Venture capital in the United Kingdom

An article in the June 1984 Bulletin *(pages 207–11) considered the emergence and growth of venture capital in the United Kingdom. This article*[1] *describes developments since then and examines the possible consequences of these developments for the venture capital industry. In particular it looks at evidence of increasing 'short termism', the effects of competitive pressures within the industry and the possible widening of gaps in the provision of finance for the start-up and expansion of young businesses. A glossary on page 81 explains some of the technical terms used by the industry.*

Introduction

In the past decade, the venture capital industry has played an important role in the restructuring of the United Kingdom's industrial base, in particular nurturing the creation and early growth of wealth and job creating enterprises. The industry's representative body, the British Venture Capital Association (BVCA), has estimated that, by 1992, venture capital backed companies will be responsible for over 1.5 million jobs in the United Kingdom.

Venture capitalists specialise in providing equity and other forms of long-term capital to enterprises, generally without much of a track record, which promise exceptional profit growth. Such investments entail considerable risk but this is balanced by the prospect of substantial returns when the investments are realised. Venture capitalists are usually more than sleeping partners, and endeavour to assist investee companies by supplying managerial, financial or technical skills. Such hands-on after-care has distinguished venture capitalists from most other types of investor.

The UK venture capital industry is now engaged in a wider range of deals and types of financing than in the early 1980s. It provides debt, including mezzanine debt, as well as equity; aims to invest for shorter periods than previously; invests in established companies as well as those without a long track record; and does not always participate in the management of investee companies. To a large extent, these developments have reflected the substantially increased number of buyouts financed by venture capitalists in recent years. By contrast, the amounts invested in start-up and early-stage businesses over the same period have only just about kept pace with inflation. Indeed, there continue to be reports that risk capital is difficult to obtain in small amounts, especially for seed-corn capital, and that venture capitalists are less tolerant than previously of projects which are slow to yield a return. There is a concern within the industry that 'short termism' is emerging via pressures on institutional fund managers to maximise immediate performance; this conflicts with the long-term outlook required of venture capitalists. Over the past five years, venture capitalists have taken advantage of the favourable economic climate and the opportunities provided by generally buoyant equity prices to realise a greater number of investments through flotation.

Investment patterns[2]

Venture capitalists invested just over £1 billion in the United Kingdom in 1988, 27% more than in 1987, and two and a half times the total invested in 1986. In the five years to 1988, roughly £3 billion has been invested by UK venture capitalists—89% in the United Kingdom, 9% in the United States and 2% elsewhere. While amounts invested have grown spectacularly since the mid-1980s, the number of companies funded, at 600 to 650 a year, has remained comparatively stable.

Table A
Investment activity in the United Kingdom

	1984	1985	1986	1987	1988
Total amount invested (£ millions)	228	279	396	795	1,006
Number of companies financed	582	597	665	638	625
Average received per company (£000)	392	467	595	1,246	1,610

Table B classifies venture capital investments by financing stage. The most significant change since 1984 has been the substantial increase in the percentage of total investment devoted to the financing of buyouts, buy-ins and acquisitions. This category accounted for one in four of the investments made by venture capitalists in 1988 compared with one in six in 1984, and absorbed almost two thirds of the total amount invested in 1988, more than double the proportion in 1984. The counterpart of the increased emphasis on buyouts has been a reduction in the relative importance of support for start-up, other early-stage and expansion projects, which together

(1) Prepared by the Bank's Industrial Finance Division, mainly by Gillian Pratt. The author wishes to thank Mr Tony Lorenz and Mr Lionel Anthony, two of the industry's leading experts, for comments on an earlier draft of this article.

(2) The figures quoted in this article are compiled by Venture Economics Ltd and have been largely taken from the *UK Venture Capital Journal*, copies of which are available from Venture Economics Ltd, 14 Barley Mow Passage, London W4. Venture capitalists are defined by Venture Economics to *exclude* organisations which provide passive investment or project finance, sponsor or arrange financings and which take only a small equity stake or earn predominantly fee income. Specialist providers of mezzanine finance and public sector bodies which invest primarily for economic development reasons rather than for capital gain are also excluded. The figures include investments made by 3i Ventures but not by 3i Regions.

Table B
UK financings, by financing stage

	Per cent of number of financings					Per cent of amount invested				
	1984	1985	1986	1987	1988	1984	1985	1986	1987	1988
Start-up	19	19	21	19	18	17	13	16	8	5
Other early-stage	13	11	11	9	8	10	6	7	4	2
Expansion	46	48	44	47	43	39	36	27	22	27
Buy-out/buy-in/ acquisition	17	16	19	21	24	28	38	44	63	62
Secondary purchase	4	5	4	4	7	5	6	5	3	4
Other	1	1	1	..	..	1	1	1	..	..
Total (£ millions)						228	279	396	795	1,006

accounted for just 34% of the total amount invested in 1988, down from 66% in 1984.

This emphasis on buyouts has led to a substantial increase in the average size of investments made by venture capitalists. Indeed, there was a virtual step-change in 1987 when the average amount invested more than doubled from below £600,000 to over £1.2 million, largely because of the effect of a relatively small number of very big buyouts. More generally, deals of over £2 million accounted for two thirds of the total amount invested in the United Kingdom in 1988, compared with just one third in 1985. At the opposite end of the size range, financings of under £200,000 have fallen from 10% of the total amount invested in 1985 to just 5% in 1988.

Following the recession of the early 1980s, many diversified UK companies decided to refocus on a limited number of core activities and this led to the sale of non-core subsidiaries, often to incumbent management. The financing of these buyouts was a natural extension of venture capitalists' traditional forms of investment since the deals required risk capital and investors who were not necessarily expecting immediate returns. Venture capitalists could additionally contribute specialist financial skills and, when appropriate, managerial and technical skills. Venture capitalists were, in other words, supporting a business when it was most vulnerable in the early years following a buyout and, in return, they expected substantial capital growth. Some of the earlier buyouts were realised after only one or two years, although typically the period is four or five years. Because buyouts usually involve businesses which have an established position in their product markets and an experienced management team *in situ*, they are, on paper at least, less risky than traditional venture capital investments.

Regional patterns

The regional pattern of venture capital investments has not changed much in the past five years. The South East has consistently received more than half of the total amount invested but there has been some evidence of a shift in investment activity towards other parts of the country in the past three years.

Table C
UK investments, by region

Percentages of amount invested

	1984	1985	1986	1987	1988
South East	55	60	63	62	55
South West	4	7	5	7	3
East Anglia	5	6	5	3	3
Midlands	9	10	6	10	16
North	10	6	11	9	14
Scotland	11	7	7	5	7
Wales	6	4	3	4	1
Northern Ireland	—	—	—	—	1

Sectoral patterns

Venture capital investments are spread across a wide range of industries and services. The sectoral allocation of investment, excluding buyouts, as set out in Table D, has remained reasonably stable since 1984. Consumer-related firms continue to account for about a quarter of total investments made, and there has been an increased emphasis on investment in services at the expense of the electronics and computer-related sectors.

Table D
UK investments, by industry sector

Percentage of number of companies

	1984	1985	1986	1987	1988
Consumer related	19	22	27	19	23
Electronics and computer related	27	26	21	19	21
Medical/genetics	8	4	7	8	7
Transport and communications	11	11	11	9	6
Industrial products, construction and other manufacturing	22	26	16	22	23
Other services	13	11	18	23	20

Structure of the UK venture capital industry

Specialist venture capital investors include both captive and independent funds. The former are subsidiaries of the major UK pension funds, insurance companies and banks, which allocate them funds for investment. Independent venture capital organisations raise capital for investment from a variety of external sources, including private investors and some financial institutions which have an in-house venture capital capacity. In addition, there are organisations supported by central and local government, such as the Scottish and Welsh Development Agencies, and those which manage Business Expansion Scheme funds. A trend in recent years has been the emergence of the semi-independent venture capital organisation, usually affiliated to a merchant bank or other fund management group and receiving funds from both the parent organisation and external sources.

Typically, independent firms set up funds of a pre-determined size, duration and investment strategy. Usually investors commit funds, which are drawn down as investment opportunities arise. The general aim is to liquidate the fund after a specified date, usually some seven to ten years later, but in recent years there has been a trend towards the immediate distribution of the proceeds of investments realised rather than their reinvestment in other ventures. By contrast, the majority of captive funds are open-ended and the amount allocated for venture capital will reflect the overall investment strategy of the parent organisation.

The independent venture capitalists are remunerated both from management fees and from retaining a proportion of realisation proceeds. The management fees provide a steady stream of income throughout the life of a fund, but the bulk of a venture capitalist's reward is derived from realisation profits.

The industry is no longer dominated by the captive organisations as was the case in the early 1980s. Independent funds are now the largest category of investor, accounting for just over half of the number of venture capital investments and two thirds of the total amount invested in the United Kingdom in 1988. The share of total investment made by captive funds has declined from 43% in 1984 to 31% in 1988. However, there are indications that the balance is changing, with the number, and market share, of affiliated firms growing.

Among the independents is 3i, which is the largest specialist venture capital investor in the United Kingdom. It is jointly owned by six clearing banks and the Bank of England and raises investment funds on the capital markets and from retained profits. Its origins go back to 1945 when the Industrial and Commercial Finance Corporation and Finance for Commerce and Industry were founded at the request of the government to fill the 'MacMillan Gap' by providing long-term loan capital to unquoted companies. It is considered by many to have been a major influence on the industry's development in the United Kingdom.

Another feature of the past five years has been a steady decline in the relative importance of BES funds as a means of investing in venture capital; in 1988 only 2% of venture capital investment was made through BES funds, compared with 20% in 1984. In part this has reflected BES investors' preferences for investment in areas other than venture capital.

Table E
UK investments, by type of investment vehicle

Percentages of amount invested

	1984	1985	1986	1987	1988
Independent	34	40	49	68	66
Captive	43	43	42	25	31
BES	20	14	8	6	2
Government/local authorities	3	3	1	1	1

An important fund-raising trend seen in the past few years has been the polarisation towards smaller niche funds on the one hand, directed at specific industry sectors, financing stages or geographical areas, and larger broad-based funds on the other. Of the forty funds set up in 1988, twenty were focused on a particular financing stage; of these, eleven were directed at later-stage and buyout investments, and three provided capital for early-stage enterprises.

Sources of finance

The amount of capital committed to independent venture capital funds grew at a steady rate in the mid-1980s before accelerating in 1987 to £700 million. This was largely fuelled by the success of, and quick returns made on, a number of earlier buyouts, and increased demand for buyout funding. Early signs are that 1989 was also a good year for fund-raising. Indeed, the amount of funds committed to the independent venture capital organisations since 1984, estimated to be in excess of £2 billion, has outstripped the £1.8 billion invested. The consequent oversupply mainly reflects funds committed for buyout and later-stage financing and has intensified competition to finance deals considered particularly attractive.

UK pension funds remain the principal source of capital for independent UK venture capital firms, providing over one third of the total raised in 1988. Overseas financial institutions have, however, been growing in importance as a source of capital and accounted for 26% of new capital raised in 1988 compared with 10% in 1984. They have mainly invested in funds specialising in buyouts and later-stage investments. The United States continues to be the main source of overseas commitments but, for the first time, several Japanese institutions invested in UK venture capital funds in 1988.

Table F
Sources of capital for independent funds

Percentages of capital committed

	1984	1985	1986	1987	1988
UK pension funds	40	40	41	33	37
Foreign institutions	10	21	12	36	26
UK insurers and fund managers	18	19	20	16	19
Private individuals/ family trusts	19	13	15	4	11
Industrial corporations	9	4	4	3	6
UK banks	1	1	6	6	—
Others	3	2	2	2	1
Total (£ millions)	**231**	**278**	**239**	**684**	**612**

A welcome development in 1988 was the increase in the capital committed to independent funds by industrial corporations and private individuals (£37 million and £67 million respectively in 1988 compared with £21 million and £27 million in 1987). Established industrial companies remain, nonetheless, a relatively minor source of capital for venture capital investment and, indeed, almost all of the corporate investors have been from the United States.

With a few notable exceptions (which include BP, Shell and BOC), UK companies appear to be lagging behind US and even European counterparts in the level of investment in smaller companies, either directly through an in-house venture capital unit or through a professional venture capital intermediary. This practice is known as corporate venturing and companies active in this area believe that, *inter alia*, it plays a key role in their forward planning, helping to identify areas of future profit growth and providing access to new technology and technology applications.

In 1988, the National Economic Development Office launched a register of potential corporate investors and investment opportunities to promote the concept of corporate venturing. Now firmly established, the register is run by BASE International, a company established in the early 1980s to assist in the financing of technology based companies.

Glossary

British Venture Capital Association (BVCA)
The BVCA was established in 1983, with encouragement from the Bank of England, to represent the views and interests of the UK industry. The BVCA also endeavours to ensure high standards of practice among member companies. Of the 130 specialist venture capital investors, approximately 120 are full members.

Business Expansion Scheme (BES)
Introduced in 1983 to encourage private investors to invest in unquoted companies by offering tax relief at their marginal rate for up to £40,000 invested a year.

Captive organisations
Venture capital organisations which form part of larger financial services groups and draw on the resources of their parents for all or most of their funds for investment.

Corporate venturing
The practice of a large company taking an equity stake in, or establishing a joint venture with, a smaller business with the objective of developing the latter's specialist skills.

Exit route
The means by which a venture capitalist realises his investment, usually by way of a trade sale or flotation.

Independent funds
Do not form part of larger financial groups. They raise their money from institutional and other private investors and usually operate closed-end funds.

Buyouts
The purchase of an existing business as a going concern. The seller might be a diversified company seeking to narrow its range of activities or the founder of a private company. The purchaser may be the incumbent management (in which case the buyout is known as a management buyout) or another company. A venture capitalist will assist the transfer of ownership by taking an equity stake in the new business and/or subscribing for loan capital. A buyout financed primarily by borrowed funds is known as a leveraged buyout.

Seed-corn capital
Often referred to as pre-start-up capital, seed capital usually involves quite small amounts (less than £250,000) to turn a good idea into a prototype, business plan or marketable product or service. It is the riskiest form of venture capital since one or more of the concept, the technology, the entrepreneur and the market are untried.

Trade sale
The purchase of a venture-capital-backed company by another business, often in the same, or related, industrial sector.

Realisation of investments

The development of the UK industry has been greatly helped by the availability of a choice of exit routes—trade sale, flotation, management buyout or buy-in and merger with another company. Trade sales remain the most common means of realisation although flotations are important for the larger companies. The equity market readjustment of October 1987 had only a short-lived effect on the level of flotations of venture-backed companies.[1] Indeed, the number of companies floated in 1988, at 39, was the second highest level ever (in 1986, 41 companies were floated) and largely reflected the realisation of venture-backed buyouts. The growing numbers of buyouts reaching maturity has also led to larger flotations and more companies seeking listings on the main market instead of the USM. The introduction of the Third Market in 1987 has had little impact on the pattern of flotations; 5 of the 75 companies floated in 1987 and 1988 were via this route, reflecting the lack of institutional interest in this market, in part prompted by its comparative illiquidity and poor levels of trading.

In the first half of 1989, the number of venture-backed companies going public was lower than in the corresponding period of 1988, reflecting the impact of the tightening of monetary policy on business confidence and unfavourable conditions in the equity market. Of those floated, a majority were on the USM and all were later-stage investments: 50% were management buyouts.

Few UK venture capital funds have been fully realised. Meaningful statistics on rates of return achieved and the success of investments are, therefore, very scarce. Anecdotal evidence suggests, however, that in general venture capitalists aim to achieve compound rates of return of 20% to 25% per annum, calculated as the pre-tax annual rate of return to the investor including dividend distributions, profits from disposals and unrealised gains, but less fees paid.

Increasing signs of short termism?

UK pension funds and insurance companies have been considered ideal investors in venture capital funds because of their long-term horizons. However, institutional fund managers have increasingly come under pressure to demonstrate better than average short-run returns, including those from their venture capital investments. Venture capitalists are responding to these

(1) Companies in which one or more venture capital organisations held at least 5% of issued share capital after flotation.

pressures in a number of ways. First, they have increased information flows to investors by providing, at least once a year, reports on the progress of funds, in particular what interim rates of return have been achieved and what final returns might be expected. Although such estimates are accepted as tentative, some indication of progress is considered to be better than none. Second, venture capitalists have increased their investments in buy-outs, attracted by the promise of quicker exits than those offered by traditional forms of venture capital investments. Third, an increasing number of new venture capital funds incorporate pre-set performance targets, which can stipulate minimum returns to investors and require capital repayment on realisation of individual investments. Fourth, the fee structures, charged to the fund's investors, are changing in response to institutional pressure. Front-end fees (up to 2% of total funds committed) are gradually being eliminated. There are indications that the size and basis of annual management fees are being increasingly examined.

There are mixed views within the industry about these developments. Many venture capitalists are concerned, for example, that too much will be read into estimates of interim returns and that this will lead to even greater short termism on the part of investors. The other developments mentioned above may, in part, be indications of greater investor experience and increased competition among venture capitalists for institutional capital as much as a reflection of increasing short termism. There is a general worry among venture capitalists that shortening investment horizons will especially damage those venture capital organisations genuinely involved in long-term, high-risk investments which need patient money.

Other competitive pressures

In the past few years, the number of new entrants to the industry has been declining; in 1988, for example, three quarters of the new funds set up were launched by established venture capitalists. As competition for investors' funds increases, it is becoming more difficult for new entrants, especially independent funds without a track record, to enter the market.

The growing importance of the semi-independent, affiliated venture capital organisations also has serious implications for the future of wholly independent firms. The former generally benefit from access to internal capital and from first refusal on internally generated deals; they thereby reduce the number of deals and the availability of capital open to the independents. Many in the industry believe that there are too many venture capital organisations and the concern is that it will be the independent firms that could be squeezed out of the industry.

Gaps in the availability of finance?

The suggestion that entrepreneurs find it extraordinarily difficult to obtain small amounts of capital for starting up a new business or for financing the expansion of a young business is far from new. Both the MacMillan Committee in the early 1930s and the Wilson Committee in the late 1970s identified such a gap in the provision of capital, and it is explicable in terms of the high fixed costs of evaluating and monitoring such investments, which by their nature entail considerable risk. Somewhat surprisingly, the development of a professional venture capital industry since the 1970s seems to have done little to eliminate or reduce the scale of this financing gap. Indeed, a number of developments suggest that the gap might have widened in recent years.

Two possible gaps have been identified: seed-corn capital and second-stage growth capital. The provision of equity finance for new and developing businesses can be especially unattractive to potential investors for two reasons—it is extremely risky and the costs of evaluating and monitoring the investments can swamp expected returns. While the industry disagrees on the extent to which, if at all, there is a gap in the availability of second-stage growth capital in amounts of £100,000 to £250,000, there is considerable agreement that seed-corn capital of less than £100,000 is hard to obtain. There are but a handful of specialist seed-corn investors in the United Kingdom who, according to Venture Economics, made just 24 investments in 1987, which accounted for a mere 0.2% of total venture investment; 1988's figure was even lower. The situation in Europe is no better, as members of the European Venture Capital Association invested only 0.3% (ECU 9.2 million—£6.7 million) in seed funds in 1988. In the United States, it would appear that a much higher proportion of venture capital (around 2% each year) is invested in seed-corn projects. Some venture capitalists in the United Kingdom, however, suggest that if an idea has genuine potential for job and wealth creation, it will find financial backing, but this backing need not necessarily come from the venture capital industry. However, few of these alternative sources—which include the commercial banks, friends, business associates, enterprise agencies and academic institutions—typically bring the management and technical expertise that venture capitalists provide and which are so often essential if an idea is to develop into a successful business. Equally, other types of investor often require extensive security or may not be comfortable with the risks involved in such ventures.

The BVCA has established a committee to look at the problems associated with the provision of risk finance for start-ups and technology-related projects, in particular to examine the problem of high management overheads. It has decided to encourage actively the establishment of further seed capital funds and increase the awareness of investors, entrepreneurs and advisors of the need for very early stage investment. Indeed, several venture capital organisations, including 3i, are increasing the resources allocated to start-up and other early-stage investments. In addition, the BVCA is pressing for the introduction of fiscal incentives to attract a greater number of able managers into higher risk ventures. There is a widely held view among venture capitalists that there are too few experienced management teams, capable of turning ideas into flourishing businesses, who are prepared to take the risk of leaving secure employment to develop new businesses. This reluctance is probably as much cultural as financial. In the United States, for example, those who take business risks are often held in high regard, whether they succeed or not; and to have tried and failed is deemed better than not to have tried at all. In European countries, the negative effects of failure are given most weight.

The European Commission has recognised the existence of a shortage of start-up and early-stage funding across Europe and has recently launched two initiatives: Seed Capital and Eurotech Capital.

The Seed Capital project, which will support twenty-four new seed capital funds across the EC, seeks to stimulate private, cross-border investment by improving the short-term viability of seed funds. The Commission will contribute towards both the operating costs and the capital resources of funds investing in selected assisted areas. On realisation of the investments made (assuming their profitability), the Commission would receive its original financial stake plus half of any capital gain made on that stake. The remaining 50% of the capital gain would be divided between the other fund investors.

The second initiative, Eurotech Capital, is a modest attempt to encourage financial institutions, with capitalisation of at least Ecu 50 million (£36 million), to increase their investment in cross-border, high technology projects by means of investment subsidies ranging from a minimum of 4% to a maximum of 50% for seed capital projects.

Prospects for the UK venture capital industry

Although the industry will, to a large extent, determine its own destiny, its future must increasingly lie with Europe. Considerable restructuring is taking place among small and medium-sized firms in Europe, not only in advance of 1992 but also as many of the founders of the continent's family-run businesses, which were created after the end of World War II, retire and seek to sell out to new owners.

The provision of venture capital funds in Europe is expanding at a very fast rate and the UK industry remains its largest and most mature arm. As the completion of the single market approaches, UK venture capitalists should be well placed to take advantage of the opportunities that will arise and to influence the direction that the European industry will follow. To this end, a small, but growing, number of British venture capitalists have established links with European counterparts or have set up their own, or affiliated, operations on the continent. The number of funds focusing on European investment opportunities is increasing.

Although no longer strictly a role model for the UK industry, the United States is still the only real indicator of likely future developments; it remains, therefore, of great interest to UK practitioners. The US industry has proved in its 25-year life to be cyclical, a phenomenon not yet seen in the United Kingdom, and it is possible that the United States is now seeing something of a cyclical downturn. In the past two years, the rate of fund raising and investment in the United States has slowed; several factors have been cited as possible causes. Of most concern locally is that the returns on investments made since 1982–83 are now coming through and are relatively modest. US investors are therefore looking for alternative opportunities and a likely area for diversification could well be the UK and European venture capital industries, especially with 1992 in mind.

After a decade of impressive growth, there are signs that the UK industry is beginning to face a period of consolidation. The preoccupation with buyouts in the past two years looked set, until recently, to continue. Indeed, during the first three quarters of 1989, over £1 billion was raised by five large buyout funds. Rises in interest rates during 1989 and the much publicised difficulties facing a handful of larger buyouts have brought the growth of this market to a virtual standstill. One question that remains to be resolved is the fate of those funds committed to buyouts, but perhaps of equal importance are the prospects for a number of other venture-backed companies, particularly those involved in consumer-related activities. Undoubtedly, the venture capital community needs to work much harder during an economic slowdown to ensure that existing investments remain sound and new profitable areas of business are identified.

The BVCA's 1989 National Conference looked forward five years. The themes were that it would be both different and harder for the industry; the rapid expansion experienced in recent years had probably come to an end, more emphasis would be placed on early-stage financing and there would be both withdrawals and mergers of venture capital companies. Europe, however, offered important opportunities. Captive and affiliated funds were likely to take a greater proportion of the industry's business at the expense of the independent funds.