Venture capital

The United States has a flourishing venture capital industry concerned with fast growing, innovative companies, often in the field of high technology. Similar institutions have recently started to appear in the United Kingdom. It is too early to form a firm assessment of this development, but this note offers a preliminary view of the present position.

The term 'venture capital' is commonly taken to include not only high risk investment with potentially high returns, but also development capital investment. It can also be used, however, in the more restricted sense, to describe a way in which new technology, entrepreneurial talent, and management resources are sought out and combined to exploit market opportunities. In this sense, the venture capitalist is concerned with fast-growing, innovating companies, principally though not exclusively in risky, high technology. He creates a portfolio of equity investments, that will be illiquid for a number of years, in companies with whose management he will be continuously and actively involved. When successful, such investments will pay exceptionally high returns, both in general economic terms (jobs, exports, and so on) and, more narrowly, through the return on invested capital.

Venture capital in the United States

The natural starting point for any discussion of venture capitalism is to describe the experience of that industry in the United States, where it first emerged, and where it has assumed an important position. Indeed, it was because of a belief that the venture capital industry might be making a contribution to the United States economy quite out of relation to its size that in 1981 the United States Senate requested a report from the General Accounting Office. Much of what follows on the US venture capital industry is based on the General Accounting Office's report, delivered in August this year.[1]

Before the Second World War, venture capitalism in the United States was undertaken by wealthy individuals. It has subsequently become the province of venture capital firms. Of these there are now three kinds. First, there are some 360 private and public small business investment companies (SBICs). These institutions, set up under the Small Business Act of 1958, encompass a great variety of types of ownership and of investment strategy, though in broad terms they consist of groups of investors seeking to make long-term loans to small companies, or to acquire an equity stake in them. Second, there are perhaps 100 venture capital offshoots of large companies and banks. These are sometimes merely divisions within the companies concerned, and sometimes venture capital subsidiaries. Third, there are about 130 private venture capital companies. Occasionally these are family firms, but predominantly they are limited, private partnerships.

In the narrower sense of venture capital with which this note is concerned, the third group of companies is of paramount importance. Most SBIC investment consists of loans, or loans with equity; of the remainder, probably only a small portion is venture capital investment.[2] This is probably the position also with the second category, the venture capital offshoots of banks and companies. The limited private partnerships are quite different.

These partnerships commonly have between two and four general partners. The investors are the limited partners. The general partners are fund managers, with unlimited liability for the obligations of their partnership. The limited partners are commonly representatives of pension funds (much the largest source of funds, accounting for some 29 per cent in 1981), major industrial companies, insurance companies, endowment funds, wealthy individuals, and foreign investors. The general partners usually begin by raising a venture fund with a fixed life of between ten and twelve years. The size of the fund might vary from $15 million to $100 million. Typically, with a fund of, say, $20 million and four general partners, each partner might actively finance and manage some half a dozen companies, investing between $250,000 and $1 million in each at any one time.

Very few of the large number of proposals presented to venture capitalists are accepted. The small number of portfolio managers available as venture capitalists is one of the reasons for this. More important are lack of management talent of the right calibre in which to invest, and the strictness of the investment criteria applied by venture capitalists, who commonly expect to make profits of up to 1,000 per cent from investments in companies that will either be traded on one of the securities markets, or be merged in larger companies, within five to seven years.

The main reasons why limited, private partnerships dominate the US venture capital market appear to lie in the flexibility of partnerships and, above all, in the overall incentive provided to the general partners by an

(1) Report to Senator Lloyd Bentsen, Joint Economic Committee, by the US General Accounting Office.

(2) Nonetheless, SBICs have played an important part in the development of the US venture capital industry, and are regularly used by the private partnerships, when the provision of loan funds is required as part of a deal.

arrangement under which it is normal for them to take at least 20 per cent of any capital gains, in addition to annual fees of 2%–3% of the venture fund.

At the end of 1981, the three groups of venture capital organisations had committed about $6 billion to the US venture capital pool (on a wide definition of venture capital). Some $2.6 billion had come from private, limited partnerships, $1.6 billion from SBICs, and $1.6 billion from companies. Of this $6 billion, perhaps half represented venture capital on the more limited definition with which this note is concerned, and most of this had come from the 130 limited, private partnerships. Much, if not most venture capital investment is syndicated—to bring in expertise rather than finance.

New private capital committed to venture capital companies (broadly defined) declined from about $175 million in 1969 to some $25 million in 1975, but rose to about $200 million in 1979 and about $1 billion in 1981. A similar amount is expected again this year. A major cause of the US venture capital market developing so unevenly appears to have been changes in government policy, and especially in securities regulations and taxation. The increase in capital gains tax between 1969 and 1976 is thought to have been one of the prime reasons why the supply of private venture capital fell over this period: the reductions in capital gains tax in 1978 and again in 1981 are similarly believed to have been an important factor in the recent increase in supply.

The report by the General Accounting Office contains some interesting calculations of the contribution made to the economy by the venture capital industry. It examines the performance of seventy-two firms that had been started with venture capital backing during the 1970s and that had gone public by 1979. The report finds that $209 million invested in these seventy-two firms had led to sales of $6 billion in 1979, to 130,000 jobs, to $900 million of export sales, and to $450 million of corporate and income tax receipts. Of course, not all these benefits have flowed from venture capital investment: some would have arisen in any event, and are not therefore additional. Nor are they typical of US venture capital investment in general. But it is thought that about 20 per cent of all venture-backed companies in the United States achieve market success, a further 40 per cent achieve success through upward mergers, about 20 per cent become profitable but continue as small, privately-owned businesses, and only some 20 per cent are deemed failures. It seems clear that venture capitalism has made an important contribution to the US economy; and its recent emergence in the United Kingdom deserves careful nurturing.

Venture capital in the United Kingdom

On a broad definition of venture capital that includes development capital, the United Kingdom has a large number of venture capital institutions, and some have existed for thirty years or more (for instance, ICFC). But, on the narrower definition with which this note is primarily concerned, the number may be about two dozen, of which only four existed before 1979. The United Kingdom has had a flourishing sector providing development and other capital in traditional 'hands off' fashion for some years, but the appearance of creative venture capitalism along US lines, with its close involvement in the management of companies, and its emphasis on risk investment, is a very recent phenomenon.

One consequence of this is that there is far less information available on the UK industry than on its US equivalent.(1) It seems that of the two dozen or so venture capital institutions in the United Kingdom, seven are regional funds, each of some £1–2 million, concerned with local investment. Of the others—all in London—some have close links with American venture capital institutions, managing funds of about £10 million each. Others are offshoots of more traditional UK institutions, and tend to manage rather smaller funds. They operate in a wide variety of ways, some following US lines closely—for example, with general partners having a 20 per cent stake in the profits of the fund—others being run on a more traditional basis by salaried managers. None seem to take the form of limited partnerships.

It is difficult to form a firm impression of the scale of venture capital operations in the United Kingdom. It has not yet developed as an industry, and lacks a structure. But discussions that the Bank has had with a number of companies suggest that total investment by UK venture capital companies may now amount to about £100 million (cf $3 billion in the United States).

Investment policies followed by UK funds vary widely. As far as individual venture capital companies are concerned, the minimum investment is usually above £100,000, and below £50,000 very rarely indeed (management costs are prohibitive on an investment below about £50,000 unless further funding is envisaged). A common maximum is perhaps about £1 million. The bulk of investments do not exceed £$\frac{1}{2}$ million; most funds do not put more than 10%–15% of their total resources into any one project; and many investments are syndicated.

The generally acceptable gestation period for a capital gain on an investment is probably five to seven years, though US-style companies, which often have a ten year life for their funds, might prefer to wait longer. Staff do not generally include people who have actually built up new businesses, though the position is different in funds based on the US partnership model.There is usually close involvement with the management of a company in which an investment is made, going far beyond just taking a seat on its board. Indeed, this involvement is generally such that a shortage of venture capitalists of the right calibre and experience appears already to be constraining the rate at which the UK industry can grow.

Investment objectives are often very high, as in the United States, with capital gains of up to ten times the value of an

(1) Though Venture Economics, which has done a great deal of work analysing the situation in the United States, has recently completed a study of the UK venture capital industry.

investment commonly sought. Where the venture capitalist is managing a fund with a ten year life, along US lines, the proceeds of investments as they mature are normally reinvested in liquid assets, until the fund is wound up. Otherwise, realisations are remitted to shareholders.

The UK venture capital industry is still in its infancy, and no doubt there will be growing pains. But it probably has considerable potential benefits for the economy and should therefore be encouraged to establish itself. Venture capitalists are natural intermediaries between institutional investors who have funds but lack the human resources for active involvement in management, and rapidly-growing businesses who often lack both.

The benefit to the UK economy of identifying and exploiting new, high-value goods and services is obvious. It may help to offset the erosion, over a long period, of competitiveness in traditional areas. There is generally no lack of innovative ideas; and venture capitalists could play a major role converting these into sales.

The future

One starting point for an examination of the future of venture capitalism in the United Kingdom would be to look at some of the more important differences between the industry here and in the United States. There is, for example, a fundamental difference in ethos between the two countries, with that in the United Kingdom having discouraged—until recently at least—the taking of major risks. Second, the size of the US market is five times that in the United Kingdom, so the opportunities facing a venture capitalist here tend to be far fewer. Third—and this is important for the realisation of capital gains—there is a flourishing over-the-counter (OTC) securities market in the United States, which it is quite easy for a company to enter. About 90 per cent of the 33,000 shares traded in the United States are traded on the OTC, where there are over 570 market makers. In the United Kingdom, by contrast, the unlisted securities market has grown rapidly, but it covers only about 130 companies, compared with 2,300 companies listed on the Stock Exchange. US companies must meet certain statutory conditions imposed by the Securities Exchange Commission, and self-regulatory ones imposed by the National Association of Security Dealers. But these seem to pose fewer obstacles than the requirements of the unlisted securities market in the United Kingdom.

There are, of course, tax differences between the United States and the United Kingdom, some more favourable to venture capitalists in the United States, others not. But international comparisons are notoriously difficult; and other factors also have a bearing on the development of venture capitalism. The general business environment is of the greatest significance, and the government's concern that this environment should encourage business creation (shown, for instance, by its establishing the Business Start-up Scheme) may largely explain the emergence of the industry in the United Kingdom since 1979. The availability of venture capitalist and business talent is manifestly crucial, too (it appears to be more difficult to put together management teams in the United Kingdom than in the United States). Indeed, because venture capitalism depends in large part on marketing and other non-financial skills, the most important contribution that government can make may be to encourage the industry through promotion of a healthy general business climate.

There is interest in establishing some form of association within the UK venture capital industry. A national venture capital association was founded in the United States in 1974, and this now represents some 80 per cent of venture capital funding activities. It has recently developed a code of conduct, acceptance of which is mandatory for members. The establishment of a similar body in the United Kingdom could be helpful in formulating and representing the industry's view on various policy issues, and in encouraging further growth by the industry.

Conclusion

Venture capitalism has a part to play in confronting a number of problems facing British industry. It can provide ready equity to innovating firms in high technology fields, and the managerial resources to make them more likely to succeed. Individual initiative is the vital ingredient of venture capitalism; removing impediments, and encouraging developments such as a more effective OTC market in the United Kingdom will be helpful, but not by themselves decisive. The UK venture capital industry is now likely to develop in any event, with success encouraging imitation through constructive envy.