been low and the onset of the recession has decreased this further as early stage finance fell from 9% in 2006 to less than 4% in 2007[14]. In part, this is because private investors switched to investing in later stage businesses where they perceived the risks to be lower. Also, venture capitalists have

[12] BVCA (2009) BVCA Private Equity and Venture Capital Report on Investment Activity 2009.
[13] NESTA (2001) Venture Capital: Now and after the dot com crash.

[14] 2006 was quite high and not a typical year.

found it difficult to identify and grow successful technology-based businesses, often because the UK market is perceived as too unreceptive or simply too small for the companies to succeed and the industry has not delivered the expected high rates of return.[15]

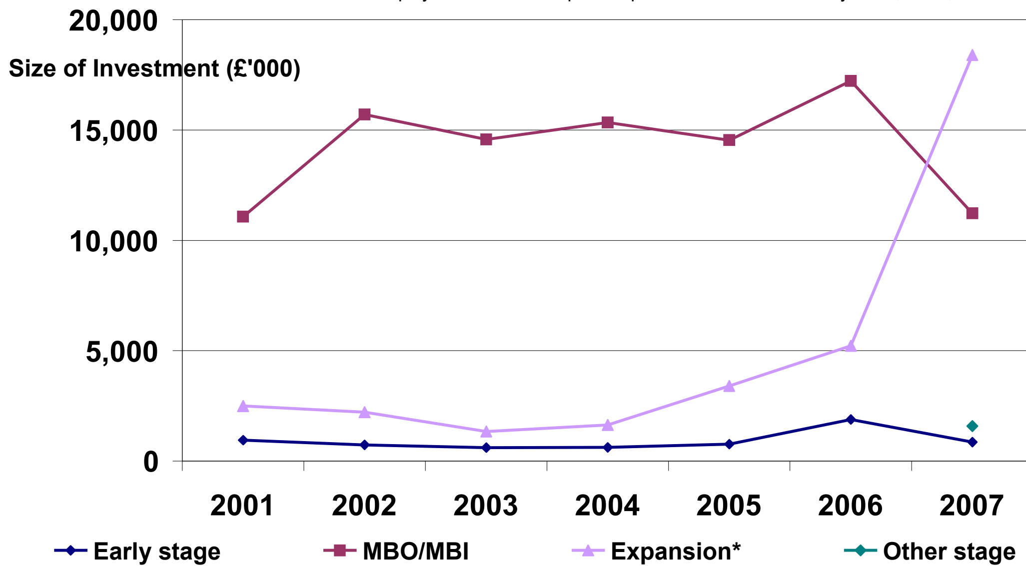
Table 2.1: Percentage of UK Investment by Financing Stage								
Stage	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Early stage	11.0%	8.2%	6.6%	6.5%	5.3%	5.6%	9.3%	3.6%
MBO/MBI	55.7%	57.4%	62.7%	72.3%	76.8%	65.8%	61.5%	62.8%
Expansion*	33.3%	34.4%	30.7%	21.3%	17.9%	28.6%	29.3%	31.8%
Other stage	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	1.8%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

- BVCA Private Equity and Venture Capital Report on Investment Activity 2009
- BVCA Private Equity and Venture Capital Report on Investment Activity 2006
- BVCA Private Equity and Venture Capital Report on Investment Activity 2003

* From 2006, includes replacement capital

2.12 As shown in Figure 2.2, aggregate growth in equity investment has driven up deal sizes for later stage companies including MBO/MBI and expansion. Larger private sector VCFs do not undertake more investments than smaller funds; rather their investments are larger. Average size deals increased from £3.6 million in 2001 to £9 million in 2007 across all stages.[16] Since deal sizes and investment stage are related, this reinforced a shift to later stage deals, contributing to the equity gap.[17] In parallel, detailed analysis of sub-£2 million investments shows that, whilst the number of companies receiving venture capital increased from 2001–2007,[18] average deal sizes decreased. Further, there was an increase in the number of investments of less than £500,000, which may reflect the Government's intervention in early stage financing through some of its hybrid schemes (e.g. the ECFs).[19]

[15] BVCA (2008) BVCA 25th Anniversary book, Private Equity in the UK - The first 25 years.
[16] BVCA Various Investment Activity Reports. London: BVCA.
[17] Pierrakis, Y and Mason, C. (2008) *Shifting Sands: the Changing Nature of the Early Stage Venture Capital Market in the UK.* London: NESTA.
[18] The increase has not been entirely linear as the number of companies receiving investment has been somewhat volatile.
[19] Pierrakis, Y. and Mason, C., (2008): *Shifting sands: The changing nature of the early stage venture capital market in the UK.* NESTA.



2.13 In summary, the size of investments has been highly skewed towards a large number of relatively small investments and a small number of large investments. It is not known whether lower deal sizes for VC stage suggest firms are under-invested, which may mean later stage investments require larger amounts per deal than early stage ones. Further, there is some evidence to suggest that venture capital firms that receive too little financing do not perform as well as counterparts that have not accessed this type of finance.[20]

2.14 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 VCFs. In 2002, deals involving publicly backed funds accounted for over 20% of all deals while their share doubled to over 40% by 2009[21]. Public funding is particularly prominent for early stage funding, accounting for 68% of all early stage investments in 2008 and 56% in 2009. This compares to 20% in 2000. The decline in 2009 may also reflect the end of some government backed VCFs (e.g. Regional Venture Capital Funds).[22]

Reasons for the Equity Gap

2.15 The reasons why some viable SMEs with growth potential can experience problems in raising capital are well documented. They relate to a

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[20] 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.
[21] Dow Jones Venture Source
[22] Pierrakis, Y (2010) *Venture Capital Now and After Dotcom Crash*. London: NESTA.

number of market characteristics on the supply and demand side, resulting in fund managers making fewer, larger and later stage equity investments. The main reasons for the equity gap are as follows:

Supply side factors:

- **Transaction costs are a higher proportion of smaller equity deals**: Assessing the viability of investments requires a rigorous assessment (due diligence) of the company involving the use of accountants, lawyers and industry specialists. Many of these costs do not vary by deal size and so represent a larger proportion of the investment compared to larger later stage investments.[23]

- **Early stage deals are higher risk**: 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 will lead to investors favouring larger later stage deals.

- **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.[24] The track record of early stage deals has shown little improvement during the 2000s, with the rate of return from venture capital investments being lower than for private equity funds. Between 1996 and 2009, since inception returns of UK private equity markets were 15.9% compared to -2.2% for VCFs.[25] In short venture capital is an asset class that has yet to prove itself.

- **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 to manage VCFs. Historically, fund managers received a management fee of 2% plus profit share referred to as 'carried interest'.[26] Carried interest represents a

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[23] NESTA (2007) *Making Money at the Early Stage: The Challenge for Venture Capital in The UK*. London: NESTA
[24] BIS (2009) *The Enterprise Fund – High Technology Venture Capital Intervention*. Draft ROAME Statement.
[25] BVCA (2010) *Investment Activity Report 2009*.
[26] Typically, this is 20% of the capital gain after investors have had their capital returned to them and a minimum rate of return.

significant financial incentive and can be maximised through focusing larger deals.[27] This is a feature of the market which leads to lower amounts of venture capital provided.

- **Investor yield**: When making capital investments, institutional investors will be assessing their prospects of either generating a high capital gain return or an 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, the time taken for investments to be realised and illiquidity that venture capital offers is not compensated by the returns available.[28]

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

Demand side factors

- **Lack of investment readiness**: 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 or reluctant 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'.[29]

2.16 The aggregate level of equity investment has seen significant growth but for the reasons outlined above, this has not led to the greater increase in the availability of venture capital funding for SMEs.

The Changing Face of Investors

Fund Investors - Institutional Investors

2.17 Typical institutional investors include banks, insurance companies, retirement or pension funds, hedge funds, investment advisors and mutual funds. These investors contribute into a venture capital fund where the responsibility for identifying, making, managing and exiting the investment lies with the fund manager. Institutional investors generally have no involvement with the companies receiving investment.

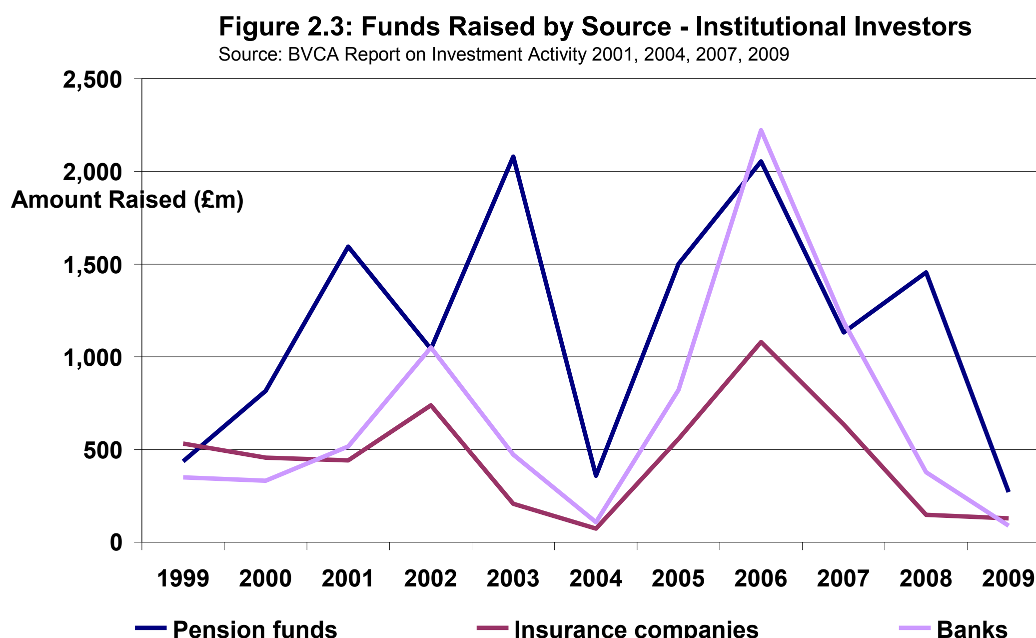
2.18 Venture capital firms' investment preferences may be affected by the source of their funds. Where investors are limited partners, the fund usually has a fixed life of ten years by which point the fund manager will have returned the original investment plus any additional returns. This requires the investments to be sold, or to be in the form of quoted shares, before the end of the fund. Some funds are structured as quoted private equity investment trusts, listed on the London Stock Exchange and other major European stock markets and as they have no fixed lifespan, they may be able to offer companies a longer investment horizon.

2.19 In light of the reasons for the equity gap cited previously, institutional investors have often been reluctant to invest in VCFs. Indeed, UK private equity firms are considered to have particular strengths in buyout (especially

[29] c.f. NESTA 2007: page 2

mid-market).[30] For instance, bank-sponsored funds tend to prefer domestic investments in later stage companies, whilst pension and insurance-backed funds often focus on later stage investments in low technology sectors.[31]

2.20 The amount committed by type of institutional investor over the last decade is detailed in Figure 2.3. Since 1999, pension funds have contributed £12.7 billion to private equity, followed by banks (£7.5 billion) and insurance companies (£5 billion). There was a peak in the amount raised across all types of institutional investor in 2006, this was followed by a significant fall in funds in 2008 and 2009.



Fund Investors – Other Types

2.21 Alongside institutional investors, corporate investors, private individuals and fund of funds[32] will invest in VCFs. The individual and corporate backed VCFs typically invest in early stage, high technology ventures, and tend to invest globally.[33]

2.22 The amounts raised for private equity and venture capital over time from these groups are shown in Figure 2.4. Fund of funds are the largest

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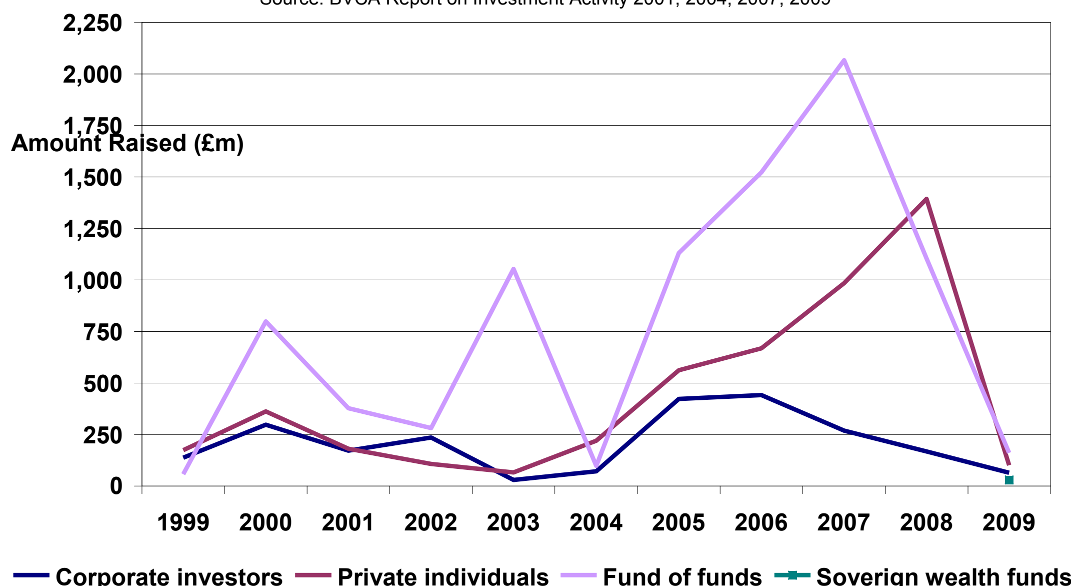
[30] *Global investor attitudes to private equity in the UK,* BVCA, 2009.

[31] *Sources of funds and investment activities of venture capital funds: Evidence from Germany, Israel, Japan and the UK,* Mayer, C., K. Schoors and Y. Yafeh (2003), NBER Working Paper No. 9645. National Bureau of Economic Research.

[32] Fund of funds invest in individual venture capital funds rather than directly in companies.

[33] *Sources of funds and investment activities of venture capital funds: Evidence from Germany, Israel, Japan and the UK,* Mayer, C., K. Schoors and Y. Yafeh (2003), NBER Working Paper No. 9645. National Bureau of Economic Research.

contributor, investing £8.7 billion, followed by private individuals (£4.8 billion) and corporate investors (£2.3 billion). The amount raised by private individuals has grown between 2003 and 2008, before falling sharply in 2009. Corporate investment also started to rise in 2003 but levelled off and began to decline from 2005.



Business Angels

2.23 Another source of equity finance is business angels. **Business angels** are high net worth individuals who invest using their own money in high growth businesses on their own or as part of a syndicate. They typically make one or two investments in a three year period, although some invest more frequently. The total value of investments made by Business Angels in the UK in 2008/09 was estimated to be in the order of £400m[34]. There are also a growing number of super, serial business angels who are more prolific in their investments.

2.24 Business angels rarely have a connection with the company before they invest but often have experience of its industry or sector. In addition to money, Business Angels are often committed to the company and will usually want a 'hands-on' role as an adviser or a non-executive director, making their skills, experience and contacts available.

[34] Annual Report On The Business Angel Market In The United Kingdom: 2008/09 Mason and Harrison

2.25 Many companies find business angels through informal contacts, but for others, finding a business angel may be more difficult, as the details of individual business angels are not always easily available.

2.26 Business Angels may co-invest alongside other business angels or venture capital fund.

Corporate Venturing

2.27 Direct **corporate venturing** is another form of equity investment whereby a corporation takes a direct minority stake in an unquoted company using funds raised from their parent organisations and/or from external sources. This has developed quite rapidly, albeit sporadically, in recent years but still represents only a fraction of investment activity. Indirect corporate venturing is where a corporation invests in private equity funds managed by an independent private equity firm[35].

Tax Incentives

2.28 There are two Treasury backed schemes, Enterprise Investment Scheme (EIS) and Venture Capital Trusts (VCT), which provide tax incentives to encourage individuals to invest in small, higher risk trading companies.

2.29 The EIS, introduced in 1994, is designed to help companies raise finance by offering a range of tax relief to investors purchasing new shares. It is intended to encourage high net worth individuals to invest more actively in early stage companies as business angels, or invest in an EIS Fund that will manage the investment. There are tax efficient benefits associated with investment in an EIS, which can also cushion any losses incurred:

- 20% of the cost of the investment can be offset against income tax;
- Capital Gains Tax relief on any gains made on the investment if held for at least three years prior to disposal; and
- loss relief whereby any losses made on investments disposed of after three years can be offset against income tax.

2.30 As of April 2011, the EIS upfront tax relief for private investors will be increased from 20% to 30%. This will bring the scheme in line with the relief available in contribution into venture capital trusts and potentially encourage more private investment in early stage businesses.

[35] Ibid

2.31 The VCTs scheme started in 1995 and is designed to encourage individuals to invest indirectly in a range of small higher-risk trading companies that are run by fund managers who are usually members of larger investment groups. VCT investees may be entitled to various Income Tax and Capital Gains Tax relief:

- Exemption from Income Tax on dividends from ordinary shares in VCTs ('dividend relief');
- 'Income Tax relief' at the rate of 30% of the amount subscribed for shares issued in the tax year 2006-07 and onwards (for subscriptions for shares issued in previous tax years the rate is 40%);
- The Income Tax relief at 30% is available to be set against any Income Tax liability that is due, whether at the lower, basic or higher rate; and
- No Capital Gains Tax on any gain made when disposing of VCT shares.

2.32 The threshold for higher-rate income tax is set to fall in April 2011 and this may have implications for the level of investment seen in these schemes as investors look for ways to avoid higher taxation.

Summary

2.33 Trends in the types of investors, wider market factors and the level of investments in the last two decades or so have resulted in a well documented equity gap for early stage businesses with growth potential. Government backed venture capital funds and tax incentives aim to increase the supply of venture capital to businesses in need of relatively small amounts of venture capital finance (mostly £2 million and below) and to encourage investors of all types to participate in this market. Despite these attempts powerful market forces are increasing the size of the gap with some commentators putting it has high as £10 million (this is elaborated further in subsequent chapters).

3 Overview of BIS Venture Capital Schemes

3.1 As private sector venture capitalists move away from early stage investments to larger deal sizes, there has been a corresponding growth in public sector initiatives to address the equity gap. This chapter presents a short overview of BIS equity funds, namely the Regional Venture Capital Funds (RVCFs), the UK High Technology Fund (UKHTF), the Early Growth Funds (EGFs), Bridges (the Community Development Venture Fund – CDVF), the Aspire Fund, the Enterprise Capital Funds (ECFs) and the UK Innovation Investment Fund (UKIIF). It identifies their main objectives and overall size (covering public and private investment).

Overview of the Funds

3.2 The design and structure of Government supported funds has changed in recent years, partly as a result of lessons learned from earlier schemes such as the RVCFs. There have been notable changes in the overall risk return profile of Government backed schemes and later funds (such as the UKIIF) operate on a pari passu basis (i.e. equal footing) or with a Government prioritised return structure (e.g. ECF) with investors. This is in sharp contrast to the structure of the earlier funds, where in some cases the Government took first loss.

Fund Background

3.3 The BIS equity funds have been created as a response to evidence of a persistent equity gap as well as to address low levels of business start-up activity in certain disadvantaged areas or groups. Table 3.1 provides a summary of the main rationale for establishing the BIS equity funds.

Table 3.1: Background to the Funds	
RVCFs	The Regional Venture Capital Funds were designed to address a perceived equity gap at the lower end of the equity capital market by providing equity finance to small and medium sized enterprises in each of the nine English regions. They were also intended to demonstrate to potential investors that commercial returns are possible from investing in SMEs in the equity gap.
UKHTF	The impetus for the Fund of funds 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 invest £20m to establish a fund of funds.[36] The UK High Technology Fund has nine underlying funds.
Bridges	The overarching objective of Bridges was to provide venture capital to SMEs capable of growth that are located in and have economic links with the 25% most disadvantaged wards in England.
EGF	Early Growth Funds were developed to ‘stimulate the provision of small amounts of risk

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

Table 3.1: Background to the Funds	
	capital' (below the RVCF limits) and to test new investment models (co-investment model) to see if they could produce returns from small investments. In total, there are seven EGFs.
Aspire	It was identified that business start-up rates amongst women entrepreneurs was low and the fund was established to address this gap.
ECF	The Enterprise Capital Fund programme was introduced as a response to the 2003 Bridging the Gap consultation which identified a long term structural weakness in the provision of risk capital to SMEs. Further, these funds were intended to be more commercially driven compared with their predecessors. There are nine ECFs.
UKIIF	The UK Innovation Investment Fund of funds was established to drive economic growth and create jobs by investing funds that invest in high growth technology businesses in specific sectors such as digital technologies, life sciences, clean technology and advanced manufacturing.

3.4 Table 3.2 presents a profile of these funds, including their target sectors or groups. Over time, the activities of the public equity schemes have become targeted with clear commercial objectives and focus on growth sectors.

Table 3.2: Profile of Funds

	Sector	Geography	Deprived area / Gender	Provide smaller investments
RVCF		Regional		
UKHTF	High tech			
Bridges			Deprived areas	
EGF		Regional		Below RVCF level
Aspire			Women	
ECF				
UKIIF	Life sciences Low carbon Digital technology Advanced manufacturing			

3.5 Notable characteristics of the BIS equity schemes are as follows:

- Three funds are 'live', i.e. they actively investing (Aspire, ECF and UKIIF) and four are legacy funds, i.e. they are closed to new investments (RVCF, UKHTF, Bridges and EGF).
- Two funds are structured explicitly as co-investment funds (Aspire and EGFs), although four of the ECFs also have co-investment provisions[37].
- With the exception of the two funds of funds (UKHTF and UKIIF), the remaining funds are generalist funds, i.e. they do not have a specific sector focus.

[37] For example IQ Capital ECF invests where an angel with specific expertise is also investing and MMC ECF co-invests with an EIS fund that they also manage.

- There are two funds that have a specific regional focus. These include the nine RVCFs and the seven EGFs that were designed at a national level but delivered regionally.

- The UKHTF and UKIIF are fund of funds that do not invest directly in businesses but in venture capital funds.

Fund Sizes

3.6 An overview of the size of the BIS VCFs, in terms of public and private capital and number of investments, is detailed in Table 3.3 overleaf. The most recent scheme, the UKIIF, is the largest to date with a total size of £325m.

Table 3.3: BIS Fund Overview £m

	Established	Total capital (£m)	Average total capital per fund (£m)	Public capital (£m)	Private capital (£m)	Number of Investments to date
RVCF	1999 – 2000	224	25	74	150	576
UKHTF	2000	126	14	20	106	247
Bridges	2002	40	-	20	20	28
EGF*	2002 - 2004	36.5	4.5	31.5	5	267
Aspire*	2008	25	-	12.5	12.5	8
ECF*	2006	239	26.5	156	82	75
UKIIF	2009	325	162.5	150	175	3

Source: CfE Quarterly Report 2010
*Source: CfE monitoring data September 2010

3.7 Key observations from Table 3.3 are that:

- Across the seven funds (both live and legacy funds), total commitment equates to over £1 billion, of which the Government's commitment represents £464 million (46%).

- Live funds represent £589 million (58%) of total commitment, and more than half of this (54% or £320 million) comes from the Government.

- Five of the funds (ECFs, Aspire, Bridges, EGFs and RVCFs) have restrictions on the maximum amount that can be invested in a company. UKHTF and UKIIF do not have such restrictions.

Summary

3.8 Overall, performance varies across the Government supported equity funds. In general portfolio values for the earlier schemes (e.g. the RVCFs, UKHTF and EGFs) have tended to decline over the last three years, partly reflecting the impact of the economic downturn as well as restrictions on their ability to provide follow-on investments to portfolio companies.

4 Investor Profile

4.1 This chapter provides a review of typical investors to BIS VCFs. It provides a profile of these investors, their investment strategy and preference of investment vehicle, including the extent of their involvement in investee businesses and their investment levels.

Profile of Investors to BIS Funds

4.2 A total of twenty-one investors were consulted in depth as part of the research. These investors fall into two broad categories: institutional investors and business angels. A breakdown of investors consulted is presented in Table 4.1 below:

Table 4.1: Profile of Investors by Type

Type	Number Consulted
Institutional Investors	12
Business Angels	9
Total	21

4.3 A brief description of each investor type follows:

Institutional Investors

4.4 Institutional investors to BIS VCFs include pension funds (public and private funds); large corporate investors (such as banks, insurance companies and other large companies); universities and charities; as well as venture capital funds (e.g. fund of funds). They typically invest through individual funds or fund of funds and rarely invest directly in a company.

Business Angels

4.5 Business angels or 'high net worth individuals' tend to invest as co-investors with BIS co-investment funds (e.g. the Early Growth Funds and Aspire). This approach enables these investors to invest at the start up or early growth stage, where their 'hands on' approach is most beneficial. Business angels often have a business background, and most are successful entrepreneurs.

Investment Strategy

4.6 The majority of institutional investors responding to the survey have more than £1 billion of total assets under management. These ranged from £28 million to £35 billion. The majority of their investments are in traditional asset classes, namely quoted equities (i.e. stocks and shares), bonds and property. Private equity investments represented between 3% and 10% of total funds under management, with venture capital investments ranging from

a low of 0.8% to a high of 7%. Most institutional investors appear to have a strategic commitment to private equity, of which venture capital is normally included, and this is maintained over time, although it is not a guarantee of any level of VC investment in the UK. One of the pension funds stated that their investment strategy aims to maintain their exposure to private equity at around 10% over a three year period, allocated across Europe, United States and Asia.

4.7 Institutional investors generally stated that their overall investment profile has not changed significantly over time and they do not anticipate any changes going forward. There is a general reluctance to change current level of exposure to venture capital and one investor commented that '*VC is a hard sell and I cannot justify increasing investment in this area*'. In general, institutional investors aim to achieve a balanced portfolio of investments across the different asset classes.

4.8 Overall institutional investors do not place restrictions on how their funds are invested and generally rely on the judgement of the fund managers. For example one investor commented that '*we are much more interested in the calibre of the fund manager than the detail of how he/she delivers returns*'. A few investors focussed their investment strategy on early stage companies and technology sectors (such as information technology and life sciences) – these were more likely to be experienced investors, with a dedicated in-house investment team.

4.9 In terms of the geographic spread of investments, the majority of investors reported that their venture capital investments are diversified through global investment, with the United States and Asia the most common markets. This helped to minimise investment risks and reduced their exposure in any single market. Overall, the majority of investment in venture capital appears to be in the United States and one institutional investor reported that as much as 80% of their venture capital investment is in Silicon Valley.

4.10 Business angels most typically invest as part of a syndicate or investor network (some of which have been developed by fund managers, for example the Advantage Business Angel Network and the Viking Club). The development of investor networks was one of the objectives of the EGF programme and these networks have enabled companies to raise large amounts of investment. Angels that co-invested with the EGFs stated that these funds doubled the investment amount and in their absence they *'would not have had enough money to make the investments worthwhile'*.

4.11 The amounts angels invested ranged from under £10,000 to over £250,000, although the average investment size was normally between £50,000 and £100,000.

Investment Strategy
We allocate what we think is the appropriate amount to [private equity] *to keep us at that 10% level over a three year period and we basically allocate it geographically between Europe, the US and Asia.* (Institutional Investor)
We like early stage and we have a bias towards information technology funds. (Institutional Investor)
Nearly 80% of our venture capital investments are in the US and although we have invested in Europe, we continue to invest very selectively… we are looking to invest in the best fund managers globally. (Institutional Investor)

Investment Vehicle

4.12 Institutional investors prefer the venture capital fund model, which relies on the expertise and track record of the fund manager to generate returns. Their preference for a specific fund model is somewhat mixed, with some investors choosing the fund of funds approach, notably because it enables larger sized investments to occur and provides broader exposure to different stages of private equity, including venture capital. Others that prefer to invest directly in individual funds often cited higher management fees as the major drawback to the fund of funds model.

4.13 Some institutional investors also invest in mezzanine loan funds and they reported that these funds tend to have a shorter financing period which lowers their perceived risks and increases the potential for obtaining a return over a shorter time frame.

4.14 Turning to business angels, they indicated a clear preference for co-investment venture capital models, which facilitated greater involvement in investee businesses. Business angels support their investee companies through a range of roles including mentoring, strategic advice and networking opportunities.

4.15 One of the drawbacks cited of the Government co-investment funds was the fixed match level, that is, these funds typically invest on a pound for pound basis with private investors. Some co-investors stated that this restriction does not provide fund managers with adequate flexibility to invest in individual companies. In essence, consultees wanted co-investment funds to have the flexibility to vary the match level based on the unique needs of each company. There was some anecdotal evidence that the decision making process can sometimes be quite slow for co-investment funds which may be

attributable to the need to co-ordinate fund and business angel approvals rather than just the fund in the case of the hybrid model.

Investment Vehicle
[Co-investment funds] *provide 'much more flexibility in how you invest and why you invest as a private investor whereas in venture capital funds... the fund manager had to manage money in a certain way, it is much less flexible.* (Business Angel)
Through the fund of funds we have a much broader exposure to private equity of various kinds. (Institutional investor)
The venture capital asset class has to be doing extremely well for us to make money from the fund of funds model. (Institutional investor)

Returns on Investment

4.16 Institutional investors typically anticipate double digit returns from their venture capital investments. They generally understand the risks associated with investing in venture capital and accept that their investments may potentially fail. Most investors regard the risks as acceptable because of the potential upside. For example, one investor noted that '*it is appropriate to have modest exposure that might produce a dramatic return'.* A few investors also stated that one successful investment could compensate for losses obtained elsewhere.

4.17 There is a general perception that the returns on venture capital investments in the UK are likely to be lower compared to other markets such as the US. Most investors, particularly institutional investors, indicated that the returns they have received to date on their venture capital portfolio have not always justified the risks associated with their investments, which may also act as a deterrent to new investors. Overall, poor investment returns from funds raised during the dotcom bubble distort the true picture of the return potential of the asset class in the UK. As shown in Table 4.2, purely commercial UK VC funds raised in the 2002 – 2005 vintage years, whilst still relatively young, have produced a pooled average IRR of 2.7%, with the top-decile returning more than 11% to their investors per annum.

Table 4.2: Since- inception[1] IRR (%) - Venture Funds[2]

	Subtotal	Pre Bubble (1980-1997)	Bubble (1998-2001)	Post Bubble (2002-2005)
No. of funds	77	32	30	15
Pooled average	-0.2	12.0	-6.4	2.7
10th percentile	15.9	24.0	2.8	11.0
25th percentile	8.5	15.5	-2.9	5.0
Median	0.0	9.0	-10.7	0.0
75th percentile	-11.8	3.3	-17.7	-11.9

90th percentile	-20.6	-10.2	-2.09	-29.2
Inter-decile range	36.4	34.2	31.8	40.2
Range of returns	98.7	71.5	58.8	51.1
Source: BVCA Private Equity and Venture Capital Performance Measurement Survey 2009. [1] Since inception returns as of 31 December 2009 on a net of fee and carry basis. [2] These are venture funds with no restrictions in their investment strategy imposed by their investors for purposes other than return maximisation or risk management. These funds are at least four years old. The returns are on the since-inception basis and are annualised.				

4.18 Overall, the performance of UK venture capital fund is not significantly worse off than other countries – See Table 4.3[38]. Germany appears to be the best performer with its venture capital funds achieving average IRRs of 4.5%, although this may be due to differences in metrics and reporting time periods. Appendix B provides further information on the since inception IRR for venture capital funds in the US.

Table 4.3: Comparative Venture Capital IRRs			
	IRR - All Funds	**Metric**	**Time Period**
UK	-2.2%	13 year IRR	Up to December 2009
France	-0.7%	10 year IRR	Up to December 2007
Germany	4.5%	Since inception IRR	Up to December 2007
USA	-0.9%	10 year IRR	Up to December 2009
Sources: BVCA, AFIC, BVKAP, NVCA			

4.19 Some institutional investors were of the view that indigenous fund managers, including BIS fund managers, are more risk averse than their US counterparts which has affected performance. One consultee commented that '*UK VC fund managers don't always take risks and tend to focus on protecting downside or maximising upside*'. A few institutional investors reported that some indigenous fund managers prefer to realise venture capital investments quite early, (sometimes within the first three years) often at lower returns, rather than choosing to support investees to later stages. These investors, especially pension funds, stated that they were satisfied to wait for a longer period to realise their investments, as this will maximise the potential for a higher return. In support of this view, one pension fund noted that they would consider VCFs with a 20 – 30 year life. Most VCFs have a 10 year life cycle to give fund managers sufficient time to realise or exit portfolio investments. However for some sectors, such as the life sciences, a longer life cycle may be more appropriate because longer product gestation periods make it difficult to realise investments within 10 years.

[38] Whilst the data is not directly comparable because of different time periods and metrics, it provides some indication of the performance of UK venture capital funds relative to selective comparators.

Investment Returns
Our target for any type of equity vehicle is double digits and we would expect venture capital to be in the very high double digits. (Institutional Investor)
We are looking to build a balanced portfolio that we think will generate the best returns. (Institutional Investor)
[Investors] *are looking at the performance of the asset class over the last 10 years and it has not been great, and I think they are finding it internally very hard to sell as to why to continue put money into it. (Fund Manager and Institutional Investor)*

Impact of Recession

4.20 Generally, the recession led to a decline in investment portfolio values, for both institutional investors and angels, however most investors indicated that their portfolios have recovered, and for some '*have gone past its previous high*'. Most business angels have reduced their overall investment activity as a result of the recession, whilst institutional investors have tried to maintain their exposure to the different asset classes so as to reduce over-commitment in any particular asset class. Most business angels have responded to the recession by focussing on the survival of existing investee companies. Some also reported that they are more cautious about which companies to invest in, (one co-investor thought that perceptions of risk intensified during a downturn). In general, institutional investors have been protected because of their widely diversified portfolios.

4.21 A few investors and stakeholders noted that the recession had an arguably positive impact on venture capital by removing poor performing managers and reducing company valuations, thereby making equities much cheaper. In contrast, some fund managers regard the decline in their numbers as a problem because they tend to perceive each other as co-investors and important sources of deal flow rather than competitors.

Impact of Recession
The recession has led to a shake out of fund managers and improved pricing for new deals. (Institutional Investor)
In 2008/09 asset value fell substantially and in 2009/10 they have recovered…it's been extremely hard and requires continual monitoring. (Institutional Investor)
I'm more cautious when investing and look harder at the business and ask whether the business can thrive in this climate. (Co-investor)
It has impacted the pace at which we have been able to make new fund commitments, because in 2009 there were few fund managers of quality out there fund raising. (Institutional Investor)

Summary

4.22 Investors to BIS supported venture capital funds include institutional investors as well as high net worth individuals. The majority of institutional investors have significant funds under management, although some have a commitment to private equity, venture capital is a small element of this at best.

4.23 Institutional investors have a clear preference for VCFs and do not invest directly into companies. In practice, business angels invest directly in companies and therefore prefer to invest alongside both co-investment and hybrid funds rather than in them. This allows them direct involvement in investee companies as well as access to fund manager expertise, especially due diligence. Business Angels have responded to the recession by focussing on the survival of investee companies.

4.24 Whilst investors expect the BIS backed funds to be commercially focussed, they accept that the small size of these funds reduces the potential for high upside returns. There was a general perception amongst UK investors and stakeholders that indigenous fund managers, including BIS fund managers, are risk averse compared to their overseas counterparts.

5 Investment Motivations and Behaviour

5.1 Qualitative interviews were undertaken with investors, fund managers and stakeholders. These interviews explored a range of issues from investor attitudes and motivations to perceived impacts of BIS supported VCFs. This chapter covers investment motivation and behaviour, focussing on attractiveness of venture capital as an asset class, including the attractiveness of BIS VCFs. It also discusses the role of fund managers and tax incentives in raising private investment and closes by highlighting some factors that could potentially improve the attractiveness of VCFs to investors.

Motivations

5.2 The underlying objective of investing in the venture capital asset class is the desire to achieve a **high financial return**. Without exception investors stated that the potential for high returns is the primary reason for investing in early stage businesses. One investor noted that *'we expect the returns from sub £2m investment to be greater*' and another expressed their expectations of potential '*eye watering returns beyond dreams of anything seen'*. Typically investors will obtain a return on their investment through an IPO or a "trade sale" of the business.

5.3 **Personal satisfaction** was an important motivator for business angels who regard investing in early stage companies as '*quite a lot of fun'*. For these investors the fun and enjoyment deriving from such investments is a key secondary motivator. This is in line with their preference for investing directly in early stage companies to add value by leveraging their expertise and business acumen. One institutional investor indicated that they derived satisfaction from being associated with companies that are making a difference and their investment was '*doing some sort of service as well as making some money'.*

5.4 Some investors also express **altruistic motives** and are looking for the opportunity to make a difference. Business angels regarded their investment in early stage companies as an opportunity to *'create a healthy commercial environment'* and highlight the importance of SMEs to the UK economy- *'we believe that businesses are the engine of society'.* Institutional investors also invested to support regional businesses and particular sectors, for example early technology companies. One institutional investor that had invested in the RVCF programme reported that their investment was motivated by a desire to be recognised as supporting high growth companies in the local economy.

5.5 **Diversification** of their portfolio is another identified investor motive, especially for institutional investors seeking to gain exposure to different asset classes. Although the majority of investors reported that venture capital was the most risky of their portfolio investments, they generally felt that *'moderate exposure to* [venture capital] *is acceptable because of the potential for high return*'. Some investors also invested in venture capital to prevent overexposure elsewhere in their portfolio (for example in quoted equity or property).

5.6 Generally, investors do not regard BIS VCFs as any different from commercial VCFs and they have the same expectations of rewards. For example one stakeholder reported that *'investors will make a judgement on the merits of the fund and will not necessarily give much weight to whether it is Government sponsored or not'*. Still, there is general consensus that Government involvement reduces the risk of investing in venture capital and increases the potential for returns (particularly so in funds where the Government has taken a subordinated role)[39].

Role of Fund Managers

5.7 The role of the fund managers is fundamental and arguably one of the primary determinants of investment in VCFs. Most investors generally reported that the quality of fund manager is more important than Government support in deciding whether to invest in venture capital. One fund manager stated that *'investors are there because of fund managers and not Government backing*'.

5.8 For institutional investors, the track record of the fund manager is a principal consideration. Not only do '*investors chase performance'*, they also expect fund managers to present a credible business case and the '*motive must be profit and not just giving away money*'. The importance of the fund manager is confirmed by the following feedback from other institutional investors:

Fund Managers
There has to be the correct structures and the correct governance and transparency for us to know what is going on. (Institutional Investor)
Our overriding interest is the track record of the fund manager. (Institutional Investor)
We are looking to invest with the very best fund managers globally. (Institutional Investor)

[39] The Government has not subordinated its stake since 2003, although ECFs do have a type of subordination which offers the Government downside protection but with lower upside gains.

5.9 The interviews revealed that co-investors valued fund managers for slightly different reasons. They placed strong emphasis on the fund manager's experience of early stage businesses and their post investment monitoring of companies. For example, the co-investment funds typically appointed a representative to the board of investees. Three functions have emerged as being particularly valued. First, due diligence support from the fund managers is cited as very important as most co-investors are unable to undertake it singlehandedly. Second, a few co-investors reported that the fund manager's knowledge of follow-on investment is useful, particularly for funds having restrictions on the amount that can be invested in a portfolio company. Third, some fund managers provided their co-investors with standard documentation (for example shareholder agreements and articles of association) which helped to reduce their transaction costs, such as legal fees.

Role of Government Support

5.10 Whilst the calibre and track record of fund managers is essential, Government support has also played an important role. Consultees were generally in consensus that Government involvement has attracted institutional investors to small VCFs, where they might otherwise have not invested. In other words, although returns were not always guaranteed, Government support reduced the risks involved, which institutional investors found attractive. For example, one institutional investor commenting on their reasons for investing in one of the RVCFs stated that '*its structure, its targeting and the Government's underpinning made it an attractive proposition… without the Government's underpinning it would have been a much more difficult decision*'. There is a notable differentiation between investors' attraction to venture capital as an asset class and their support for Government supported VCFs - the former is attractive because of potential high returns and investors are investing in venture capital irrespective of Government involvement.

5.11 Investors appear generally satisfied with the Government coming in on a pari passu basis, however there is a difference of opinion about the role of Government subordination. Some consultees are pro Government subordination, specifically in terms of anticipated returns, to attract investors who would not otherwise invest in the sub £2 million venture capital market. In support of this view, they reported that the small size of some VCFs operating at this end of the market acts as a disincentive to attract large investors. The counter view is that unless the Government invests on an equal basis with investors, they are more interested in fund performance when it is performing very poorly. In other words, if investors obtained their returns first, they are

unlikely to have much incentive to encourage fund managers to maximise performance. However, when the Government prioritises return on its investment (as in the ECFs) before investors they are more likely to have an interest in monitoring performance.

5.12 There were mixed opinions on whether the Government should invest directly in the venture capital market. One investor thought that the Government's role was better placed encouraging institutional investors to participate in venture capital instead of investing directly. This investor reported that '*it is appropriate for pension funds to invest in venture capital because if the sector is properly funded it is more likely that winners will come out of it*'. Some consultees also reported that the Government's involvement can sometimes be interpreted as a subsidy and that '*the best performing VCFs prefer to not accept Government support*'.

Government Support
I'm not sure [venture capital] *is something the Government should be getting involved in. I can see why they do, but I think they should rather consider encouraging local authority pension schemes and other state pension schemes to put money out there for the long run.* (Institutional Investor)
We possibly could have done it [without Government support] *but their involvement made the fund more scalable and more efficient and the fees could be lowered because there was more money to be put to work.* (Institutional Investor)
[Our investment in the fund] *is relatively small, a quarter of a million is less than 1% of our exposure and there needs to be a hook and I think the Government's gearing is an attractive hook. (Institutional Investor)*
A lot of co-investors like the thought that there is someone co-investing alongside them because funds tend to follow the money a bit better than individuals. Having an institutional fund alongside the individual investors gives them a degree of comfort. (Fund Manager)
The Government's contribution essentially lowers the risk, or if you like increases the potential return and that of course is attractive. (Institutional Investor)

Role of Tax Incentives

5.13 Overall, the tax incentives were regarded as complementing Government supported VCFs. That said, there were mixed views on the effectiveness of the different tax schemes in attracting private investors to venture capital.

5.14 For the most part, investors were in agreement that the Enterprise Investment Scheme (EIS) was as an important motivation for individual investors (business angels) who invest directly into eligible companies. Co-investors, in particular, indicated that the EIS was a key factor underpinning their investment in venture capital companies and one commented that

‘*Government investment with EIS makes venture capital attractive to us*’, whilst such investors do not directly benefit from Government subsidy (other than tax), they are able to benefit from fund managers’ due diligence processes. Most consultees were in consensus that the EIS scheme attracts the type of investor who otherwise might not have considered investing in venture capital. It was noted as being especially useful for new investors, who may need additional reassurance. One consultee observed that experienced investors should make their investment decisions based on the quality of the investment and not allow the tax relief to determine their investment activity. That said, the majority of business angels were in consensus that the tax relief increases potential return and was an important incentive to invest in venture capital.

5.15 The majority of fund managers and institutional investors stated that there is a need for better balance between EIS and ‘managed money’ – VCFs. To elaborate they felt that more investors could be attracted to VCFs if they enjoyed the same EIS benefits as investors going directly into companies. One fund manager observed that ‘*EIS attracts individuals who are investing off their own backs and not through a fund manager*’. Whilst this view was somewhat popular it would potentially give these investors double public benefit of tax relief and risk reduction.

5.16 Looking at the VCTs, some consultees felt that it has not supported early stage businesses as widely as it could have done, partly because they have tended to support low risk businesses. For example, one consultee observed that the VCT scheme arguably crowds out investment from high growth early stage companies and is being used as a tax avoidance scheme.

Government Restrictions

5.17 The older funds (for example the RVCFs and EGFs) were established with restrictions placed on the maximum initial investment and follow on investments. For example the RVCFs could not invest more than £800,000 in a company. The newer funds (e.g. ECFs and UKIIF) operate on a purely commercial basis without most of these restrictions (although ECFs have a maximum investment size of £2 million). Consultees were generally in consensus that these restrictions did not discourage private investors (because of the attractiveness of upside subordination under ECF) however they may have adversely influenced the overall performance of these funds. Still, the level of downside protection subordination observed in earlier funds are unlikely to reoccur in future Government supported VCFs.

5.18 There are mixed views about the regional focus of some of the earlier funds. Some consultees were of the opinion that having a specific geographical remit enabled fund managers to benefit from "good–will" investment from local institutional investors, who might not have otherwise supported these funds. This is consistent from interviews with some institutional investors who reported that they invested to support companies within their local economy. Further, some fund managers and investors stated that in the absence of regionally focussed funds, companies, particularly in the North, would not benefit from venture capital investment.

Restrictions on Funds
The restrictions on the investment size and sector meant that we had to wait a certain amount of time before re-investing in a business. This meant that if businesses unexpectedly needed extra money we had to sit and wait before we could give it to them. (Co-investor)

Enhancing the Attractiveness of VC

5.19 There is general consensus across investors and stakeholders that venture capital has an important role in building high growth businesses. Differences of opinion emerge as to the role of Government – including level of subordination; the appropriate form of investment vehicle; and structure of venture capital funds.

5.20 Generally two main factors were identified that could potentially improve the attractiveness of venture capital to institutional investors:

5.21 **Increasing Scale of Hybrid Equity Funds.** Institutional investors reported that individual hybrid funds were still too small to be commercially viable, given the size of their overall portfolio. Whilst, the ECFs are a notable improvement on earlier funds, there is an appetite for much larger funds to attract more institutional investors. Institutional consultees stated that early stage financing is better met through funds of significant scale which will attract investors and generate good returns. Their reasons were threefold: first, the fixed costs (e.g. management fees and due diligence costs) of managing VCFs do not vary proportionately with the size of the fund, therefore small VCFs are likely to have high management costs. Second, larger funds are better able to provide follow on investments to investees, hence preventing a 'drip feed' of finance. Third, most institutional investors are unable to invest below a certain threshold, which effectively rules out investment in very small VCFs. For example, one institutional investor reported that as standard they invest a minimum of £20 million in venture capital funds.

5.22 Another investor who has committed £100 million to a hybrid scheme indicated that they would have invested significantly more but doing so would have made them the largest investor – thereby increasing their risk. Further, some institutional investors stated that they do not have the expertise internally to make and manage a wide range of direct investments in small VCFs. These views are not new as existing research also recommends that hybrid VCFs should have a minimum size of around £50 million, and even larger for funds specialising in life sciences and clean tech[40]. Whilst the Government has not directly placed restrictions on the overall size of funds, interviews with fund managers suggested that they have tended to cap fund sizes at between £30 million and £50 million to avoid them becoming larger than they could manage (this is elaborated further in chapter 7).

5.23 **Promoting Successful Exits.** There is a perception among investors and some stakeholders that there are only a few well performing venture capital funds in the UK and the majority have generally performed poorly. '*Expectations for high returns were not really met'* and **'***the performance of the asset class overall is negative'* claimed one stakeholder. This has made it difficult for fund managers to attract new investment from institutional investors. For the most part however, institutional investors reported that they would consider investing more in venture capital if there was more evidence of existing funds achieving successful exits. This is an important issue for these investors, some of whom do not typically invest in new funds, and rely on historical evidence of good performance to justify their investment activity. Some investors reported that they would be happy to increase their investment in the UK venture capital market if they were able to receive the kind of returns obtained elsewhere, for instance in the United States. Fund managers of BIS equity schemes have reported that they find it challenging to exit investments primarily because of difficulty making follow on investments in their portfolio companies as some companies needed investment beyond the capacity of the fund. Further the credit crunch made it particularly difficult for these companies to obtain financing elsewhere.

5.24 As noted earlier some consultees reported that expanding the scope of the tax schemes, in particular the EIS, could potentially encourage more private investors to invest in VCFs. These consultees recommended a reassessment of the existing rules governing EIS to make it easier for private investors to retain their EIS benefits whilst using professional fund managers. Whilst the existing VCT scheme partly fulfils this purpose, consultees

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[40] Nightingale et al (2009) From Funding Gaps to Think Markets UK Government Support for Early Stage Venture Capital. NESTA and BVCA; SQW Consulting (2009) The Supply of Equity Finance to SMES: Revisiting the Equity Gap. BIS

generally reported that VCTs tend to invest in lower risk later stage companies at the expense of higher risk early stage companies. They want the Government to '*make it easier for investors to get EIS benefit and the expertise of a fund manager*' for early stage companies. A small number of consultees also noted that the EIS scheme can be quite bureaucratic at times and easing this process could enhance its attractiveness as an incentive to invest in venture capital.

5.25 There was anecdotal evidence to suggest that some institutional investors, particularly pension funds with small internal investment teams, required more market intelligence on the venture capital industry. '*The industry is not very good a publishing honest data'.* These investors reported that they would benefit from a *'hub of expertise and resources'* from which they can leverage intelligence to support their investments in venture capital. Overall pension funds are investing at most 2% of their total funds in venture capital, probably because of limited internal expertise in this area. One investor recommended that the services of Capital for Enterprise should be better promoted which may raise awareness among other pension funds.

5.26 A number of consultees suggested that the target group for smaller VCFs should be the big pension schemes (£5 billion and above). Essentially it was felt that these investors had the in-house expertise to manage small scale investments. One consultee commented that '*smaller pension funds are less likely to do it because they have issues around what we call scheme governance... it is not just about risk, it is also the oversight responsibility*'.

Attracting Investors
Managers can attract investors based on successful exit record. (Fund Manager)
The only one thing that [investors] *are interested in is an exit.* (Stakeholder)
It is very important that the fund manager has a clear idea of how to achieve exit and that is a different skills set from the investment monitoring skill-set, it is actually the disposal challenge. (Stakeholder)
Seeing significant venture backed companies generate liquidity would drive investors back to venture capital. (Institutional Investor)
Some more targeted and bigger chunks of investment would probably attract greater institutional money. (Institutional Investor)
It is a combination of the right structure and credible management team. (Stakeholder)
It is important that we find additional ways of getting investors involved….on the institutional investment side we need to encourage/nudge them to have balanced portfolios. (Stakeholder)

Summary

5.27 Investors invest in the venture capital asset class for a range of reasons, more commonly because of potentially high returns and to achieve diversification in their portfolios. Some investors do it for personal

satisfaction, particularly business angels who enjoy investing in early stage companies.

5.28 Generally, investors do not regard BIS supported funds differently from purely private VCFs. However, they have indicated that Government support reduces the risk of investing in what is perceived as a very risky asset class.

5.29 Overall, the fund manager plays an important role, which is valued by institutional investors and business angels alike. Co-investors with BIS supported co-investment funds reported that they valued the due diligence support of these fund managers; their knowledge of follow on investment sources and their provision of standard documentation.

5.30 It is clear that Government support is appropriate and necessary to meet the equity gap (this is further elaborated on in Chapter 6). In particular, Government support has attracted institutional investors to small VCFs, in which they might otherwise have not invested. Government involvement minimised the risks, which investors have found attractive. Overall, there are mixed views on the role of Government subordination, however the extent of subordination observed in earlier funds are unlikely to reoccur in future Government supported VCFs.

5.31 Tax incentives complement existing Government VCFs, and the EIS in particular has been an important motivator for most business angels. Some consultees, mainly fund managers, have indicated a desire for a better balance between the EIS scheme and VCFs. They generally feel that they would potentially be able to attract more private investors to VCFs if these investors benefitted from the same EIS tax reliefs as investors going directly into companies. Respondents have suggested that increasing the scale of existing VCFs and raising awareness of the performance of VCFs could potentially attract more institutional investors.

6 Impact of BIS Funds

6.1 This chapter focuses on the impact BIS equity funds have had on the operation of the venture capital market and investors, in particular the supply of venture capital. It also discusses some suggested enhancements to current and future delivery of public supported equity schemes which could potentially enhance their overall impact.

The Impact on the Venture Capital Market

6.2 This section examines the extent to which BIS equity funds have responded to the equity gap, and influenced the operation of the venture capital market. It looks at their impact on the supply of equity finance, the structure of venture capital market and the overall performance of venture capital – in other words has the asset class demonstrated that it can perform?

Increasing the Supply of Equity Finance

6.3 There is general consensus among consultees that BIS supported equity funds are responding to equity finance market failures by helping increase the supply of investment, especially to companies requiring less than £2 million. The interviews with fund managers, co-investors and stakeholders found that BIS funds have made equity finance available to companies that would not have been able to raise funding elsewhere. For example, one fund manager reported '*at least 50%, probably 75%, of my portfolio would have gone bust'* without support from the Fund.

Examples from Portfolios
When [the company] *came to us, it was basically two university professors and they had between them little or no experience of running a business so they really had to learn the roles from scratch… and we helped structure the deal, we helped to bring in a new chief executive.. and we were able to attract private investment which I am pretty sure they would never have received, the company would never have got off the ground*. (Fund Manager regarding an EGF portfolio company)

6.4 Consultees also reported that fewer VCFs would be operating in the venture capital market without BIS support. They highlighted BIS's role in easing the difficulties that fund managers often face trying to raise new funds, which was primarily attributed to the lack of commercial returns in venture capital over time, which in turn has undermined investor confidence. For example, one of the fund managers reported that '*whilst our investors are there because of our track record, BIS's support meant we effectively only needed to raise £10 million rather than £30 million, which would have been much more difficult*'. Consultees have noted that Government support has enabled VCFs to achieve critical mass enabling further investments, and of a

higher value. Government support helps fund managers to establish funds of sufficient scale to attract other investors; develop a suitable portfolio of companies; make investments of significant value; and finance later round investments.

6.5 There is anecdotal evidence that BIS equity funds have increased the supply of equity finance to growth sectors in two main ways. First, its co-investment funds have, in some instances, encouraged angel investors to invest in non-traditional sectors (e.g. technology), in which they are less familiar but willing to invest because of the expertise and due diligence brought by these fund managers. Second, BIS has supported the development of large scale sector specific funds like UKFTF and HEIF (part of UKIIF), which consultees reported would not have existed without its support. The latter is highlighted as an important impact as some high technology sectors, such as life sciences, often have difficulty obtaining venture capital funding because long gestation periods often make it difficult to achieve a return during the life of the portfolio. Companies in these sectors are therefore less attractive to mainstream VCFs.

Increasing Supply of Equity Finance
Investments would never have happened without Government money. (Co-investor)
It is highly unlikely for a company to back out because they obtained money from elsewhere. (Fund Manager)
A lot fewer deals would be done because the big VCFs who have arranged these £500 million funds just don't do early stage in a kind of professional way. (Fund Manager)
ECFs would not exist without BIS support – definitely catalytic and positive. (Fund Manager)
Government helping fund managers to reach critical mass. (Investor)

Supporting the Venture Capital Ecosystem

6.6 The additional support provided was an attractive feature for many investors and the study has found evidence of BIS's funds improving the overall venture capital ecosystem through its co-investment funds. As discussed elsewhere, venture capital investment is more appropriate for early stages of the SME funding escalator (see chapter one) and these companies require what is often referred to as 'smart money', i.e. financing coupled with non-financial support. Consultees reported that the co-investment funds through their business angel networks have been able to provide early stage companies with essential non-financial support, such as mentoring, strategic advice and access to networks, which is crucial at this stage of their development. For example, one co-investor observed '*the co-investment*

model forms a certain symbiotic relationship – the fund manager brings half of the capital and private investors bring the other half and expertise'. Alongside the provision of non-financial support, there is anecdotal evidence that the co-investment funds support companies to the stage where they are able to obtain follow-on funding or a trade sale.

6.7 Whilst there is a consensus that BIS's support is necessary because of the equity gap in venture capital financing, a small number of respondents reported that the current focus of its funds on early stage businesses may be at the expense of later stage companies that are still not large enough to attract mainstream VCFs, but fall outside the scope of its equity schemes. Some consultees noted that BIS's support in equity finance remains fragmented and could be enhanced by having fewer funds of sufficient scale to support larger investment amounts and follow-on investment. A few stakeholders suggested that BIS invest in VCFs that are clear winners (they estimate they are only about three or four successful VCFs in the UK), and help to increase their overall supply of equity finance to early stage companies instead of committing small investment amounts across several VCFs.

Building the VC Ecosystem
It makes more sense to let the market select what are the best VCFs to back. (Investor)
I don't think there is a massive angel community in the UK and Europe… and they are the people you want to try and encourage to be active, because they are not just bringing money, they are bringing experience of what it is like to start their own companies and they are actually able to act in a mentoring role with the entrepreneurs that they back and I think that's just essential. (Investor)

Stimulating the Venture Capital Market

6.8 Some of the BIS supported funds were initially intended to demonstrate to private investors that good financial returns can be made from investing in early stage companies (see overview of equity schemes in chapter three). However, consultees identified two key factors that have made it difficult for BIS equity funds to achieve this objective. First, venture capital as an asset class has not performed as well as expected over the last ten years and BIS equity schemes have not been immune. There is evidence that BIS funds have found it difficult to raise private investor finance from investors who have been dissuaded by anticipated low commercial returns from venture capital. Although consultees mostly agree that there are some well structured BIS

funds (ECFs and UKIIF are often cited as examples), prevailing negative perceptions of venture capital continue to make it difficult for fund managers to raise private investment.

6.9 Second, with the exception of a few individual schemes, the overall structure of BIS supported funds, notably their small size and restrictions on investment size, have often made it difficult to achieve commercial success. There is evidence that some funds have been unable to make follow on investments in their portfolio companies, and as a result these investees have not been able to achieve the scale of growth necessary to attain a successful exit or to attract investors at the next funding stage. Further interviews with fund managers and other stakeholders suggested that earlier BIS funds have generally found it difficult to achieve the 'double bottom line' i.e. the economic objectives of supplying the equity gap and achieve a financial return for investors.

6.10 Despite these drawbacks, some of which are distinctive to the asset class and outside the absolute control of VCFs, there is some evidence that BIS funds have stimulated activity in venture capital. Fund managers and investors conceded that BIS funds have attracted investors, who would not have otherwise participated in venture capital. For example, an institutional investor to one of BIS's fund of funds indicated that they would not have made an investment in the fund without the Government's support. As one fund manager noted '*ECFs are raising private investment and this can be taken as validation that they are working*' and also '*whilst the Government is taking large but not majority stakes in these funds*' their involvement is a positive for the overall industry.

Raising Private Investment
[Fund X] have just raised £140 million from public market investors to invest in early stage technology and the fact that they have been able to do so indicates that there is an appetite out there from institutions but it is a question of getting the structure and the story right. (Fund Manager)

The Impact on Investors

6.11 This section outlines the way in which BIS equity funds have made an impact on investors. It considers their impact on investor attitudes to venture capital and their investment activity.

Changing Investor Attitudes to Venture Capital

6.12 The impact of BIS equity funds on investor attitudes to venture capital as an asset class is not immediately evident, primarily because investor confidence in venture capital has generally diminished over time, for reasons

discussed in chapters two and four. There is consensus that the performance of the asset class has not been universally impressive and it is unlikely that all investors will return unless they are able to make a strong asset class argument based on historical performance, which currently seems unlikely.

6.13 There is evidence that BIS funds have attracted two types of institutional investors: investors with a strategic commitment to venture capital because of its potentially high returns (a third of institutional investors, 4 respondents) and investors who might not have otherwise invested in venture capital without Government involvement (around 40%, 5 respondents) – see table 6.1. The latter group reported they have invested in VCFs, particularly in smaller VCFs because of BIS's involvement. They reported that BIS's involvement helped to reduce the risks associated with their investment by reducing their overall stake in these funds. These investors provide evidence of BIS equity funds leveraging additional private sector investment in early stage companies that otherwise would not have occurred. Investors with a strategic commitment to venture capital would have still invested in VCFs, including funds specialising in sub £2m investments, in the absence of BIS equity funds.

6.14 Further interviews with fund managers and co-investors suggested there is a growing group of high net worth individuals who have co-invested with BIS funds and are actively encouraging other private investors to do so. As shown in Table 6.1, a third of co-investors (3 respondents) stated that they would not have made their investment without BIS co-investment funds (pure additionality). Partial additionality was reported by a further three respondents indicating that the amount invested would have been lower without BIS as a partner. Overall, deadweight was reported by a third of co-investors, who would have still invested in the company in the absence of BIS co-investment fund.

Table 6.1: Additionality of BIS Funds

	Institutions[41]	**Co-investors**
No additionality – *would have invested anyway*	4	3
Pure additionality – *would not have invested without BIS funds*	5	3
Partial (scale) additionality – *would have invested anyway but smaller amount*	-	3
Total	9	9
Source: ekosgen 2011		

[41] Three institutional investors were unable to comment on the role of Government involvement at the time they invested in BIS equity funds.

Impact on Investors
I think the EGFs have been able to get private investors, people who otherwise would have bought property in Albania or coal mines in Africa, to actually look at opportunities on their door step and start investing in, if you like UK PLC, to the extent that they might otherwise not have done. (Fund Manager)
BT Pension Scheme would not have made the commitment to HEIF without BIS. (Fund Manager)
I would not put higher sums into company without EGF. (Co-investor)
Two thirds of investment would not have occurred without EGF. (Fund Manager)
In the ECFs we get private investors that would not have invested otherwise and there is no crowding out. (Fund Manager)

Additional Benefits

6.15 This section provides a summary of other impacts of BIS supported funds not already covered above. These include:

- **Building fund manager capacity.** A small number of consultees reported the Government's intervention in equity finance has enabled fund managers to develop specialist skills in venture capital financing. Fund managers reported they have gained experience in attracting institutional investors as well as an understanding of the particular needs of early stage businesses. This is an important outcome from BIS interventions that has taken time to build and could be easily lost if opportunities for fund managers are significantly reduced in light of the current financial challenges.

- **Providing market intelligence.** This involved providing business angels with market information on suitable investments, which helped to raise their confidence in venture capital and subsequently leverage more private investment in early stage companies.

- **Enhancing the UK's image.** A small number of stakeholders (mainly European based) reported that BIS supported funds provide important lessons across the EU on how to engage investors. This particularly related to the perceived success of its co-investment funds in leveraging private investment in early stage companies.

Wider Impacts
BIS funds are giving fund managers experience of engaging institutional investors. (Fund Manager)
We need to foster and develop fund management team experience and build a professional asset class of people that can do well. (Stakeholder)

Wider Impacts
BIS is doing okay among my experience with various BIS equivalents throughout Europe. What BIS is doing is absolutely laudable and the way they are trying to do it as well… they have made it absolutely clear that they want to be professional and commercial. (Stakeholder)

6.16 Overall the BIS equity schemes that have been identified as being the most successful in terms of leveraging additional private sector money are (in no particular order) the co-investment funds (EGFs, Bridges), ECFs and UKIIF. They are regarded as successful because of their structure, which makes them more commercially viable compared with their predecessors. Alongside these, the EIS tax scheme was also widely commended by consultees as encouraging additional private investment in early stage companies.

6.17 For most of the later funds (e.g. ECFs, UKIIF), fund managers perceived that it was too early to review performance, however they felt their portfolio pipeline is generally strong and has the potential to generate good returns for both the Government and private investors.

Successful Funds
For me it is the ECFs and then the EIS. (Fund Manager)
The UKIIF, the ECFs and the EIS investment programme are positive examples of Government intervention. (Fund Manager)
The big difference with the ECFs is the teams who were chosen, the way they were chosen and what they were asked to do. (Stakeholder)

Lessons, Enhancements and Future Delivery

6.18 Without exception, respondents agree that there is a case for some form of Government intervention in equity finance. They thought the rationale underpinning the establishment of hybrid equity schemes is valid and appropriate. Overall, the drawbacks of the earlier schemes (e.g. RVCF) are well documented and lessons have been learned which have led to improvements in the design and delivery of later funds. For example, some of the restrictions relating to geographical remit of investments have been removed. A number of consultees reported that whilst it is appropriate to focus funds on early stage businesses, putting restrictions on the amount that can be invested in a company was counterproductive.

Removing Restrictions on Investment Size
ECFs can't put more than £2 million into an investment and let's say they go in at £500,000 in the first round and the second round they put in another £1.5 million that is then kind of done and the company

Removing Restrictions on Investment Size
becomes a superstar and massive growth is achieved. The trouble is the fund is restricted and can't follow on and keep building their position so ultimately they get diluted in further rounds. (Fund Manager)

6.19 There are differing views on the appropriate form that Government intervention should take with regards to increasing the supply of equity finance to early stage companies (below £2 million). Some respondents have a clear preference for co-investment funds, which they felt reduced the government influence, maximised private sector leverage and facilitated small scale investments, without high transaction costs. In essence, they felt the co-investment model, by partnering with business angels, was more suited to the needs of early stage businesses, which is consistent with other research findings[42]. The counter view was that a direct investment fund approach offered simplicity and relatively greater returns for the fund (subject to successful exits). Anecdotal evidence suggests that VCFs are better suited to later stage investments (often after business angels have assisted companies at the pre venture capital and early stage level).

Appropriate Model for Supplying Equity Finance to Early Stage Businesses
VC model is more attractive than putting money directly in companies. (Investor)
The co-investment model is better at bringing in the expertise of individuals like myself. (Co-investor)
I honestly think the best model is a top team managing a partnership on behalf of other people… we would rather not have the co-investment thing because then you have to persuade people each time and they might have changed their mind. (Fund Manager)

6.20 As noted elsewhere, consultees generally reported that the promotion of BIS equity schemes could be strengthened to attract more investors. Capital for Enterprise is generally highly regarded as being very professional and knowledgeable about the sector; however it was felt that their role could be promoted further and their expertise more widely accessed, particularly among some of the larger institutional investors.

Promoting BIS Equity Funds
They [BIS] *need to make sure they publish and promote these schemes effectively so everyone is aware of them.* (Stakeholder)
Some work can be done to publicise these new funds [ECFs] *that are doing well.* (Fund Manager)

[42] SQW (2010) Improving the Coherence, Coordination and Consistency of Publicly Backed National and Regional Venture Capital Provision.

6.21 A few consultees reported that financial support should be coupled with investment readiness assistance to enhance the viability of investments. This view was manifested in two ways. First, some investors reported that fund managers needed additional support to improve their chances of raising investment from private investors. In these instances, the relationship between Capital for Enterprise and fund managers was regarded as important to build their capacity. Second, consultees thought that Government supported VCFs had a responsibility to help investee companies to become investment ready at different stages of financing, in other words offering pre as well as post investment support. This was regarded as being especially important in those funds (e.g. Aspire and Bridges) with a specific target group such as geography or gender.

Enhancing Investment Readiness
It's not just about [financial] *commitment; it is also the time* [Funds] *spend with each investment proposal.* (Stakeholder)
Funds targeted at groups should be accompanied by investment readiness [support]. (Stakeholder)

6.22 There is appetite among some institutional investors for further engagement and dialogue with the Government regarding the future design and delivery of hybrid funds. One of these investors noted that '*we want to help design [funds] and if we help to design it then we are more likely to put a significant amount of money in*'. In other words, investors want to become involved at the design stage to ensure their views are considered and most would prefer to communicate directly with the Government, rather than through fund managers. This is an important finding, in light of current Government moves aimed at encouraging institutional investors to increase their investment in venture capital. These investors have also noted that they wanted to become more involved in the selection of fund managers too. A couple of investors stated that one of the advantages of a more collaborative approach with the Government was greater control of fund management fees, which they thought were unduly high.

6.23 As discussed elsewhere, the small size of Government equity schemes is having a detrimental effect on their ability to attract larger institutional investors as well as provide follow-on funding to investee companies. Two potential enhancements have emerged from the interviews. First, some consultees have suggested that the Government establishes a large VCF of significant scale to attract corresponding large investments from investors. This large scale fund of fund (similar in structure to the UKIIF but larger) would then invest in other smaller funds, with a clear track record of performance, targeted at early stage companies. Second, respondents

believe that a graduation fund is needed to help investee companies obtain later round funding and prevent 'drip feed' investment and early stage companies spending too much time fund raising rather than focussing on growth.

Increasing the Size of Funds
The key problem is the scale of these funds, I would aggregate them to [create] *larger funds with the ability to do follow on investments.* (Stakeholder)

Summary

6.24 The interviews found that BIS supported equity funds have helped to increase the supply of equity finance, particularly for companies below the £2 million threshold. There is general agreement these funds have provided financing to companies that would otherwise not have been able to raise investment. Not only have they ensured that VCFs are operating at this end of the market, they have improved the supply of equity finance to key growth sectors, such as the life sciences.

6.25 The overall performance of venture capital as an asset class has undermined investor confidence somewhat and made it increasingly difficult for fund managers to raise additional investments. Still, there is evidence that despite the difficult economic environment, BIS equity funds continue to successfully leverage private investment, from institutional investors as well as business angels.

6.26 Whilst investor attitudes to venture capital have not obviously changed because of BIS supported funds, there is evidence of BIS equity funds leveraging additional private investment. The interviews found that BIS equity funds have successfully attracted institutional investors who might not have otherwise invested in venture capital without Government involvement. Still, a third of investors surveyed reported that they would have invested anyway and reducing deadweight in these funds would clearly maximise the benefits for BIS's investment in venture capital.

6.27 Overall, the EGFs, ECFs and UKIIF have been highlighted as the most successful BIS supported schemes. Consultees regarded these as being appropriately designed and having good return prospects because of their generally strong portfolios. HM Revenue's EIS tax scheme is also thought to encourage more private investment, particularly from business angels.

6.28 There are a few areas consultees felt could potentially enhance the impact of Government intervention in equity finance in the future. These include:

- strengthening the promotion of existing schemes to attract more institutional investors;
- maximising the expertise of Capital for Enterprise;
- improving engagement with investors, particularly regarding the future design and delivery of equity schemes; and
- establishing larger funds of sufficient scale.

7 Fund Manager Experience

7.1 This chapter is based on qualitative interviews with nine fund managers of BIS supported equity schemes (see Appendix A for a list of consultees). The interviews focussed on their fund raising activity, their approach to attracting private investors, the role and impact of Government restrictions and overall delivery of BIS supported funds.

Fund Management

7.2 All fund managers interviewed reported that they were managing other funds alongside BIS supported funds. These included loan funds, solely commercial VCFs, other publicly backed VCFs including co-investment funds, as well as fund of funds. Generally, there were no significant differences in the investment criteria associated with these other funds and most were reported to focus on early stage businesses.

7.3 Fund managers were generally in consensus that there were a number of benefits associated with managing several VCFs. These more commonly included:

- **Complementary deal flow.** This involved drawing on different funds under their management to encourage cross investments in portfolio companies. For example, if Fund X which is backed by the Government is limited to a certain investment size, the fund manager is able to use other funds under management to make second round investments.

- **Reduction of operational costs.** Fund managers reported that they were able to deploy certain administrative functions (e.g. finance and accounting) across funds, which led to a reduction on overall operational costs and greater efficiencies.

- **Development of key skills.** Venture capital skills are quite specialist and tend to be acquired on the job. The opportunity to manage several funds builds the knowledge, skills and expertise of the team.

7.4 Most were unable to cite any drawback of managing several funds as it was generally thought that the benefits highlighted outweighed any potential limitations. However, one consultee highlighted the significant administrative burden (e.g. regular reporting) that is often associated with the management of several hybrid equity schemes.

Synergies and Conflicts of Managing Several Funds
We also have back office infrastructure for the fund management process from everything from finance and reporting to compliance to investor relations and administration which are leveraged across our entire funds programme. (Fund Manager)
We did one or two investments from our transition loan fund into the [X Fund] *portfolio because they were at the stage where there was a risk that jobs would be lost.* (Fund Manager)
These funds come with multiplicity of stakeholders who place different demands on fund managers. (Fund Manager)

Raising Private Investment

7.5 Overall fund managers have targeted a pool of potential investors, including pension funds, financial institutions, other private funds, and high net worth individuals. They generally used their own network of contacts to identify investors, and reported that some of their investors are '*repeaters*', i.e. they have invested with the fund manager on a number of occasions. This reflects the overall importance of the fund manager's track record in attracting new investment as well as further investment from existing investors (see Chapter 5).

7.6 A couple of fund managers reported that whilst early VCFs were predominantly private, the last ten years had seen a marked shift towards public funding and the majority of live VCFs being publically supported, reflecting an overall retrenchment of private VCFs from the market. There was anecdotal evidence that the co-investment model has been more successful in raising venture capital finance because they have access to more high net worth individuals. Fund managers reported that these investors were more willing to invest in venture capital, since the financial crisis and subsequent recession, perhaps because they have more control over their investment through greater involvement in investee businesses.

7.7 There were notable differences in the approach taken by fund managers in attracting private investors. For the most part, managers of the co-investment funds have relied on existing business angel networks to identify potential co-investors whilst managers of the ECFs and UKIIF are more selective and specifically targeted institutional investors. In the latter case, these managers reported that they identified potential investors prior to developing the funds and these were mainly investors that they had used in the past.

Attracting Private Investors
The public money will be matched with private investor money when the fund is under construction. (Fund Manager)

7.8 There were also differences with regards to the challenges experienced in attracting private investors. In general, fund mangers of the earlier funds (e.g. RVCF, EGFs, UKHTF) did not experience much difficulty raising investment and some even capped their funds to avoid them becoming larger than they could manage. For example, the underlying fund managers of the UKHTF reported that at the time it was established, the private equity market was saturated with available finance to invest. In contrast, fund managers of the later funds (e.g. ECF and UKIIF) generally reported that they found it more challenging to raise private investment. This was mainly a result of the poor track record of venture capital as an asset class over the last ten years and a lack of exit opportunities in the UK. Notably, these fund managers did not attribute challenges raising private investment to any restriction that came with Government support.

Challenge of Raising Private Investment
It's a real chicken and egg thing because the problem has been that say from 2000 and onwards there were some venture capital funds in the UK that did not do well. The problem is that investors have invested in these funds but of course those funds aren't around anymore but it's very difficult for new funds to get through this perception. (Fund Manager)
The problems of investing relatively small amounts of equity money would be common across all types of VCFs, not just BIS equity funds and is one of scale. (Fund Manager)

7.9 Although the venture capital market is seen to have deteriorated as it has become increasingly difficult for fund managers to raise new funds, they perceived that investors will continue to invest in teams demonstrating a good track record. Fund managers also agreed that it is generally easier to raise private investment with Government involvement as this support has enabled fund mangers to increase the overall amount raised. Most also had plans to raise additional funds in the future and hoped to use their current investors.

Raising Investment
We had people lined up before we applied and more or less pulled that all together. (Fund Manager)
We would always want to be looking to have a long term career of raising funds and investing. (Fund Manager)
The reputation of venture capital is quite tough with sort of managed money, pension funds and things like that, but I think if you look at high net worth individuals and people managing family money, they seem to be more prepared to take risks in this area. (Fund Manager)
To raise a first time fund is incredibly difficult and no one actually does it without Government support.

(Fund Manager)

Performance of Portfolio

7.10 Overall, the majority of fund managers interviewed generally felt it was too early to comment on the performance of BIS funds, and a small number thought that some of these funds (more specifically the RVCFs) had been misrepresented in the media.

7.11 ECFs fund managers were in consensus that it was too early in the life of these funds (they have been operating for just over four years) to generate positive returns; however they were generally confident that their investors would secure a good return in the future. Similarly, fund managers of some of the earlier schemes also expected to obtain good returns from the investments that were made in the later stages of the fund life.

Fund Performance
It is obviously early days for the UKIIF and the ECFs which are only 4 years old… my impression of the portfolios that these managers have created and innovation investments in the pipeline is that there is a strong opportunity for it to generate a positive return… in terms of their contribution to the UK economy I think it will be very significant and very positive. (Fund Manager)
I think the Government has got to get its head around the fact that the economic benefits from providing funds in this sector of the market is more about the collateral benefits of investment, so employment growth, export growth and things like that. (Fund Manager)
By definition VCFs last for ten years minimum and in the first five years there is no return, there is no exit, so you have negative return. (Fund Manager)
The ECFs and the RVCFs have been misrepresented in the press… these things have a ten year life at least and you only get your gains at the end. They always say the lemons ripen before the plums, all the bad ones go bad before the good ones go good so you are always going to have a period when your portfolio is valued less than what you put in. (Fund Manager)

7.12 A few fund managers reported that they would have made the same investment decisions even if the fund had only included private investors, which reflected the overall commercial operation of these VCFs, despite public support. *'If we had raised the money from a group of private investors on similar terms we would have made the same sort of investments*'.

Delivery of BIS Equity Funds

7.13 Overall, fund managers are generally satisfied with the level of Government involvement through Capital for Enterprise, which is regarded as an important source of market knowledge. They have reported that the Government's decision to employ commercial teams to manage its hybrid funds ensured that the funds were subjected to the discipline of the market. Consequently, they did not report any particular difference in their approach to

hybrid funds compared with other wholly private sector funds. As commented by one fund manager *'we are treated as a private sector operation by both sides, investors and by the investees'*.

7.14 Fund managers were also in consensus that the factors attracting private investors to BIS supported VCFs are relatively the same as any other private VCF. They agreed that whilst Government support helped these funds to reach a critical threshold in investment size, investors based their investment decision on the performance of fund managers.

BIS VCFs Versus Private VCFs
I think the same principles apply. BIS investment will help funds to reach a critical size but the underlying assessment will be the same with managers as it is a sector [investors] *want exposure to and they want the track record of the manager to be strong enough.* (Fund Manager)
They [Government] *has been a pragmatic stakeholder, their focus has been at the right level rather than dipping too much into the detail… Overall I would certainly do it again and quite satisfactory really.* (Fund Manager)

7.15 Generally, fund managers did not report any particular challenges associated with managing a hybrid fund compared to a purely commercial one. Even those that were managing funds with restrictions reported that they have not found these to be major constraints on delivery. As discussed earlier, a few fund managers, mainly of the earlier funds, reported that some of these restrictions (particularly those related to investment size) restrained their overall investment activity. Overall, fund managers were generally positive about their experience of managing a hybrid fund and all felt there was a clear case for Government intervention in the market.

Perspectives on Delivery
We have not felt any restrictions on us from the fact that we are an ECF compared to just an ordinary private sector fund of the same size… we would have more scope to do things if we had a larger fund that is certainly true. (Fund Manager)
I think the way the Government is going about it is effective and I think essentially achieving what it set out to achieve and we are pretty confident about what we are doing at the moment. (Fund Manager)
I have no complaints about how the ECF is structured. The bigger beef is that the £2 million limit is too small. (Fund Manager)
From the RVCF you were limited to a maximum investment of £250,000 and that was reduced by the portion that any other private sector venture capital investor was also investing or had invested in the business. So if there was another fund that had already invested simplistically £50,000 then we could only invest £200,000 and then there were rules about following on your investment. (Fund Manager)

Summary

7.16 Overall, BIS fund managers have several funds under management, which offer a number of benefits including complementary deal flow, reduction in operational costs and accumulation of specialist skills.

7.17 Fund managers have targeted a range of investors, from pension funds to high net worth individuals. They have noted a general shift in investor profile within VCFs over the two decades towards more Government support and less private sector support. This has become more acute in the last decade as poor performance in the asset class has led to a general loss of investor confidence which has made it difficult for fund managers of the later BIS funds to raise investment.

7.18 There is evidence that BIS fund managers are generally positive about their experience of managing a hybrid fund and they felt there was a need for Government to intervene in the market.

8 Summary and Conclusions

8.1 The primary objective of this research is to understand the role and motivation of private investors identifying, in particular, what they regard to be the benefits of BIS supported investments compared to other investments.

The Characteristics of Investors to BIS VC Funds

8.2 Investors to BIS supported VCFs include institutional investors as well as business angels (high net worth individuals). Institutional investors to BIS VCFs include pension funds (public and private funds); large corporate investors (such as banks, insurance companies and other large companies); universities and charities; as well as venture capital funds (e.g. fund of funds). They typically invest through individual funds or fund of funds and rarely invest directly in a company. The majority of institutional investors have significant funds under management - typically over £1 billion. In most cases only a small proportion is allocated to venture capital; the majority of investments are in traditional asset classes, namely quoted equities (i.e. stocks and shares), bonds and real estate. A key point from the survey is that institutional investors appear to have a strategic commitment to private equity, although not specifically to venture capital. They are investing globally, with the United States and Asia being the most common markets for their venture capital investments. Institutional investors generally state that their overall investment profile has not changed significantly over time and they do not anticipate any changes going forward.

8.3 Business angels or 'high net worth individuals' tend to invest as co-investors with BIS co-investment funds (e.g. the Early Growth Funds and Aspire). This approach enables them to invest at the start up or early growth stage. In practice, business angels prefer the co-investment model, which enables more direct involvement in investee companies (through mentoring and strategic advice for instance). Business angels often have a business background, and most are successful entrepreneurs. Business angels most typically invest as part of a syndicate or investor network (some of which have been developed by fund managers, for example the Advantage Business Angels Network and the Viking Club). The amounts angels invest range from under £10,000 to over £250,000, although the average investment size is normally between £50,000 and £100,000.

Investor Motivations

8.4 Investor motivations include the potentially high returns and the diversification of their portfolios especially for institutional investors seeking to gain exposure to different asset classes. Personal and altruistic motives are not uncommon amongst some business angels who are motivated simply by the enjoyment of investing in early stage companies. Some institutional investors will invest altruistically, particularly where they wish to be seen to support venture capital in a particular region. Generally, the investor survey found that investors do not regard BIS supported funds differently from purely private VCFs and importantly they have the same expectations of rewards. They indicated Government support reduces the risk of investing in, what is perceived to be a more risky asset class, in part by providing additional funding so that they are not the majority investor. The fund manager plays an important role, which is valued by institutional investors and business angels alike. For institutional investors, the track record of the fund manager is a principal consideration. Co-investors with BIS supported co-investment funds reported that they valued the due diligence support of these fund managers; their knowledge of follow on investment sources; and their provision of standard documentation (for example shareholders agreements).

8.5 Government support has attracted institutional investors to small VCFs, in which they might otherwise have not invested. Government involvement tends to minimise the risks which investors have found attractive, however, there are mixed views on the role of Government subordination. There were different opinions on whether the Government should invest directly in the venture capital market - one investor thought its role was better placed encouraging institutional investors to participate in venture capital. Tax incentives are seen to complement existing Government VCFs, and the EIS in particular has been an important motivator for most business angels. Some consultees, mainly fund managers, have indicated a desire for a better balance between the EIS scheme and VCFs. They generally feel that they would potentially be able to attract more private investors to VCFs if these investors benefitted from similar tax reliefs. The current VCT scheme enables investors to benefit from the expertise of professional fund managers whilst investing in equity; however, consultees generally reported that VCTs do not sufficiently target young venture capital companies and mainly focused on later stage investments. Whilst this view was somewhat popular it would give these investors double public benefit. Respondents have suggested that increasing the scale of existing VCFs and raising awareness of their performance could potentially attract more institutional investors.

Additionality and the Attractiveness of Funds

8.6 The interviews found that BIS supported equity funds have helped to increase the supply of equity finance, particularly for companies below the £2 million threshold, and they have provided financing to companies that would otherwise not have been able to raise investment. They have helped to ensure that VCFs are operating in this market and have improved the supply of equity finance to key growth sectors such as life sciences, advanced manufacturing and digital technologies. The survey also found evidence of BIS's funds improving the overall venture capital ecosystem through its co-investment funds.

8.7 The overall performance of venture capital as an asset class has undermined investor confidence somewhat and made it increasingly difficult for fund managers to raise additional investments. Still, there is evidence that even in a challenging market BIS supported funds have successfully leveraged private investment, through its co-investment funds, as well as from institutional investors. Whilst investor attitudes to venture capital have not obviously changed because of BIS supported funds, they have successfully attracted institutional investors who might not have otherwise invested in venture capital. Overall, around 40% of institutional investors (5 respondents) and a third of co-investors (3 respondents) reported pure additionality, i.e. they would not have made their investment without BIS's support. These investors reported that BIS's involvement has reduced the risks associated with their investment. There is also some partial additionality where BIS funds have lead to a greater amount of funds invested in venture capital. However, a third of investors would have invested anyway (deadweight). For future funds, BIS will want to minimise the degree to which this deadweight is occurring to maximise the impact of its interventions on increasing the supply of venture capital.

8.8 Overall, the EGFs, ECFs and UKIIF have been highlighted as the most successful BIS supported schemes. Consultees regarded these as being appropriately designed and having good return prospects because of their generally strong portfolios. HMRC's EIS tax scheme is also thought to encourage more private investment, particularly from business angels.

The Effects of the Recession

8.9 Institutional investors generally understand the risks associated with investing in venture capital and regard the risks as acceptable because of the potential upside. Generally, the recession has led to a decline in investment portfolio values, for both institutional investors and angels, however most investors indicated that their portfolios have now recovered. Most business angels, whilst demonstrating greater resilience in the face of the adverse financial climate than institutions, have reduced their overall investment activity as a result of the recession or become more cautious or focussed on business survival. Institutional investors have tried to maintain their exposure to the different asset classes so as to minimise over-commitment in any particular class. More widely diversified portfolios have led to a degree of protection for institutional investors.

Suggestions for Future Activity

8.10 Respondents generally agreed that there is a case for some form of Government intervention in equity finance and that venture capital has an important role in building high growth businesses. They thought the rationale underpinning the establishment of hybrid equity schemes is valid and appropriate. Overall, the drawbacks of the earlier schemes (e.g. RVCF) are well documented and lessons have been learned which have led to improvements in the design and delivery of later funds. There are a few areas consultees felt could potentially enhance the impact of Government intervention in equity finance in the future. These include actions around promotion, engagement and information. BIS and its partners may wish to consider:

- **Strengthening the promotion of existing schemes and market intelligence:** to attract more institutional investors and engage big investors who might not have the in-house expertise to manage investments, or potential business angels who understand the concept but not the process. BIS could:
    - **Promote links to relevant intelligence on its new business improvement website** - investors require more market intelligence on the venture capital industry to support their investment decisions and business angels would welcome tips and advice (on different stages of the investment process from sourcing deals to realising investments).

- **Promote venture capital information and contacts** to business intermediaries; coaches and mentors so that businesses are aware of financing options available to them.

- **Help to raise the profile of the venture capital sector** by endorsing the marketing activities of intermediaries where appropriate.

- **Work with other Government Departments (Treasury for instance)** to jointly promote the benefits of venture capital tax schemes.

- **Promote the UK to institutional investors** as an attractive place for future investment.

- **Highlight successful exits -** institutional investors reported that they would consider investing more in venture capital if there was more evidence of existing funds achieving successful exits / strong performances. Some of these investors do not typically invest in new funds, and rely on historical evidence of good performance to justify their investment activity.

- **Maximising the expertise of Capital for Enterprise** – they could be encouraged to make their market knowledge and expertise more widely accessible to help raise the profile of venture capital amongst institutional investors / angels.

- **Maximising BIS's investment** by encouraging private investment in BIS equity funds that are truly additional. There is a general perception that the scale of institutional investment in venture capital seen in the past is unlikely to make a comeback, for reasons including poor asset class performance. BIS and its VCFs might consider targeting non traditional alternative investors such as sovereign wealth funds, charitable foundations and endowment funds as well as non-institutional investors such as high net worth family funds.

- **Improving engagement with investors**, particularly regarding the future design and delivery of equity schemes (and encouraging changes in behaviour where appropriate). This might include strategy days/events, networking events, the development of an informal network or formal consultation through intermediaries or simply information. Investors may need to be segmented by investor type (for instance

pension funds, banks, business angels) to reflect their different investment behaviour.

- **Continuing to support the development of effective business angel networks** as a key conduit to the financing of early stage businesses.

- **Exploring corporate venturing** as a possible source of co-investment in early stage high growth companies. HMRC Corporate Venturing Scheme, provided tax incentives for corporate equity investment in the same types of companies as those qualifying under the EIS and VCT schemes.

- **Increasing the scale of hybrid equity funds.** Institutional investors would welcome much larger funds (£50 million or larger) to attract them into early stage financing as some institutional investors are unable to invest below a certain threshold and do not have the expertise to make and manage a wide range of direct investments in small VCFs. They would be more cost effective, in terms of fixed costs, and better able to fund follow on investments.

- **Maximise the use of taxation measures** to encourage private investors to invest in VCFs making it easier for private investors to retain their benefits whilst using professional fund managers (e.g. by expanding the scope of the EIS).

- **Reduced bureaucracy** is seen by some respondents as being a way to improve take up of the EIS scheme.

Appendix A: List of Consultees

Market Stakeholders

Organisation
British Venture Capital Association
European Venture Capital Association
National Association of Pension Funds
Enterprise Investment Scheme Association
Association of Investment Companies
British Business Angel Association
Association of British Insurers
London Stock Exchange Alternative Investment Market
Linc Scotland
European Business Angel Network
European Investment Fund

Fund Managers

Organisation
Advantage Early Growth Fund
Viking Early Growth Fund
GEIF Early Growth Fund
Oxford Technology Enterprise Capital Fund
Dawn Capital Enterprise Capital Fund
North East Regional Venture Capital Fund
London Regional Venture Capital Fund
Hermes Environmental Innovation Fund
UK Future Technologies Fund

Appendix B: Performance of US Venture Capital Funds

Since Inception IRR[1] and Multiples of US Venture Capital Funds						
Vintage Year	Pooled mean	Arithmetic mean	Median	Upper Quartile	Lower Quartile	Number of Funds
1981	8.47	9.01	7.87	13.24	5.94	9
1982	7.38	7.21	7.92	9.11	4.87	11
1983	10.23	9.55	8.72	12.46	7.10	28
1984	8.62	7.74	6.27	12.92	3.41	32
1985	12.90	11.58	12.66	17.99	4.72	35
1986	14.52	8.82	9.43	12.90	5.27	30
1987	18.27	14.53	15.65	22.18	8.70	34
1988	18.90	14.32	11.87	21.73	6.62	26
1989	19.16	17.05	13.32	28.80	7.75	37
1990	33.96	24.25	21.86	31.76	11.64	16
1991	26.77	23.01	18.56	27.50	11.64	17
1992	32.79	28.69	20.99	38.85	11.11	23
1993	46.65	29.50	18.81	41.48	10.89	37
1994	55.63	34.55	26.45	49.34	6.83	42
1995	87.95	56.76	42.92	81.44	17.49	34
1996	103.28	61.15	37.05	93.12	6.22	40
1997	90.97	52.77	8.63	62.54	-1.52	73
1998	12.32	18.20	0.38	17.59	-7.72	81
1999	-1.06	-3.72	-4.58	3.31	-12.04	112
2000	-1.04	-4.00	-3.53	3.07	-8.20	155
2001	1.16	-1.84	-0.22	5.08	-6.97	52
2002	0.14	-0.27	-0.43	6.65	-7.34	32
2003	4.80	0.13	0.92	3.56	-8.42	34
2004	7.98	1.55	0.76	4.89	-9.48	64
2005	3.16	-1.35	0.75	5.02	-4.30	58

Source: Cambridge Associates LLC US Venture Capital Index and Selected Benchmark Statistics, December 2010
Based on data compiled from 1,298 US venture capital funds.
[1] Internal rates of return are net of fees, expenses and carried interest

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URN 11/984