

Stimulating Venture Capital – the need for a new £1 billion fund

- Measures recently announced to support small businesses will assist those most immediately affected by the credit crunch. But there are longer term challenges – exacerbated by the current recession – which must be addressed.
- High-potential, innovative new firms are central to the UK's future economic prosperity. They drive employment growth, with 4 per cent of surviving start-ups responsible for 50 per cent of the jobs created by all new firms ten years later.¹
- These firms need patient capital to reach the point where breakeven revenues can be generated. However, private sector venture capital is abandoning early-stage investments. Only 4 per cent of private equity now goes to early-stage companies.
- High-potential new firms are forced increasingly to rely on public sector funding. Over half of all early-stage venture capital deals now use public funds.
- Government has the opportunity to attack the recession by closing this gap and targeting growth sectors. A £1 billion commercially-focused fund-of-funds is needed to leverage private capital and support the UK's innovative new companies in a number of key dynamic sectors.

Current Government support is addressing the immediate problems faced by small firms by improving their access to loan capital

NESTA welcomes announcements in the PBR to support improved access to loan finance for small businesses. These measures, including government-backed loans on preferential terms, will help SMEs overcome temporary cashflow difficulties. Over recent months, the Government has focused on ensuring that lending continues to small businesses.

But while meeting the immediate concerns of businesses and employees facing bleak economic prospects, it does not address the structural weaknesses that are developing in the funding environment for early-stage technology companies.

But high-potential innovative firms require risk capital, not loans

Early-stage businesses often require large amounts of up-front capital to develop new products in advance of sales. They often have little direct collateral, beyond their intellectual property, and the creation and commercialisation of new ideas is an inherently risky process. Particular kinds of high-technology investment, such as life sciences, have extremely long pre-revenue periods during which ideas are tested and refined.² This also acts as a deterrent to most potential investors.

¹ Storey, D.J. (1994) 'Understanding the Small Business Sector.' London: Thomson Learning.

² Scottish Enterprise estimates, for example, that life science therapeutics requires over eight years of pre-revenue funding before profits can be realised. Cited in Lord Sainsbury (2007) 'The Race to the Top: a review of government's science and innovation policies.' London: HM Treasury. Table 6.2.

All these factors combine to make raising capital from conventional sources, such as bank loans, difficult at the best of times.³ Loans force greater risks on the borrower, as they demand interest payments and the eventual repayment of capital. Venture capital is an absolute necessity for high-potential new firms.

Institutional investors are retreating from early-stage investments

The UK has the largest private equity market in Europe, accounting for one in every three investments in Europe.⁴ There has been a trebling in the value of investments between 2003 and 2007 to nearly £12 billion.⁵

However, recent expansion in investment activity has been in 'private equity', focused on management buy-outs, mergers and acquisitions, and investments into established companies, rather than in the 'venture capital' new firms desperately need.

Early-stage investments have slumped from 11 per cent of total equity value invested in 2000 to less than 4 per cent in 2007.⁶ The number of companies requiring investments below £2 million rose by 20 per cent between 2001 and 2007.⁷

The 'equity gap' between the funding that new, high-potential companies need, and the value of funding available, is growing.⁸ Innovative new companies will suffer as a result.

³ Bank of England (1996) 'The Financing of Technology-Based Small Firms.' London: Bank of England.

⁴ NESTA (2008) 'Shifting sands – The changing nature of the early-stage venture capital market in the UK.' London: NESTA. p.8.

⁵ BVCA (2007) 'Report on investment activity 2006.' London: BVCA.

⁶ As a share of total investment by value. See BVCA (2006) 'Report on investment activity.' London: BVCA.

⁷ From 880 to 1,049. See *ibid*.

⁸ Estimation in 2005. See Almeida Capital (2005) 'A mapping study of venture capital provision to SMEs in England and Wales.' Sheffield: Small Business Service. Forthcoming research suggest that the gap is widening.

Individuals cannot make up the difference

There has been a shift in financing for early-stage businesses from venture capital funds to private individuals, including business angels. Business angels are prominent investment partners, involved in approximately half of all public-private investment deals.⁹

But individual investors, acting alone, are not able to provide enough to make good the gap in funding. And the creation of angel syndicates, pooling many angels' capital, has sometimes worsened the problem. Angels in syndicates are increasingly able to invest in larger – and thus attractive – later-stage deals. There is some evidence that this has resulted in a migration of many angels away from their traditional realm of early-stage investment, towards later-stage investment, leaving even less funding available to companies seeking sub-£500,000 amounts.¹⁰

This has left many early-stage companies to rely even more on 'friends and family' financing, which will likely be very hard hit by the current economic downturn. The situation could be worsened by a side-effect of the credit crunch. Businesses that would normally seek loan capital may be pushed into chasing seed or early-stage funding, increasing the pressure on shrinking capital funds and further squeezing new businesses.

With the financial crisis hitting investors hard, risky early-stage investments are likely to be the first to feel the pinch. Returns from early-stage investment in the UK trailed those for later-stage activity during the recent economic expansion; many believe the current economic climate will only exacerbate this situation. The retreat from early-stage

⁹ NESTA (2008) 'Shifting sands – The changing nature of the early-stage venture capital market in the UK.' London: NESTA. p.17.

¹⁰ As an example, the criteria for applicant companies to the London Business Angels read much like a classic institutional venture capitalist, including: strong management team; a product or service that can be taken to market without further development; some sales validation within the market place; and eligibility for EIS. See <http://www.lbangels.co.uk/companies.php>

business by private investors could turn into a rout.

NESTA calls for a £1 billion fund-of-funds to support high-potential innovative firms

To fill this gap, the UK Government should set up a new £1 billion fund-of-funds to support those new firms that are most likely to produce wider economic benefits: high-potential, innovative, early-stage businesses. These are the companies that are suffering most from the effects of the equity gap.

£500 million of public funds should be used as leverage

The time commitment, fixed costs for due diligence, focus on financial criteria, and risks involved in investing in early-stage businesses often deter private investors from engaging in the area, setting very high effective hurdles for even the most promising early-stage companies.

Public sector funds can help reduce the high risks faced by investors at the early stage. Government has already recognised the importance of private sector involvement in publicly-backed early-stage investments, particularly through the creation of Enterprise Capital Funds (ECF) – which required approved funds to raise matching funding from the private sector – and the business-led Capital for Enterprise Board to oversee them.

NESTA research has shown that deals involving public sector funds, both as sole investors and with private investors (funds and individuals), have risen from 30 per cent of all early-stage venture capital investments in 2001 to 57 per cent in 2007.¹¹

NESTA therefore recommends that the Government uses £500 million of public funding to leverage in matched private sector funding. In this way, the Government can act as a catalyst for the general expansion of equity funding to those new firms with the greatest potential. This will also provide the

¹¹ NESTA (2008) 'Shifting sands – The changing nature of the early-stage venture capital market in the UK.' London: NESTA. p.15.

credibility and the substantial investment sums needed to bring institutional investors, with their valuable experience, back to the early stage.

The fund should be strongly future-focused, with an expectation that it will be sufficiently resourced to maintain funding over the next 20 years or more.

Targeting key sectors

The £1 billion fund-of-funds could provide a major boost to high-potential growth sectors. Separate funds should be created to provide vital early-stage equity funding to innovative firms, particularly in the following areas:

Low-carbon technologies and 'cleantech'
Investment into 'cleantech' is growing exponentially, with US venture capital investing \$2.7 billion into the sector in the first three quarters of 2007 – up 44 per cent from the preceding year, and nearly five times as much as 2005.¹² UK equity investments are lagging behind this expansion, potentially missing out on a market forecast to be worth £2 trillion by 2030. Tackling climate change is now a major government priority and the fund-of-funds should play a major part in this fight.

Life sciences and biotechnology
Development times for life sciences and biotechnology firms are exceptionally lengthy, with eight years on average from first investment to any commercial returns.¹³ Although of very high potential, and with undoubted UK strengths in the area, this delay in returns can deter potential investors. The fund-of-funds should provide support for funds investing in high-potential companies in this sector.

The funds should be directly targeted at investing in early-stage companies falling into the 'equity gap'. As such, it should make investments in companies seeking sub-

¹² National Venture Capital Association (2007) 'Cleantech Venture Investments by US Firms Break Records in 2007.' Available at: <http://www.nvca.org/pdf/CleanTechInterimPR.pdf> [Accessed 4 December 2008].

¹³ Ibid., Ch. 6.

£500,000 amounts, with a target level for first investment of between £250,000 and £500,000. It should then have the ability to make follow-on investments through to exit.

Generating commercial returns

Existing public funds often encompass a wide range of criteria additional to their core missions – for instance, in promoting certain regional objectives, or meeting very broad social criteria. This blurring of focus can weaken the impact of public venture funding, with clarity of purpose being lost and the ability to make decisive funding commitments undermined.

The £1 billion fund should therefore hold to a clearly-defined mission statement to support funds backing early-stage companies and operate as far as possible on broadly commercial lines.

Drawing on best practice

Best-practice elsewhere can act as a guide for government actions. Beyond the lessons learned from the Regional Venture Capital Funds and the Enterprise Capital Funds, the Government should look to the Yozma high-technology funds in Israel, for example. These were established in 1993 and provided \$200 million to support high-technology investments in Israel and attract foreign funding.¹⁴ NESTA's own experience in establishing a fund-of-funds, NESTA Capital, has shown a market need for such bodies.

¹⁴ Lord Sainsbury (2007) 'The Race to the Top: a review of government's science and innovation policies.' London: HM Treasury. p.91.