Venture capital in the United Kingdom[1]

This note, which is a sequel to an article in the December 1982 Bulletin *(pages 511–3), describes the provision of venture capital in the United Kingdom. It outlines the considerable problems of definition and statistics in this area, offers a commentary on recent developments on the basis of available statistics and other information, and looks briefly at the provision of finance for research and development in the light of venture capital activity in the United States.*

The growth of the UK venture capital industry has to some extent followed the pattern seen earlier in the United States. In the present period of rapid technological change, many companies require not only injections of finance but also finance of a different nature—in particular, long-term funds from investors willing and able to have a close involvement, in both financial and other matters, with the companies in which they are investing.

The demand for venture capital financing in the United Kingdom has also reflected particular changes in the structure of industry and in the economic environment. An important feature of recent years of recovery from deep recession has been the number of management buy-outs and small company start-ups. These have required long-term finance and, typically, a closer involvement by investors. At the end of a period when industrial concentration has been at an historically high point, the advantages of small scale and small company production are being recognised anew. Expectations of improvement in the economy since 1981 have both encouraged the demand for venture capital funds and provided an environment where riskier, longer-term investments are more attractive to investors. This situation contrasts sharply with much of the United Kingdom's recent history, during which investors have been driven to shorten their horizons by the uncertainties engendered by inflation and the economic cycle.

The growth in supply of venture capital has also been heavily influenced by the tax and regulatory regime, by developments in capital markets, and by the industrial environment. Changes in taxation in recent years, the creation of the unlisted securities market (USM), and the encouragement given by government to smaller companies have all tended to encourage investors to allocate part of their funds to investment in riskier but potentially highly profitable businesses. This trend has also been strengthened by poor trading performance in some of the more traditional industries, which will have encouraged investors to look for new outlets for their funds and to reduce the higher risk associated with this by seeking a closer involvement in the affairs of the companies in which they are investing. Such activity has encouraged the development of expertise in seeking out and managing investment capital opportunities.

Definitions and statistics

Venture capital investment may be undertaken directly by individuals or industrial companies; or indirectly through financial institutions (whether of the long-established kind such as merchant and other banks, and investment trusts, or the more recently established specialist venture capital organisations); or by government agencies (such as the Scottish and Welsh Development Agencies). This diversity applies whether one defines 'venture capital' as high-risk, long-term investment in companies at a very early stage in their life, or adopts a wider definition. The term venture capital is used by different people to mean different things. There is general agreement that portfolio investment of a purely passive nature, where the investor has no involvement at all in the affairs of the company in which he invests, is not venture capital. There is also general agreement that it does not include investment in listed companies. But beyond this point definition becomes very difficult. For the purposes of this article, 'venture capital' investment is used to describe a way in which investors support entrepreneurial talent with finance and business skills to exploit market opportunities, and thus to obtain long-term capital gains. It is in essence concerned with venture capital companies that have managers with the necessary industrial and commercial—as well as financial—expertise to give active, involved help to companies across a range of problems, over a long period.

But even with this definition, there remain a number of important difficulties. There is no standard model of a venture capital company: venture capital companies in this country are very heterogeneous, both in terms of their investment policies and the ways in which they operate; much more so than in the United States where the market first emerged in its modern form. There are different degrees of involvement with investee companies, and of the extent to which this is at the instigation of venture capital investors. There are also differences in the

(1) This article was prepared by David Shilson in the Bank's Industrial Finance Division.

form of investment (though most venture capital companies provide a package of financial support, which can include equity, preference and convertible preference capital, subordinated loans, and other secured and unsecured lending).

The UK venture capital industry as defined here is still very young, and there is a paucity of statistical information about it. There has been extensive discussion of the industry in the Press, specialist articles, and elsewhere. But statistics have only recently started to be gathered, and the only extensive data currently available is that compiled by Venture Economics, a subsidiary of Venture Economics Inc (which produces the venture capital statistics of the United States National Venture Capital Association). The problems surrounding the definition of venture capital are such that caution is needed in interpreting Venture Economics' figures. For example, they do not include venture capital investment made by non-specialist institutions, nor that of the ICFC Division of Investors in Industry (though this organisation is often considered to be a major force in the venture capital industry). They do not include, either, such venture capital activities as those of stockbrokers organising private placings for companies. On the other hand, they do include all the Business Expansion Scheme (BES) funds,(1) although not all these funds have been invested in ventures carrying a high degree of risk and requiring active involvement by the funds.(2)

In view of the importance of venture capital in promoting enterprise, the Bank of England is investigating whether it might be able to help with the collection of venture capital statistics, with a view to producing annual surveys of venture capital investment, and to assessing its economic impact.

Venture Economics' figures(3) show that the number of specialist venture capital organisations operating in the United Kingdom rose from nineteen before 1979 to about seventy at the end of 1983. A peak in new formations was reached in 1981 (at the end of 1980 the USM was established, while in 1981 the Stock Exchange introduced new listing requirements for investment companies), though growth in the number of venture capital organisations has continued, particularly in 1983 when a number of funds were set up to take advantage of the BES.

The sums raised by independent venture capital organisations(4) amounted to about £30 million in 1979 and 1980 together, £115 million in 1981, over £40 million in 1982, and more than £160 million in 1983. The total of £345 million includes nearly £120 million raised on the Stock Exchange for publicly-quoted venture capital companies, and about £55 million raised for BES funds. Of the remaining £170 million, the main sources were pension funds (31%), investment trusts (18%), insurance companies (17%), and banks (15%). Thus the financial institutions were the main providers of funds to unquoted venture capital organisations. Industrial companies accounted for only 4%.

Investments by independent venture capital organisations, together with those of the specialist venture capital subsidiaries of the clearing banks and the Ventures Division of Investors in Industry, rose from £73 million in 1981 to £120 million in 1983. The total of these investments (many of which were syndicated) was lower during 1981–83, at roughly £280 million, than the £345 million raised during the period by independent venture capital companies alone.

The number of UK companies financed by venture capital institutions (including some dependent ones) rose from 163 in 1981 to 266 in 1983, while if investments in companies abroad are included (these rose from 21 to 83), the increase was from 184 to 349.(5) The statistics show that an increasing proportion of investment by UK venture capital companies has been in US industry (roughly one-third in 1983). Investment in Europe has been very small.

The proportion of start-up and other very young companies receiving finance rose from 23% to 46% between 1981 and 1983, but the proportion of total venture capital finance received by this group rose only from 24% to 26%. By amount, finance for expansion accounted for about 36% of the total in both 1981 and 1983, while finance for management buy-outs rose from 24% to 31%. The average size of investments fell from £380,000 in 1981 to £265,000 in 1983 (in which year the average investment in management buy-outs was £435,000, in start-ups £140,000).

Communications, computer-related industries and other electronics took roughly half the amount invested in 1981–83, though when the technological content of genetic engineering, advanced medical equipment and industrial process control are also taken into account the share of new technology-based industries was even higher. Computer-related investment is dominant in the United Kingdom, as in the United States. Nonetheless, a substantial proportion of the businesses being backed has not been in high technology areas, but in companies seeking to exploit market opportunities over a wide field (for instance, in consumer goods and services). Even where investments have been in high-technology areas, a

(1) The BES, which was introduced in the 1983 Budget, provides full income tax relief for individuals investing up to £40,000 in a year in the equity of new and existing unquoted companies. The Business Start-up Scheme (BSS), announced in the 1981 Budget, gave full income tax relief for investment in new companies only (i.e. those less than five years old). In this article, all references to the BES subsume the BSS.

(2) Venture Economics' statistics concentrate on the specialist venture capital organisations in the belief that this sector will provide the key to the industry's future. In general, those organisations are included which meet three criteria: they are equity investors, are long-term investors, and are heavily involved in investee companies' affairs. However, because the industry is very young, and rigid application of these criteria would mean that there were very few venture capital organisations, the criteria are flexibly applied; the main focus is on the first two.

(3) Largely taken from *UK Venture Capital Journal*, available from Venture Economics Ltd., 37 Thames Road, London W4 3PF.

(4) I.e. specialist venture capital organisations which are not funded by parent bodies (as are, for instance, some clearing bank subsidiaries).

(5) Some companies have received more than one injection of funds.

sizable proportion has been in companies distributing goods (often foreign) rather than producing them.

Commentary on recent developments

Various developments are highlighted by these statistics: for instance, the increase in investments, their wide spread, the upward trend in the proportion of buy-outs, the increasing number of very young companies receiving finance, and the liquidity of the venture capital industry at the end of 1983. However, as mentioned earlier in this article, there has also been venture capital investment not included in these figures. In particular, the ICFC Division of Investors in Industry, which has been investing in unquoted companies since the end of the Second World War, made investments of over £100 million in 1983 alone, about £50 million with a substantial equity content. This £50 million is equivalent to roughly half the total of investments by organisations included in Venture Economics' statistics, and approaching two-thirds if investment abroad is excluded from the latter.

Despite the problems of interpreting Venture Economics' statistics, they also serve to indicate—especially when taken in conjunction with additional sources of information—a number of other features of UK venture capital. Venture Economics' figures for disbursements in 1983 (£120 million), plus the £50 million of equity-linked investment in unquoted companies by the ICFC Division of Investors in Industry, gives a total of £170 million. Comparable investment in the United States was some £2 billion. Thus even allowing for the difference in size between the two economies, and despite the growth of venture capital activity in the United Kingdom in the last few years, it is clear that the venture capital market in this country is still a long way behind the United States. However, the US venture capital industry, too, is a fairly recent phenomenon, and in both countries the proportion of financing needs of all unlisted companies met by the venture capital market is probably still very small.

As far as the United Kingdom is concerned, it is not at present possible to set available statistics on venture capital investment in a broader context of sources available to unlisted companies (venture capital investment is at one end of the spectrum; at the other end is passive long-term equity and other investment). Some research that may help in this area is in train.[1] But at present, the only way of setting UK venture capital investment in some sort of context would be to compare it with, say, fixed investment by all UK industrial and commercial companies (over £15 billion in 1983), or external financing raised by them (nearly £8 billion in 1983).

Growth has been particularly marked in certain types of venture capital company, for instance, investment companies[2] and those organisations which have modelled themselves on the US pattern. The number of the latter has increased, and some are setting up additional funds. If BES funds are included in venture capital, they have become an important part of the industry, and a major contributor to its growth. They have raised over £40 million, entirely from the personal sector.

Provision of venture capital by industrial companies is currently small. In the United States, between 12% and 15% of funds raised by venture capital limited partnerships (a major part of the US venture capital industry—see the December 1982 *Bulletin* article) now comes from industrial companies, though they were slow to engage in this activity. The United Kingdom seems likely to develop in a broadly similar way. Links are beginning to be forged between some of the larger industrial companies in this country and venture capital companies, and at least one industrial company intends to establish its own venture capital fund—a step that has already been taken in the United States and several European countries. Such involvement in the provision of venture capital funds is spurred on by profits and the desire for a 'window on technology'; and it is likely to grow further in the United Kingdom, through investments via existing venture capital organisations and new funds (including, perhaps, joint ventures with existing venture capital companies).

Another potentially significant development has been the emergence of the first UK venture capital limited partnership. Although the limited partnership is particularly important in the United States, it has been widely believed that this kind of venture capital vehicle is less appropriate in the United Kingdom, because of differences in the legal and tax framework here. For instance, limited partners in this country cannot in general claim tax relief for a share of partnership tax losses unless the partnership activities constitute trading, and the amount of the loss on which a limited partner may claim tax relief is currently the subject of litigation. This is a complex area. But the fact that an onshore venture capital partnership was launched last summer as an investment vehicle deemed appropriate for both gross and net funds is of importance.

A substantial portion of UK venture capital investment has been made in companies abroad, largely in the United States. There are several reasons for this. For instance, the venture capital market is more developed there, and investment opportunities sometimes particularly attractive, especially to the larger, listed venture capital companies seeking early capital gains to obtain a performance record. Second, some US companies seek assistance with technology transfer to the United Kingdom. This is likely to be very difficult to achieve on any scale, but could both create investment opportunities in the United States and encourage industrial companies

(1) For instance, D Adamson at Nuffield College, Oxford, is currently seeking to establish how much funding of unlisted companies has been undertaken by pension funds, insurance companies, and investment trusts, seeking to identify the composition of this funding by region, industry, and stage of investment.

(2) I.e. investment companies quoted under stock exchange rules introduced in 1981, and thus able to obtain certain tax and other advantages.

there to set up in the United Kingdom, with the further opportunities for investment that this would bring. A number of links have been forged between venture capitalists in the United States and in this country, which have enhanced UK venture capital expertise.

Of particular importance to venture capital activity in the United Kingdom have been three factors. First, improving business conditions, combined with the Government's general support for smaller businesses, have clearly given much encouragement to venture capital investment. Second, the Government has taken a number of measures that have helped venture capital investment —for instance, the indexing of capital gains tax and, in the 1984 Budget, the replacement of income tax liability in respect of certain share options by a capital gains tax liability (a change that is likely to increase the ability of small, fast-growing businesses to attract key employees).

The third factor has been developments in UK share markets. These markets provide one of the most important means by which venture capital entrepreneurs and investors in venture capital organisations can ultimately realise their gains (and reinvest in new ventures). Buoyancy of the main stock market is important. But the creation of the USM in 1980, and its subsequent growth—about 220 companies are now quoted there—has given considerable encouragement to venture capitalists. The very recent development of a more broadly based over-the-counter market may help further (the number of shares traded in this way has increased from 10 in early 1982 to some 100 now, though the market is still very limited). Furthermore, with companies now able to repurchase their own shares, entrepreneurs are more likely to look for outside equity because they can regain overall control later.

The venture capital industry has also been helped by the establishment of the British Venture Capital Association, set up in February 1983 on the US model to promote the growth of venture capital finance, to assist the management of smaller companies, and to maintain the highest standards of professional practice and ethics. The Association has adopted a high profile, and has sought, among other things, to increase contacts between venture capitalists and entrepreneurs.

A European Venture Capital Association was also established last year, to promote co-operation in the financing of small and medium-sized high-technology companies developing products for Community markets. Eleven of the thirty-six members of this Association are British, reflecting the more developed venture capital industry in this country compared with other Community countries.

Research and development

Venture capitalists are primarily concerned with the provision of early-stage and subsequent finance for the commercial exploitation of products and ideas that have already been researched and developed. Very recently, however, there has emerged a rapidly-expanding sub-sector of the venture capital industry in the United States concerned with research and development itself. A number of research and development limited partnerships have been established which are highly tax-efficient vehicles for investors. At the same time, they enable the initiators of research to control the technology involved, protect their secrets, utilise existing research facilities, and—most importantly—obtain off balance sheet finance. In this way they can avoid parting with equity and incurring debt while at the same time they can transfer the research risk to the partnership. Broadly speaking, research and development limited partnerships are formed to finance a specific project, though a growing number are being set up to invest in several research activities. The limited partners provide most of the finance for the research, with the general partners (one or more often coming from the company initiating the research) managing the partnership. The partnership acquires the rights to the results of the research, and then normally contracts out most if not all the research to the initiating company. If the results cannot be exploited commercially, that is that. If they can, the initiating company commonly has the option to buy back the technology rights from the partnership and to market the results, in exchange for shares, royalties on sales, etc.

The emergence of these partnerships in the United States owes much to two factors. First, a Supreme Court ruling held that limited partnerships organised for the purpose of developing a new process or product can offset expenditure against current income even where there is not yet any trade or business offering a product for sale. Second, the proceeds from the sale of patents and patent rights are treated for tax purposes as long-term capital gains, irrespective of the length of the holding period. From the investor's point of view, these advantages can make research and development partnerships particularly attractive.

In the United Kingdom, the limited partnership has not so far been a popular vehicle for financing research and development because of uncertainties about tax treatment and partnership law as well as the lack of the particular advantages available to US investors mentioned above. In consequence, some have argued that tax and company law changes are needed to encourage the development of this vehicle in the United Kingdom. It is not clear, however, that such changes are necessary. The recent setting up of a limited partnership in the mainstream of venture capital could perhaps lead in time to the setting up of a research and development limited partnership. Moreover, one or two financial institutions in the United Kingdom already support selected research programmes in a different way; and perhaps developments in this country will follow a different course from the United States, as has happened elsewhere in the venture capital market.

Present position and prospects

Developments in the UK venture capital market have differed from the United States for a number of reasons —different cultural, institutional, legal and fiscal frameworks being among the more important. Nonetheless, the availability of venture capital in the United Kingdom has increased sharply over the last few years, Indeed, it is now sometimes said that there is too much money chasing too few investment opportunities (though a larger supply of venture capital funds is likely to generate an increase in demand).

A wide range of companies in the United Kingdom are now benefiting from venture capital investment. Further expansion of the venture capital market seems desirable because of the help it can give to technological advance and industrial growth more generally. Conditions are favourable, with good investment propositions coming forward and venture capital management experience being built up. But the industry is still young and fragile; and there are bound to be some failures among investments.

Competitive pressures to invest (and not only from BES funds anxious to invest before the end of each tax year) could lead to some unwise investments. There is a danger that, when failures occur, there could be some reduction in the supply of venture capital. There is thus a clear need for the highest professionalism on the part of venture capitalists.

Expansion of the venture capital market could be limited by a shortage of specialists combining the financial, technical and management skills required both by venture capital companies and the entrepreneurs in whom they invest. Indeed, such a shortage is seen by many as the single most important factor likely to limit venture capital growth (though the recent change in taxation of share options could help alleviate it by encouraging the movement of specialists from larger to smaller companies). But the expansion of the venture capital industry in the past eighteen months seems likely to continue, and this should do much to encourage a growing supply of the talents necessary to use venture capital funds to best effect.