Department for Business Innovation & Skills

BRITISH BUSINESS BANK

EQUITY RESEARCH REPORT

Review of Equity Investment in Small Businesses

March 2015

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Contents

Ministerial Foreword

The right financial environment is vital to making Britain the best place in the world to start and grow a business. This is the reason we set up the new British Business Bank itself – as a permanent institution with the long-term vision and the financial firepower to change markets for the better.

This report's headline is that the foundations of a vibrant equity culture are now firmly established in the UK. Equity finances the growth of many successful businesses, so we are very pleased that there has been year-on-year growth in the use of equity finance by small businesses over the past four years. This is the result of concerted Government reforms so that businesses can access the finance that they need.

But the report also identifies a continuing lag in the supply of finance at the venture stage, particularly for more capital intensive businesses. The traditional "valley of death" for finance in the UK, where more capital intensive businesses can access the funding to develop a product but lack the scale of funding to exploit it fully in the market, remains stubbornly wide.

That's why we secured £400m of new funding over the next three years at Autumn Statement for the Bank to invest in its Enterprise Capital Funds programme and have increased the investment limit to £5m. It is also why the Enterprise Investment Scheme and Venture Capital Trust scheme were recently expanded, and the new Seed Enterprise Investment Scheme has been made permanent. Together these actions will make a real difference. Equally, the Bank's conclusions should provide a real challenge to institutional investors to look again at the small business finance market and at the opportunities for them to invest in its long-term growth.

We hope that the publication of this report starts a wider debate both about the strong success of our current support for small businesses seeking equity finance and about how to create an even more vibrant equity culture for UK businesses.

Vince Cable
Secretary of State for
Business, Innovation and Skills

Andrea Leadsom
Economic Secretary
to the Treasury

Introduction

The British Business Bank is pleased to have worked with the Department for Business, Innovation & Skills and HM Treasury for this report on equity investment in small businesses. A vibrant and diverse equity market is essential to help early stage and high-growth firms deliver on their potential.

A broader assessment of the market for small business finance as a whole was recently published by the British Business Bank[1]. This report builds on that document to provide a fuller exploration of the issues facing small business equity finance markets.

First, the report provides an overview of reasons why equity is an important source of finance, particularly for growing small businesses. It also highlights the wide ranging role currently played by British Business Bank, and Government generally, in small business equity markets.

Second, the long-term features of small business equity finance are explored, highlighting both the structural market failures that have persisted in equity markets and recent cyclical weaknesses.

Third, existing and new data sources on private equity markets are used to explore recent trends in equity investment, both for the market as a whole and in more detail at the seed, venture and growth stages.

Finally, it offers some conclusions as to how to improve the functioning of equity markets for smaller businesses, which are set out in the Executive Summary.

The British Business Bank is committed to increasing the supply of finance where markets do not work well; creating a more diverse finance market with more options for smaller businesses; and increasing awareness and understanding of the finance options available. Our activity through Enterprise Capital Funds and the Angel CoFund already delivers investment capacity of over £650m, making us the biggest single provider of funding in the UK in this part of the market.

Early stage equity funding is a small but disproportionately important part of the UK economic landscape. We are committed to playing our part in making the UK the best place to start and to grow a business.

Keith Morgan
CEO, British Business Bank

[1] British Business Bank (2014) "Small Business Finance Markets 2014", available at: http://british-business-bank.co.uk/performance/small-business-finance-markets-2014/

Executive Summary

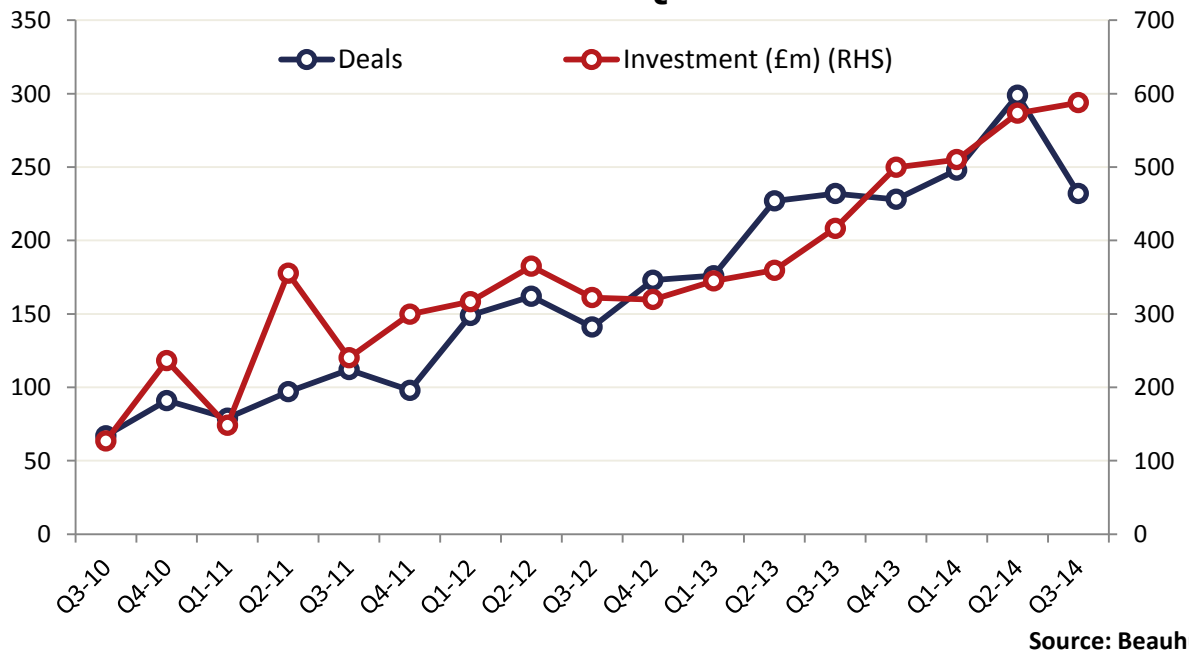
External equity investment is an important source of finance for companies with growth potential

For a specific group of businesses with the potential for high growth, but whose risk level makes bank finance unsuitable or unavailable, external equity finance is vital to enable them to achieve their full potential. This makes equity investment an important component of industrial and entrepreneurship policy despite less than 1% of small firms financing themselves using equity from external providers such as venture capital funds and business angels.

Overall equity investment has increased in each of the past four years, thanks to growth in seed and growth activity

New data produced for BIS and the British Business Bank by Beauhurst, a market data provider, shows an overall increase in equity investment to small firms in each of the past four years, with both the number of deals and the total amount invested showing a clear upward trend.

Figure E.1: Equity deals and investment, 2010 Q3 to 2014 Q3



Source: Beauhurst

The recent growth in equity investment has been driven by increasing activity at the seed and growth stages. The strong performance in seed deals, shown in the chart below, is indicative of a lively funding environment at the seed stage, with angels, funds and crowdfunders all involved, backed by significant support from Government in the form of the Enterprise Investment Scheme (EIS), Seed Enterprise Investment Scheme (SEIS) and Venture Capital Trust Scheme (VCT) tax reliefs, and from British Business Bank programmes such as Enterprise Capital Funds and the Angel CoFund.

The growth stage shows increasing investment, with an increasing share of funding provided in deals of more than £10m. Institutional funding is much more significant than Government at this stage.

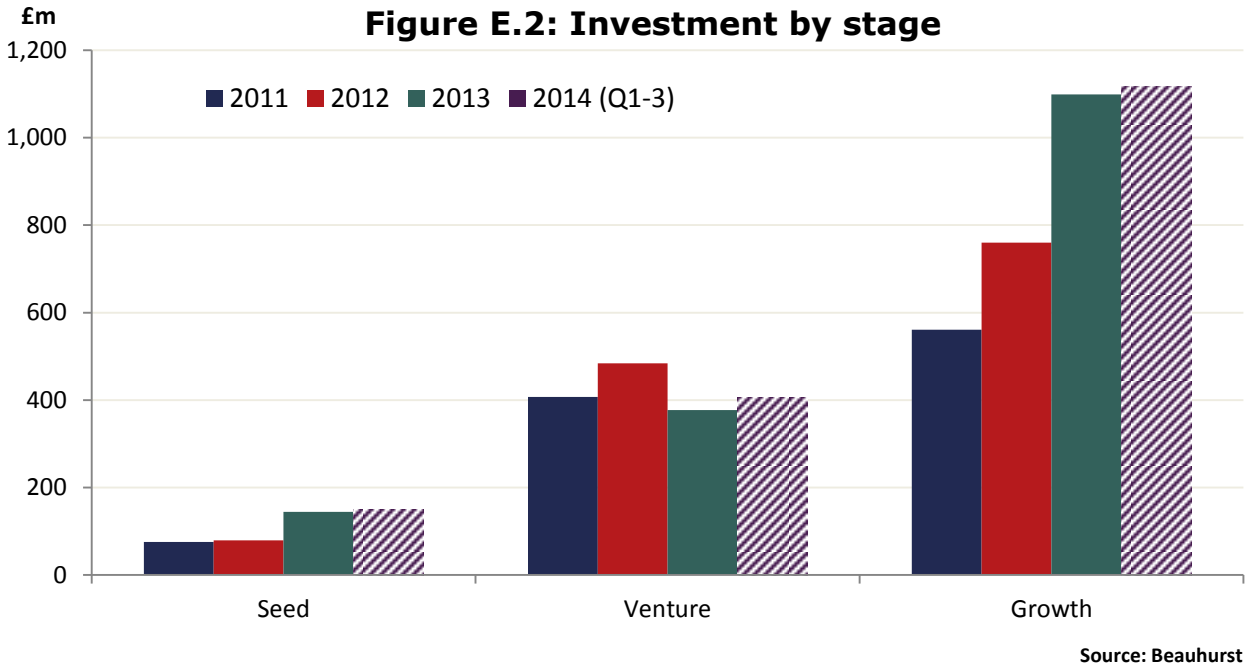


Figure E.2: Investment by stage

Source: Beauhurst

Investment at the venture-stage has been broadly flat over the past four years. Within this total, there has been a significant increase in investment in software-related businesses, but overall the venture-stage has not seen the increases observed at the seed and growth stages. The available evidence suggests the equity gap persists, and extends to larger deal sizes

The Beauhurst data shows broadly flat venture-stage investment since 2011, with some fluctuation from year to year. This compares to consistent year-on-year increases in seed and growth investment. Within the overall picture, venture investment in software-related businesses has more than doubled since 2011, while other sectors have not on the whole shown significant increases in investment.

The gap in venture-stage investment, according to the Beauhurst data, is most notable in the £2m-£5m range, where levels of investment decreased from 2011 to 2013, before experiencing a rebound in 2014. Separate data from the EVCA supports this conclusion, showing that "earlier stage" (seed) investment seems to have held up well since the financial crisis, but that "later stage" (venture) investment and fundraising have seen reduced investment. Funds that are raised often include Government funding, with institutional investors' share declining.

Further analysis of the data from Beauhurst shows the "traditional" private equity and venture capital investor group was involved in a decreasing proportion of venture-stage deals between 2011 and 2013, with an increasing share involving Government, angel networks (aided by greater syndication, enhanced tax incentives and the Angel CoFund), and crowdfunding (which is small at the venture stage but growing quickly). Although the proportion of deals accounted for by private equity and venture capital increased in the first three quarters of 2014 (with

Government and angel networks falling back), they still accounted for a significantly lower share of deals than in 2011.

This is why the investment limit of the Business Bank's flagship Enterprise Capital Fund (ECF) programme was recently raised to £5m, following new state aid clearance, and £400m of new investment was committed at Autumn Statement 2014 to the ECF programme over the next three years to strengthen this part of the market. The market trends observed also support the increase in EIS and VCT limits (to £5m) which occurred in 2012.

The UK is a leading player in the European VC market, but has tended to lag behind the most successful international examples

The UK has historically been the leading market within Europe for VC investment – although France and Germany have made recent gains – and one of the largest in the world. A comparison of VC investment as a proportion of GDP shows the UK market generally exceeds its European competitors, but lags behind the leading world players of Israel, the USA and Canada. The policy tools utilised are remarkably similar across countries, suggesting there is a common understanding and use of the most appropriate policies, but the underlying ecosystem is stronger in certain countries.

The British Business Bank and Government have had a positive impact on the market to date, but still have a significant role to play in the equity market

The actions of the British Business Bank, and of Government more generally, have had a positive effect in providing funding to viable but under-served businesses looking to grow, and in encouraging the development of the supply-side. Two forthcoming evaluation reports, for Enterprise Capital Funds and the Angel CoFund, demonstrate the success and continued value of these schemes to the market.

Interventions taken by the British Business Bank and Government to date have established some of the foundations for future growth of the market. The ECF programme has been an enabling factor for new VC funds and managers, as well as providing capital to promising businesses; as the successful managers seek to raise their next funds, the ambition is for them to secure funding with less need for Government backing. The recent extension to the ECF programme demonstrates the Bank's continued commitment to developing the venture capital market, building upon an already-successful scheme.

The Angel CoFund has a similar aim to the ECF scheme, in that it encourages the "professionalisation" of angel investment and adoption of rigorous investment principles by setting high standards for due diligence and closely scrutinising each investment. The intention is to develop the "quality" of investment as well as providing an increased quantity of funding.

The continued role of the British Business Bank is to support the development of the equity market for smaller businesses, building on these foundations: improving firms' awareness of their finance options and how best to approach investors; providing capital to more traditional venture capital funds; and encouraging the development of alternative products and sources of equity finance.

At the same time, Government has a wider role to play. The Department for Business, Innovation and Skills (BIS) is the department responsible for helping people to start and grow a business. Businesses with the right level of ambition, capability and capacity to improve and grow are supported through the Business Growth Service (BGS), which is particularly relevant for firms with high-growth potential seeking equity finance. The BGS has consolidated schemes such as Growth Accelerator into a single service which provides a tailored package of support to enable businesses with growth potential to realise their ambitions, for example, through improving their "investment readiness".

Tax incentives offered and operated by HM Treasury and HM Revenue & Customs (HMRC) are also particularly important to encouraging early stage investment by private individuals. The Enterprise Investment Scheme, Seed Enterprise Investment Scheme, and Venture Capital Trusts are an important aspect of the market, and of Government's support for small and growing businesses.

Nevertheless, despite the increasing use of equity finance, this paper identifies several weaknesses in the market: the persistence of the equity gap, especially at the venture stage; a lack of institutional investment; lack of awareness of finance options on the part of small businesses; and insufficient data for more detailed analysis of market trends.

This paper concludes with a set of specific recommendations as to how the British Business Bank and Government could improve the functioning of equity markets for smaller businesses:

- Deliver the extended Enterprise Capital Funds programme, including larger funds and investments
- Consider the options for encouraging "patient capital" investment which supports companies with longer-term capital-intensive propositions
- Investigate options for additional private sector capital to expand the successful Angel CoFund
- Increase awareness of equity financing options amongst smaller businesses
- Deliver the pilot for the "Help to Grow" scheme
- Work to attract institutional investment to early-stage equity
- Improve the available data by establishing an "equity tracker" for early stage investment

Chapter 1: Use of equity finance by smaller businesses

Equity is a small but important source of finance for business

Equity finance is used by a minority of small businesses, but is particularly important for those with high growth potential. The SME Finance Monitor shows that around 1% of businesses currently use equity from third parties (such as venture capital funds or business angels), and less than 1% apply in a given twelve month period. By contrast, around 4 in 10 businesses use any form of external finance[2].

In this report, "equity investment" is defined as any form of external equity finance, excluding public markets, buyouts and investment by family or friends. The definition incorporates business angels, equity crowdfunding, venture capital, corporate venturing and, for larger "growth" deals, some activity of "traditional" private equity funds. The analysis recognises the limitations in data on equity investment, particularly at the seed stage, where many deals are "hidden" and not publicly announced; trends are presented for the "visible" market only.

The report focuses on private markets rather than public markets, as the former are those in which the British Business Bank is active as an investor. Public equity markets are a relevant and important part of the funding ecosystem, particularly at later stages of firm development, but for this report they are covered only in the context of providing an exit route for equity investments.

Analysis by Ares & Co[3] estimates that, by value, equity accounts for around 5% of total external financing used by smaller businesses, which suggests the average small firm equity deal is larger than the average debt deal[4]. It is clear that demand for equity increases with company size, as table 1 demonstrates.

Table 1.1: Application rate for equity funding by company[5] size, 2012 Q2 to 2014 Q3

No. of employees	0	1-9	10-49	50-249
Application rate	0.4%	0.6%	0.7%	1.0%

Source: SME Finance Monitor

[2] BDRC Continental (2014) "SME Finance Monitor Q3 2014", available at: http://www.sme-finance-monitor.co.uk

[3] Ares & Co (2012) "SME Financing: Impact of regulation and the Eurozone crisis"

[4] Although it should be borne in mind that this estimate includes small cap public markets in addition to early stage equity deals in private markets, which limits comparability with the SME Finance Monitor figures

[5] The table refers to registered companies only, as the relevant question in the SME Finance Monitor survey is asked only to these businesses

Finance theory helps explain the niche nature of equity finance

To explain the lack of widespread use of equity financing, a few theories have been developed. Perhaps the most famous of these is the Modigliani-Miller theory. In its purest form, the theory states that it does not matter how a company finances itself, as its total value will be judged purely by its earnings and the risk attributed to its assets. When real-world considerations such as taxation are introduced, however, incentives are skewed towards debt finance, as the interest payments are tax-deductible[6]. This leads to a favouring of debt as a form of financing, although there remains a role for equity to keep the debt levels sustainable and help the company withstand shocks to its creditworthiness[7].

Whilst the Modigliani-Miller theory may be relevant to larger companies, its applicability to smaller firms is rather limited. Small businesses are less motivated by company tax considerations than their larger brethren (the liability, and therefore potential gain, is much smaller), are generally less sophisticated in their financial affairs, and are more averse to the perceived loss of ownership or control that equity investment entails.

Business owners and investors are, however, highly motivated by personal tax considerations: investors in particular have a clear personal tax incentive to favour equity investment, should it meet their risk/return preferences. But the focus here is instead on the motivations of business owners and how they approach different forms of finance; the personal tax liability when drawing from the business should be unaffected by the type of finance used. The experience of how small businesses approach external finance points to a different set of considerations for these firms compared to larger businesses.

Small businesses appear instead to follow a "pecking order" of options when seeking finance, as outlined by the Enterprise Research Centre in their review of the literature[8].

- First choice is internal finance (or personal injections of capital), which is cheapest and without covenants;
- Friends and family might come next in the order of preference, again as an easier or cheaper source;
- Only once these "softer" forms of finance are exhausted will the business typically seek external funding, in the first instance debt (principally from banks), then possibly asset or invoice finance;

[6] This is, however, offset to a degree by the existence of the tax-advantaged venture capital schemes: EIS, SEIS and VCT. These incentivise the individual investor to invest in small and growing businesses which would otherwise struggle to access finance through the provision of generous tax reliefs.

[7] Modiglianni, F & M. H. Miller. (1958). "The Cost of Captial, Corporation Finance and the Theory of Finance." *American Economic Review*. 48 (37), 261-297

[8] Enterprise Research Centre (2013) "What Do We Know About The Relationship Between Entrepreneurial Finance and Growth?" (White Paper No 4), available at: http://enterpriseresearch.ac.uk/wp-content/uploads/2013/12/ERC-White-Paper-No_4-Finance-final.pdf

- Equity is rarely sought, given the costlier nature of the investment[9] and the relinquishing of ownership or control it involves.

This order of preference is likely in part to be based on the likelihood of success in obtaining external finance. It is clear that the smallest and newest businesses are most likely to be rejected for a debt facility[10]; this also feeds the perceptions of smaller firms and reinforces a desire to postpone applying for external facilities and relying instead on internal sources of finance for as long as possible. Only a very small proportion of the deal-flow receives equity investment[11], further reducing the desire for most businesses to actively seek equity given the large amount of time spent identifying and pitching to potential investors.

Yet, where equity is used appropriately, financing businesses with the right risk-reward profile, it can offer significant additional benefits over debt finance. There may be no such thing as a "typical" firm receiving business angel or venture capital investment, but those businesses are more likely than normal to be:

- Small, young and at an early stage of development (early or even pre-trading);
- A risky proposition lacking assets to use as collateral;
- Developing a disruptive product or business model; and
- Either growing rapidly, or with the potential for rapid growth.

In short, these are businesses likely to be turned down for a conventional term loan because of their risk profile, lack of collateral and revenues to service the interest and capital repayments of a term loan, but offer the potential for strong growth and high financial returns to an investor willing to take on the risk.

Equity investment therefore fills an important space, providing finance to firms too risky for the banks and other debt providers but with potential to contribute strongly to innovation, productivity and economic growth. By investing in return for an equity stake, investors give entrepreneurs space to develop their businesses without the pressure of making regular repayments, and the interests of both are well aligned towards maximising the value of the

[9] Equity investors expect higher returns on capital to compensate for their greater risk and the illiquidity of their investment. In addition, equity finance requires a greater amount of due diligence than debt providers (as there is more uncertainty as to the value of the business), and holds a low rank in terms of the repayment of capital in the event of the business being wound up.

[10] For loan applicants, the overall success rate in the period Q2 2013-Q3 2014 was 56%; success rates varied from 48% for firms with no employees to 93% for firms with 50-249 employees. For overdraft applicants over the same period the approval rate ranged from 73% for firms with no employees to 97% for firms with 50-249 employees. For loans and overdrafts combined, 45% of first-time applicants were successful, compared to 56% of all applicants seeking new money and 71% of applications overall (for new or renewed facilities). Source: SME Finance Monitor (http://www.sme-finance-monitor.co.uk)

[11] BIS (2009) "The Supply of Equity Finance to SMEs: Revisiting the Equity Gap" suggests on average VC funds invest in around 2% of the applications they receive, indicating fund managers are very selective in trying to identify the investments that will generate the highest financial returns.

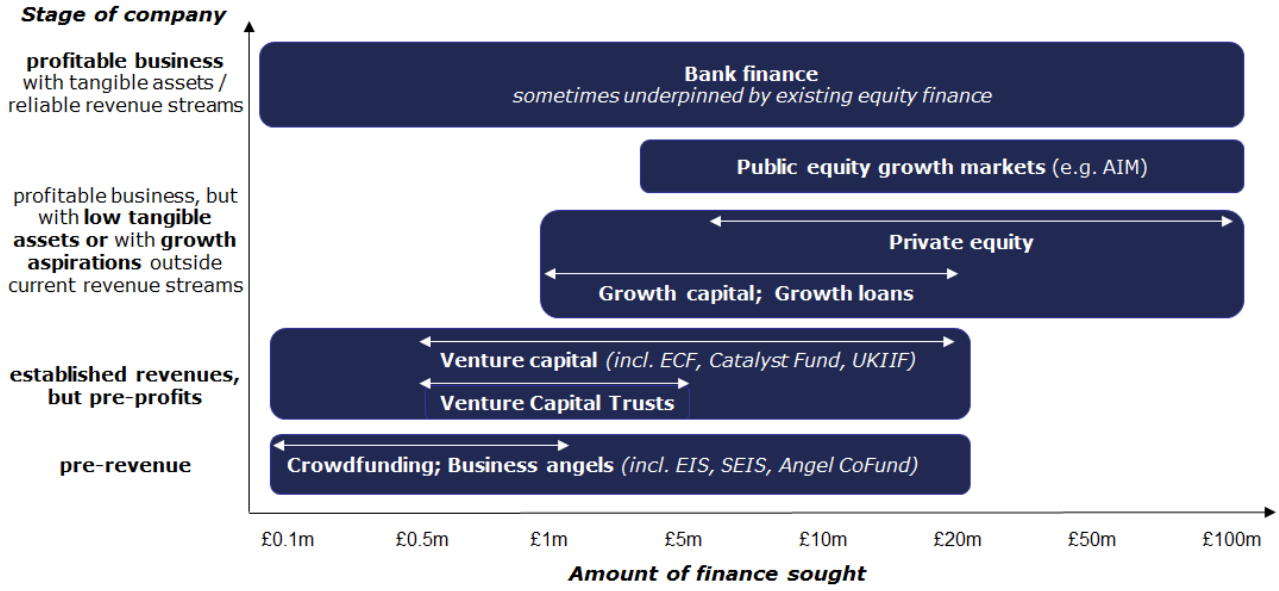
company[12]. The business can benefit from the experience and know-how of the investor, who often takes a seat on the board; this also means the investor can closely monitor the actions of management, reducing the likelihood of principal-agent problems.

In summary, equity investment is rarely used, and often as a last resort for many business owners, but for a quite specific group of risky businesses with the potential for high growth, it is an appropriate and important source of funding that can enable these businesses to achieve their full potential. This makes equity investment an important component of industrial and entrepreneurship policy.

Different types of equity finance are appropriate depending on the development path of the company

The type of equity finance that is available to, or most appropriate for, a business depends on its size and stage of development. The range of finance options, from business angels and equity crowdfunding up to pure private equity and public markets, is often presented in the form of a "funding escalator[13]", as in figure 1.1:

Figure 1.1: Stylised equity "funding escalator" for growing businesses



The funding escalator suggests that a small business might receive investment from business angels initially, then a round or two from VCs, move on to growth investment, then private equity or public markets once they have become a stable, profitable company that can also obtain debt finance from banks or public markets.

[12] Equity investors only make a financial return on their investment when they exit their investment at a greater value than they paid, with a trade sale or IPO being favoured exit routes

[13] For instance, see NESTA (2009) "Reshaping the UK Economy: The Role of Public Investment in Financing Growth", available at http://www.nesta.org.uk/sites/default/files/reshaping_the_uk_economy.pdf

Figure 1.1 is, of course, an over-simplification for illustrative purposes. In reality, the journey through different investors is unlikely to be so smooth, or involve as many steps. Firms may use internal funds for longer or sell out sooner. But what it does show is the interdependency between the different stages of investment. Investors need deal-flow and exit opportunities; the former is provided by firms being funded at earlier stages, while the latter is provided by later-stage investors and public markets. A healthy market therefore requires all stages to be functioning effectively.

The other dependency involves other forms of finance and their risk appetite. Banks, for example, used to have a greater risk tolerance when making loans, but have now pulled back from this space following the global economic downturn in 2008-09. To the extent that some of their lending was effectively risk capital, this potentially reduces the total availability of risk capital to smaller firms whilst increasing the opportunities for "purer" forms such as venture capital to meet the demand. In addition, there is still something of a culture of approaching banks for high-risk facilities: Russel Griggs, the independent assessor of the banks' appeal process for rejected loans, notes that some small businesses "*still ask banks at times for debt that is in effect equity and so beyond the risk boundary that debt would allow the banks to operate within*"[14].

Growth loans can bridge the gap between debt and equity finance

"Growth loans" are a form of debt finance which is either unsecured, or contains some form of participation rights (a characteristic of what might otherwise be described as "mezzanine" finance). They are normally positioned between the provision of secured senior debt generally provided by banks, and the provision of equity finance by venture capitalists and the private equity industry, with the risk-reward profile in the middle of the two. Growth loans are typically used by established growth-stage businesses to fund further development. These businesses may lack security or be considered outside the risk appetite for secured senior debt, but will be less likely to generate the high returns required by equity investors. Some, such as family businesses, may not wish to give up equity or majority stakes.

Private debt funds are currently the principal providers in this space, deploying a range of debt instruments (either individually or in combination) using fund structures similar to those of the private equity industry. According to forthcoming British Business Bank research, the UK growth loans market is, however, currently very small, particularly for smaller deal sizes.

The British Business Bank, and Government more generally, are active participants in the early-stage equity market

The British Business Bank and wider Government, in particular HM Treasury and HMRC, intervene in the market through multiple programmes that aim to address market failures[15], develop the capacity of existing providers, encourage new providers to the market, and ensure viable businesses can obtain the investment they need to grow to their potential.

[14] Better Business Finance (2013) "Banking Taskforce Appeals Process: Independent External Reviewer Annual Report 2012-13." Available at: http://www.betterbusinessfinance.co.uk/images/pdfs/Annual_Report_Master_2013.pdf

[15] Chapter 2 provides a detailed discussion of market failures

The main "live" British Business Bank investment programmes and HM Treasury/HMRC tax incentives are summarised below, whilst support for public markets is also discussed, so as to demonstrate the full range of Government's offer to the market[16].

Active[17] British Business Bank programmes[18]

Enterprise Capital Funds

Enterprise Capital Funds (ECFs) support early-stage venture capital. The programme has 17 funds in total, of which 9 are currently investing, with a combined investment capacity of over £550m. In the last financial year, ECFs invested £45m in smaller businesses.

At Autumn Statement 2014 the Chancellor announced a further £400m of funding for the ECF programme. This will ensure the programme can continue investing beyond 2015 and will enable funds to make larger investments in small businesses with growth potential, providing finance at a key stage of their development.

ECFs are structured so that the British Business Bank provides up to two thirds of funding, with private sector investors providing at least one third of funding. The private sector investors take on relatively more risk and, in return, are granted a larger share of the returns, incentivising private sector involvement in this part of the market. Each fund is managed by an experienced fund manager, including teams from the venture capital industry as well as serial entrepreneurs with a history of success in building early stage UK companies. Applications from the fund managers are subject to a competitive process and are evaluated by the British Business Bank venture capital team before a decision to co-invest into a fund is made.

The investment limits for ECFs have recently changed. From the launch of the programme in 2006 until autumn 2014, state aid rules capped the Government contribution to funds at £25m and limited investments in individual companies to a maximum of £2m[19]. Following the new state aid approval for the programme, ECFs can now receive up to £50m in capital from the British Business Bank and make investments of up to £5m. The first ECF to close under the new criteria, IQ Capital II, started making investments in November 2014.

VC Catalyst Fund

The VC Catalyst Fund invests in later-stage venture capital funds which might otherwise fail to launch due to current weaknesses in the provision of institutional capital to venture capital funds.

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[16] Public markets are relevant as a source of exits for investors and companies involved in early-stage equity deals.

[17] The British Business Bank also administers other programmes which are beyond their investment period, such as Regional Venture Capital Funds. We do not include these "legacy programmes" in this summary.

[18] Case studies of investments supported by the British Business Bank can be found on the Bank's website: http://british-business-bank.co.uk/

[19] For first investments in that company. The criteria for follow-on investments were slightly more flexible, with some exceptions to prevent dilution of the ECF's equity stake.

The Fund was first announced at Budget 2013, and expanded in size at Autumn Statement 2013 as part of a £250m funding package for alternative forms of finance[20].

The Fund typically commits between £5m and £10m to underlying funds; the contribution should not account for more than 20% of the total fund size. Applications from fund managers are subject to a competitive process, and potential fund managers are only considered formally for the Fund once they have significant private investment already committed. Funds will typically have a minimum size of at least £50m at their first close, though proposals for smaller funds will be considered on a case-by-case basis.

Aspire Fund

The Aspire Fund invests in women-led businesses across the UK, helping to increase the number of successful women-led businesses within the UK, and to ensure those with real potential to succeed are not held back through a lack of available funding. The Fund supported £5.5m of investment in smaller businesses in 2013-14.

The Fund makes investments of between £100,000 and £1m on a co-investment basis, investing on the same or better terms as private investors. Lead investors can be established venture capital funds or experienced business angels.

Business Angel CoFund

The Business Angel CoFund makes pari passu[21] equity investments in smaller businesses with growth potential in the UK, alongside business angel syndicates. It makes initial investments of between £100,000 and £1m, with capacity for follow-on funding. From its first investment at the start of 2012 to September 2014, the CoFund supported £94m of investment in smaller businesses. Collectively, businesses backed by the CoFund employ over 850 people; through the next eight years of the fund's life, it is expected to support more than 6,000 jobs.

Through its investments, the CoFund aims to improve the quality of angel investment, by insisting upon the highest standards of due diligence and scrutinising every deal with an independent Investment Committee. The aim is to encourage the "professionalization" of angel investment in the UK.

UK Innovation Investment Fund

Established in 2009, the UK Innovation Investment Fund (UKIIF) is a venture capital fund of funds that makes pari passu investments in technology-based funds with an investment focus on strategically important sectors to the UK, including digital technologies, life sciences, clean technology and advanced manufacturing.

[20] The Autumn Statement 2013 package also included support for asset finance and wholesale guarantees on small business bank loans

[21] Government invests on equal terms with private investors

UKIIF has a combined £330m of capital – £150m of Government funding, £100m from the European Investment Fund and £80m from private investors – to invest in underlying funds. The underlying funds also raise private capital of their own, which further leverages the impact of UKIIF funding.

Other venture capital programmes

The European Investment Fund is also a significant funder of UK equity finance, providing £330m of investment in 2013. Alongside this, some Local Enterprise Partnerships support access to finance schemes through funding allocated to them as part of the European Regional Development Fund (ERDF) programme.

Investor tax incentives

Enterprise Investment Scheme (EIS)

EIS helps smaller companies raise equity finance by offering a range of tax reliefs to investors who purchase new shares in those companies. It underpins the majority of business angel finance in the UK and therefore plays a pivotal role in supporting a vibrant early stage equity culture. In 2012-13, £1,016m was invested in almost 2,400 businesses.

Recent changes to the EIS scheme have also significantly increased the amount of investment supported by the scheme, enhancing the early stage equity culture of the UK. Between 2010-11 and 2011-12 there was an 88% increase in the amount of investment raised by companies under EIS, to £1,032m. This was the highest amount raised under EIS since 2000-01, and coincided with the increase of the rate of tax relief available for EIS investment from 20% to 30%. In 2012-13, there was also a significant increase in the annual investment limit per company under EIS from £2m to £5m, which led to a redistribution of investment that was previously clustered at the £2m boundary to larger deal amounts.

The scheme currently applies to individuals investing in companies of fewer than 250 employees with assets of less than £15m. Further details about the scheme can be found on HMRC's website (http://www.hmrc.gov.uk/eis/).

Seed Enterprise Investment Scheme (SEIS)

SEIS was launched in April 2012 to help small, early-stage companies raise equity finance, supporting investments of £150,000 or less. In its first year of operation (2012-13), £84m was invested in 1,120 businesses; by July 2014, over 2,000 companies had raised over £175m through the scheme.

SEIS was initially set up as a temporary measure that would apply to shares issued before 6th April 2017, but at Budget 2014 the Chancellor announced the scheme would be made permanent.

The scheme applies to individuals investing in start-up and early-stage companies of fewer than 25 employees with assets of less than £200,000. Companies can receive a maximum of £150,000 under SEIS. It offers to investors a higher rate of tax relief than EIS – 50% of the cost of the shares, up to an annual investment limit of £100,000 – as an added incentive to invest in high-risk small firms with growth potential.

Venture Capital Trusts (VCTs)

The VCT scheme encourages individuals to invest in small, unlisted companies indirectly through the acquisition of shares in a trust approved by HMRC. In 2013-14, investors made £440m of investment into the scheme.

Recent changes to the VCT scheme has increased their ability to invest in a broader range of businesses. From 6 April 2012, VCT qualifying holdings were extended to companies with up to 250 full time equivalent employees and gross assets of up to £15m before investment and £16m after investment. The annual investment limit for companies was also increased to £5m.

VCTs encourage potential investors to invest through tax incentives:

- The maximum investment in VCT shares by any individual in any year is £200,000, which will qualify for relief against income tax at a rate of 30% of the amount invested. Shares must be held for at least five years from the date of their issue by the VCT.

- There is an exemption for capital gains tax on disposal of shares in a VCT, and dividends on VCT shares are exempt from income tax.

In order to show the relative scale of the support provided through these schemes, table 1.2 presents a summary of the volume of investment though each programme, and the number of companies supported, for each year since 2010-11.

Table 1.2: Investment[a], and number of supported businesses[b], for British Business Bank programmes and HM Treasury/HMRC tax reliefs, 2010-11 to 2013-14

British Business Bank funds		2010-11	2011-12	2012-13	2013-14
ECFs	Investment (£m)	29	45	34	45
	Number of companies	14	40	18	27
VC Catal-yst Fund[c]	Investment by underlying funds (£m)	-	-	-	4
	Number of companies	-	-	-	2
Aspire Fund[d]	Investment (£m)	9	1	2	5
	Number of companies	1	0	0	3
Angel Co-Fund[e]	Investment (£m)	-	2	34	36
	Number of companies	-	1	26	14
UKIIF	Investment by underlying funds (£m)	20	50	108	140
	Number of companies	7	18	16	20
HMT/HMRC investor tax reliefs		**2010-11**	**2011-12**	**2012-13**	**2013-14**
EIS[f]	Investment (£m)	549	1,032	1,016	-
	Number of companies	1,070	1,565	1,135	-
SEIS[g]	Investment (£m)	-	-	84	-
	Number of companies	-	-	1,120	-
VCT[h]	Funds raised (£m)	350	325	400	440

Notes:

a) "Investment" refers to the total invested through the programmes in UK businesses, including private investor commitments. In the case of the VC Catalyst Fund and UKIIF, this includes the investment of all underlying funds which have received British Business Bank funding.

b) "Number of companies" refers to unique businesses receiving investment, i.e. excluding follow-on investments in the same company. HMRC use the term "companies raising funds for the first time" in the published EIS/SEIS statistics.

c) The VC Catalyst Fund began investing in 2013 Q4. The Fund has continued to establish itself in the market in 2014-15

d) The Aspire Fund was closed to new investments between July 2010 and February

2013, but remained able to make follow-on investments during this period

e) The Angel CoFund began investing in 2012 Q1. By September 2014, the fund had supported £94m of investment in smaller businesses.

f) EIS statistics are published with a significant lag due to the need to wait for sufficient data to produce reliable statistics; 2012-13 is the latest year available

g) SEIS statistics are similarly lagged, and the scheme launched in April 2012, so only one year of investment data is available

h) Data on VCT investments is not readily available, so funds raised are shown here. Similarly, there is no data available on the number of companies receiving investment through VCTs

Source: British Business Bank; HMRC

Support for public markets

While outside the focus of this paper, the listed public equity markets also play an important role in providing equity finance to growing UK businesses. They are important not only for the support that they give to individual businesses quoted on those markets, but also as a means for venture capital and other earlier stage investors to exit their investments as businesses reach later stages of growth.

Because of their importance in supporting the wider environment for equity finance in the UK, recent significant changes have been made to improve the financing environment further for quoted companies. This includes:

- The abolition of stamp duty on purchases of shares made on equity growth markets, boosting liquidity in equity growth markets.

- For similar purposes, making changes to enable SME equity shares admitted to trading on a recognised stock exchange to be held in a stocks and shares ISA. This means, for example, that AIM shares can be held in ISAs.

Looking forward, the Government intends to work with its European partners to deliver a Capital Markets Union, with a view to maximising the benefits of capital markets (including equity markets) for the real economy. The Government will seek to ensure that businesses have appropriate access to equity markets, including by seeking to optimise the Prospectus Directive[22].

[22] The Prospectus Directive provides for an effective single passport regime for issuers of securities in the EU by harmonising the requirements for content, format, approval and publication of a prospectus. For more details visit http://ec.europa.eu/finance/securities/prospectus/index_en.htm

Chapter 2: Long-term market features

2.1 Structural market failures in equity finance

Structural issues in the market create the well-known equity gap

Structural failures in the market are well-established and understood. The informational asymmetry[23] between business and investor necessitates costly due diligence in advance of any deal; this cost is relatively fixed, meaning it accounts for a greater share of smaller deals, which drives funds toward larger deal sizes and larger/less risky firms. This gives rise to the classic "equity gap", first identified in the Macmillan Report as long ago as 1931[24].

The 2003 HM Treasury and Small Business Service "Bridging the Finance Gap" consultation[25] identified an equity gap affecting VC deals of up to £2m, and provided the basis for the establishment of the Enterprise Capital Funds (ECF) programme. The most recent published assessment of the equity gap, carried out by SQW, confirmed the existence of an equity gap, and placed the investment range at £250,000 to at least £2m, and up to £5m or more in certain (technology-intensive) sectors[26].

The nature of the equity gap is also discussed in forthcoming research evaluating British Business Bank equity schemes. The stakeholders interviewed suggest that, by 2014, there was reasonable availability of seed-stage finance towards the lower end of the "traditional" equity gap, as business angels have become involved in larger deals due to greater levels of syndication, the expansion of EIS and VCT investment limits to £5m per year, and the introduction of SEIS, the latter two of which occurred in 2012. Despite these changes, there was a clear view that an unaddressed gap persists for investments of between £2m-£5m.

This new research is consistent with the findings of a 2013 CfEL[27] survey of fund managers delivering publicly-backed funds, in which the majority of managers put the upper limit of the equity gap at £3m or more, and 1 in 3 specifically put it at £5m[28].

This range is above the previous State Aid limit for the ECF programme – although the limit recently increased to £5m for new funds, starting in November 2014. Some other British

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[23] It addition to asymmetric information, there is a related failure that arises from an absence of information on the likelihood of success for seed and early stage businesses, especially for 'ground breaking' technology or products/processes that are completely new to the market.

[24] The Macmillan Report described a long term funding gap which has come to be known as the equity gap

[25] HM Treasury (2003) "Bridging the finance gap: a consultation on improving access to growth capital for small businesses", available at: http://webarchive.nationalarchives.gov.uk/20081113023136/http:/www.hm-treasury.gov.uk/d/adinvest359kb03.pdf

[26] SQW Consulting (2009) "The Supply of Equity Finance to SMEs: Revisiting the 'Equity Gap'"; available at http://www.sqw.co.uk/files/8713/8712/1030/47.pdf

[27] Capital for Enterprise Ltd, predecessor organisation of the British Business Bank

[28] Capital for Enterprise Ltd (2013) "2013 Survey of Fund Managers", available at http://british-business-bank.co.uk/wp-content/uploads/2013/10/Fund-manager-survey-2013-report-final.pdf

Business Bank schemes are able to invest in this space, such as the new VC Catalyst Fund and the UK Innovation Investment Fund; the latter has been a significant investor at the growth stage but is now fully committed, whilst the former is only beginning to make investments. Companies receiving EIS and VCT investment have also been able to access up to £5m since 2012, and have likely made a positive impact in this space, but it is hard to judge the extent of this: detailed data on investment patterns are scarce, particularly for VCTs. The recent extension of the ECF programme offers the chance to make a further impact on the later-stage equity gap, building on the other programmes.

The Business Growth Fund (an independent investment company with £2.5bn to invest, funded by five major UK banking groups) makes investments in this space (£2m -£10m) for a minority equity stake, but typically in more established companies with sizeable turnover[29], so still misses out a range of businesses that are early or pre-revenue, typically in tech-focused sectors with long product development times.

It is important to emphasise that, at the earlier stage, increased funding availability does not mean the equity gap has diminished; the market is to a large extent supported by British Business Bank and wider Government support of one form or another, for example Enterprise Capital Funds, the Angel CoFund, EIS, SEIS and VCTs, such that the underlying structural weakness remains. For now, market participants are observing the palliative of Government intervention rather than the long-term solution of a market that can function effectively without widespread Government support.

Equity investment yields positive spill-over benefits

Aside from the traditional equity gap, a market failure arises from the difference between private and social returns to equity investment. Investment generates positive externalities, or spill-overs, to the rest of the economy in the form of innovation or knowledge transfer[30]. These spill-overs are particularly significant for smaller firms, which find it more difficult to appropriate the value of their new knowledge, and high-tech firms, which rely more on innovation for their profitability[31]. The external benefits are not taken into account in the decision-making of private investors, resulting in an under-provision of equity finance in societal terms, as projects which do not offer sufficient returns to private investors but generate significant social benefits are not undertaken.

[29] http://www.businessgrowthfund.co.uk/our-criteria/

[30] Even where a business or investment fails, there is residual value in the form of physical and intangible capital, skills and know-how that are not destroyed but spread to other parts of the economy, as was observed in a qualitative element of the forthcoming research into ECFs and the Capital for Enterprise Fund.

[31] Oxera (2005) "Innovation market failures and state aid: developing criteria", available at: http://www.pedz.uni-mannheim.de/daten/edz-h/gdb/06/innovation_market_failures_and_state_aid.pdf

A variety of studies have associated venture capital with increased innovation (as measured by patent counts)[32,33] and greater commercialisation of research[34,35], whilst more general innovation literature demonstrates the divergence between private and social rates of return, and hence the existence of spill-overs between businesses, industries and countries[36].
The extent of the divergence between private and social returns to innovation (as measured by R&D) has been the subject of multiple studies over several decades. A recent report by Frontier Economics for the Department for Business Innovation and Skills (BIS)[37] summarises many of the results, and finds that annual private rates of return from innovation average around 30%, with social returns being around "two to three times" this level.

Table 2.1 shows the ratio of social to private returns to R&D investment for studies carried out at firm, industry and country level. Most used industry as the unit of analysis; these are most useful, as they allow an estimation of cross-industry spill-overs, which approximate the "national" returns to R&D. The industry-level studies estimate an average social return of 2.9 times the private return (median 2.4), revealing substantial external benefits. Firm-level and country-level studies, measuring within-industry and cross-country spill-overs, show less of an impact, from a smaller sample of papers.

Table 2.1: Ratio of social to private rates of return to R&D[38]

Level of analysis	No. papers	No. estimates	Min ratio	Max ratio	Median	Mean
Firm	1	4	1.4	2.1	1.8	1.8
Industry	11	15	1.0	8.1	2.4	2.9
Country	3	3	1.3	1.6	1.3	1.4

Source: Frontier Economics estimates on behalf of BIS

[32] Ueda and Hirukawa (2008) "Venture Capital and Industrial Innovation"

[33] Kortum and Lerner (2000) "Assessing the contribution of venture capital to innovation"

[34] Engel and Keilbach (2007) "Firm Level Implications of Early Stage Venture Capital Investment – An Empirical Investigation"

[35] Hellman and Puri (2002) "Venture Capital and the Professionalization of Start-Up Firms: Empirical Evidence"

[36] Cameron G (1996) "Innovation and Economic growth" Centre for Economic Performance Discussion Paper No. 277, available at http://eprints.lse.ac.uk/20685/1/Innovation_and_Economic_Growth.pdf

[37] BIS, (2014) "Rates of return to investment in science and innovation: A report prepared for the Department for Business, Innovation and Skills", available at: http://www.frontier-economics.com/documents/2014/07/rates-of-return-to-investment-in-science-and-innovation.pdf

[38] From studies where both private and social returns are estimated

The demand for equity finance is affected by issues of awareness and investment readiness

Market failures occur on the demand side largely as a result of imperfect information: businesses often do not understand who to approach for equity finance, and how best to seek it. For example, 55% of small businesses are aware of venture capital, but only 20% are aware of a specific supplier to approach[39]. When they do approach equity funders, many smaller businesses lack sufficient know-how to convince investors to provide funding. Mason and Kwok[40] summarise the main issues, which they divide into three areas:

1. **Equity aversion:** consistent with the "pecking order" hypothesis of firm finance, owners of growing businesses are often unwilling to seek external equity as they do not want to give up control of their business to third parties[41]. Mason and Kwok suggest this may to some extent reflect a lack of understanding of the different sources of finance. Either way, for viable high-growth businesses this can prevent their full growth potential from being reached.

2. **Investment readiness:** a high proportion of applications to business angels and VC funds are rejected, either because the business is not a good "fit" for the investor[42] or because they do not believe the business would offer sufficiently strong returns[43]. While the first point is relatively innocuous[44], the latter raises concerns about the quality of management, strategy, or the underlying product and ability to monetise it. Businesses need to better understand the expectations of investors to address these issues ahead of an application.

3. **Presentational weaknesses:** many small businesses lack the knowledge or experience of making an investment proposition, and therefore do not sufficiently promote themselves and their businesses to potential investors. Important failings identified by Mason and Kwok include incomplete business plans and poorly delivered pitches to investors. A weak presentation can result in a failure to raise funds for even the most promising businesses, so it is important for those seeking equity to make the best possible case.

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[39] British Business Bank (2014) "SME Journey Towards Raising Finance 2014 Survey" (BMG Research), available at http://british-business-bank.co.uk/wp-content/uploads/2014/12/Final-BMG-SME-Journey-Research-Report.pdf

[40] University of Strathclyde (2010) "Investment Readiness Programmes and Access to Finance: A Critical Review of Design Issues", available at: http://www.strath.ac.uk/media/departments/huntercentre/research/workingpapers/WP_version.pdf

[41] For instance, qualitative research for the 2013 SME Journey Towards External Finance revealed "most respondents have concerns regarding equity finance, as they did not want to give up control of their business to third parties"

[42] Each investor will have their own set of investment parameters, covering stage, sector, deal size, location etc.

[43] It also reflects the model of equity finance, with whereby angels and funds target only those businesses with the highest potential to generate the largest returns. A high rejection rate can be the result of a lack of supply as well as a lack of good quality deal-flow.

[44] Although it does suggest there is imperfect information if managers are approaching sources of funding which are not appropriate for their business

Each of these failings on the demand side affect the overall efficiency of the market for small business investment, by reducing the pool of firms seeking funding and perpetuating the problem of imperfect information, thus making funding decisions more difficult. Investors are faced with an unwelcome choice of either making fewer investments or making investments in firms they perceive to be of "lower quality", with the former option more likely to be taken.

Demand-side issues also compromise the effectiveness of supply-side interventions, such as funds supported by the British Business Bank, if there is a lack of quality deal-flow. It is therefore important to the success of the Bank's investments, as well as to the overall health of the market, to address the weaknesses on the demand side[45].

On a related point, a 2009 Nesta report[46] identified how supply and demand side factors for SMEs raising external equity finance can interact leading to a "thin market", where a limited number of investors and high growth firms have difficulty finding and contacting each other at reasonable cost. This friction in the market can lead to inefficient matching and, consequently, an economically inefficient allocation of equity finance.

Market failures also affect the provision of growth loans to small businesses

Whilst there has been a lot of new entry in the private debt market in Europe over the last few years, by funds offering a range of debt products including various types of growth loans, these funds have targeted investments in larger corporates with deal sizes in excess of £10-20m. There has been limited entry by private sector debt funds specifically targeting smaller businesses with deal sizes of less than £10m; only a small number of funds focused on providing growth loan finance to smaller businesses are active in the UK.

Forthcoming research by the British Business Bank shows that, despite its potential to fill an important gap in the funding landscape, the market for small business growth loans is underdeveloped in the UK, with a number of structural market failures affecting both the supply and the demand side restricting this market from becoming established.

These market failures are similar to those affecting equity finance for small firms, and include issues relating to the cost of undertaking due diligence relative to transaction size; the lack of a proven track record for this asset class with investors; and constraints on attracting institutional investment into small funds. There are also demand-side barriers, including a lack of awareness of growth loan products and providers on the part of small businesses, and issues relating to investment readiness in how firms market themselves as investable propositions.

[45] The British Business Bank has already made progress in raising awareness, publishing the Business Finance Guide in conjunction with the ICAEW Corporate Finance Faculty, and will consider further how to improve the investment readiness of small businesses seeking equity finance.

[46] Nesta (2009) "From Funding Gaps to Thin Markets", available at http://www.nesta.org.uk/publications/funding-gaps-thin-markets

Availability of long-term, "patient" funding may be limited

As part of its market engagement, the British Business Bank has encountered a perception of a wider problem in the supply of more "patient" investment to high growth potential businesses. This is, broadly speaking, funding provided for capital-intensive projects with long lead times. The potential funding gap may prevent certain firms, particularly those developing and commercialising technology[47], from reaching their full commercial potential, because they take longer to create value for investors than the typical 5-7 years sought by venture capitalists. There are three main reasons for this view:

1. **Venture capital investment can be viewed as not being sufficiently long-term**. The "typical" 12 year fund, which is established for an initial period of 10 years with an option for two more, may not be suitable for making longer-term commitments to fund companies through to exit. Relatively small fund sizes in the UK (compared to the US) exacerbate the problem. This can force early sales or closures which adversely affect the development of promising new ideas (or result in the loss of intellectual property overseas).

2. **Larger funds are incentivised to make larger investments**. The expected failure rate in venture investing is relatively high compared to later stage investments. At the same time, there tend to be no more than 15 to 20 investments made by any given fund, to achieve diversification but keep the number manageable. Thus, the incentive for managers of large funds, encouraged by their investors, is to focus on larger and later-stage deals.

3. **Longer term investing presents liquidity problems for investors**. VC investors already lock their money away for at least 10 years in a high risk, illiquid asset, which often (especially in the case of technology investments) does not generate a yield prior to exit. If the same investors are expected to tie up their capital for even longer, the "liquidity premium" required to compensate them is likely to be prohibitive – or they may not wish to invest at all. The management fees, too, are likely to be a barrier for prospective limited partners in such a structure.

In short, there may be certain businesses in industries characterised by long lead times which are not well-served by the existing model of venture capital. Yet it may not be traditional "venture" capital they require: the model of "buy and hold" VC investment might not be appropriate over a significantly longer time horizon.

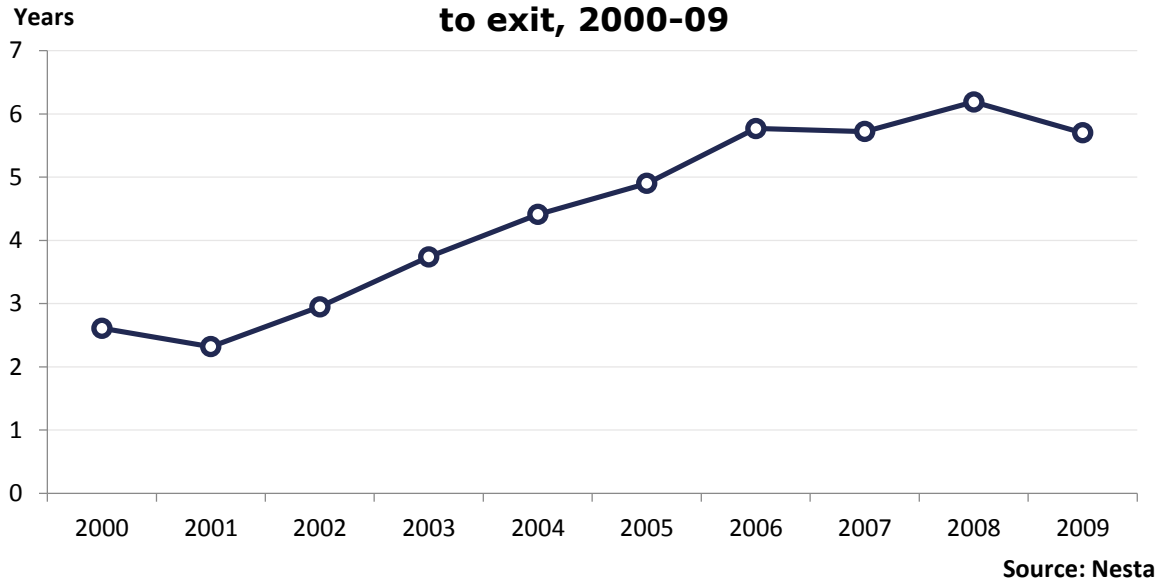
Two potential alternatives might arise from this analysis. Firstly, it may be the case that a fundamentally different sort of "patient" investor is called for. The types of investor likely to be willing and able to invest over a longer time horizon might include corporates, institutional investors and some business angels. There is a small but growing number of evergreen investment vehicles that suggest some investors are more "patient" in outlook.

[47] Such as drug development firms or those involved in large-scale clean technology projects

Alternatively, longer-term funding could be provided by multiple investors within existing structures with more trading of stakes in portfolio companies. Increasing the number of such secondary transactions would provide liquidity to investors, effectively shortening their exit horizon without forcing a business into an early trade sale or IPO, and thus from the firm's point of view would offer a more stable form of funding (although it would not offer stability of guidance and oversight from their investors). There is currently a relatively limited market for secondary deals, which is related to the unique nature of each investment.

One way of looking for evidence of possible "patient" investment is in the time taken to exit, either through a trade sale or IPO. There is a relative lack of recent data on this subject, but a 2010 study by Nesta[48] estimated the average time to exit from a VC investment in 2009 at 5.7 years. This average had been on the rise since 2001, but still does not point to a VC industry that routinely backs long-term projects. The Nesta data does, however, show increasing dispersion in exit times from the mid-2000s, including some cases of 10+ years: this might reflect more "patient" investment, or it could just be the result of weak exit markets[49].

Figure 2.1: Average time from initial investment to exit, 2000-09



There does not appear to have been a general lengthening in conventional funds' lifespans which would signal more "patient" investment. Whilst it is true that VC funds are able to extend their lifespan with the agreement of investors – and many have in recent years – this is done in an ad-hoc fashion, whilst the funds are in operation. This implies the reasoning is a difficulty in exiting investments rather than an active decision on the part of managers and investors to support longer-term deals, as would be the case if the longer fund life were determined at the fundraising stage.

[48] Nesta (2010) "Venture Capital: Now and After the Dotcom Crash", available at http://www.nesta.org.uk/publications/venture-capital-now-and-after-dotcom-crash

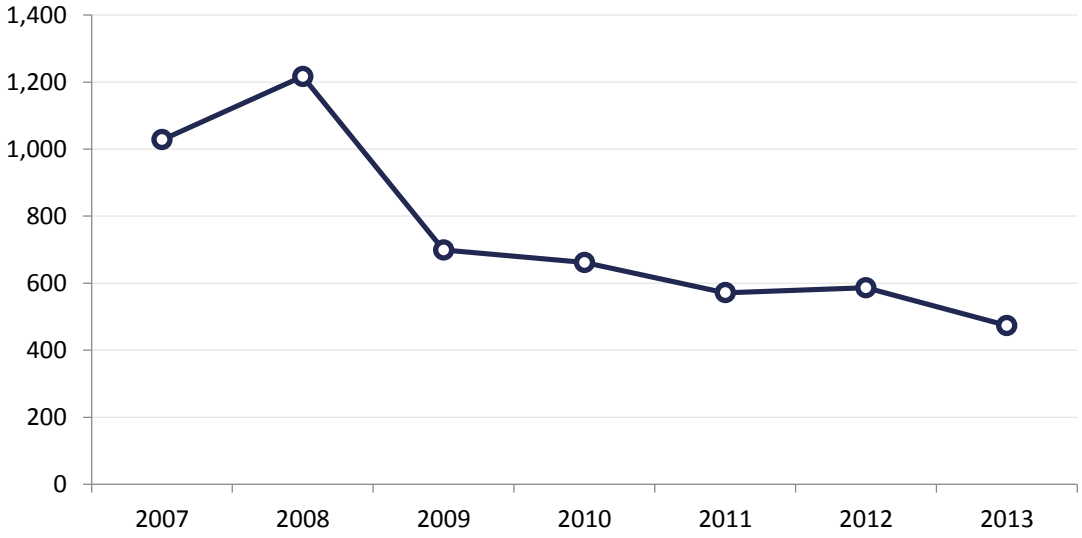
[49] This time period is pre-financial crisis, but the Dotcom crash had a profound and lasting effect on VC, including exit markets: many companies funded during the preceding bubble struggled to make an exit. A more detailed discussion of the issues in exit markets is provided later in this chapter.

2.2 Cyclical issues

Cyclical factors affect equity investment and returns

Cyclical problems in the market emerged after the financial crisis of 2008. The crisis had a severe impact on liquidity in the VC market; private investors have to a large degree fled to safer and more liquid investments in the aftermath, leaving a significant "hole" in the availability of VC. Figure 2.2 shows the decline in venture capital investment between 2008 and 2013.

Figure 2.2: VC investment, £m



Source: EVCA; ECB

There are, however, signs that the VC market may have picked up again in 2014. The Beauhurst data, for example, shows that venture investment had exceeded its 2013 total in the first three quarters of 2014 alone, whilst Dow Jones VentureSource also reports increasing VC investment in 2014, albeit from fewer deals[50].

Financial returns are typically affected by wider market conditions. The year in which a fund launches (vintage) appears to be correlated with returns; funds making investments at the time of a market downturn tend on average to have significantly lower returns. In particular, the Dotcom crash of 2000 is a landmark event that had a major impact on VC returns; the effect has lasted for several years for vintages before 2002, whilst more recent vintages have seen healthier returns.

Table 2.2 demonstrates this divergence in VC returns by fund vintage, and the extent to which Dotcom-era funds affect the aggregate. Over the 10 years to December 2013, venture capital in aggregate under-performed every comparator index measured by the British Venture Capital

[50] Dow Jones (2014) "Venture Capital Report" available at http://images.dowjones.com/company/wp-content/uploads/sites/15/2015/01/VS_Report_Europe_4Q14.pdf

Association (BVCA) in their annual performance survey[51], with an Internal Rate of Return (IRR) only just equal to inflation. However, funds launched from 2002 onwards have a more respectable IRR of 6.2% per year (even if this still trails the private equity total); in contrast, pre-2002 funds have lost money. Looking more closely at individual vintage years also reveals that IRRs have been consistently improving since 2002, as figure 2.3 demonstrates.

Table 2.2: Rates of return for venture funds & comparator investments, position at year end 2013, IRR (%p.a.)[52]; 1996 vintage funds onwards

	1 year (2013)	3 years (2011-13)	10 years (2004-13)
Private Equity total[53]	**19.2**	**10**	**15.6**
Venture Capital	22.9	7.7	3.3
pre-2002 vintage funds	32.1	0.3	-0.7
2002 vintage funds onwards	21.4	9.7	6.2
Small MBO	20.4	10	29
Medium MBO	28.1	14	18.3
Large MBO	16.6	9.2	15.8
Selected comparators			
UK Equities	22.6	10.2	8.9
UK Bonds	-0.8	6.9	5.8
Cash	-0.7	1.3	3.5
FTSE SmallCap	32.8	14.1	8.7
Retail Price Index	2.7	3.5	3.3

Note: comparator investment performance based on UK pension fund investments

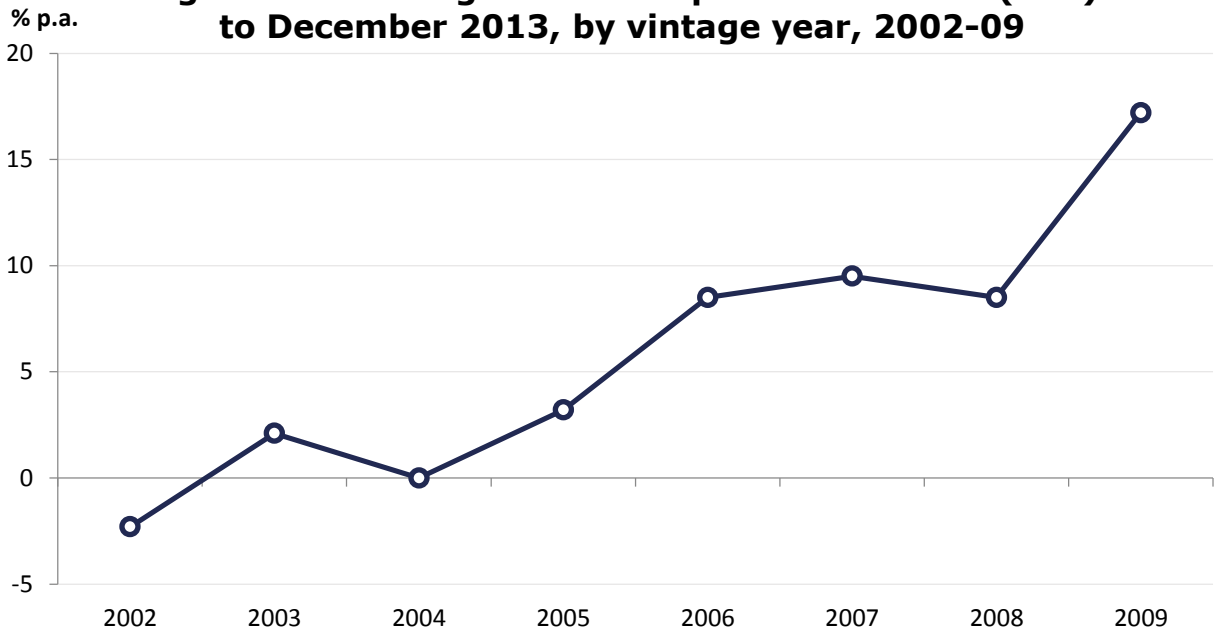
Source: adapted from BVCA Performance Measurement Survey 2013

[51] BVCA (2014) "Performance Measurement Survey 2013", available at: http://www.bvca.co.uk/Portals/0/library/documents/Performance%20Measurement%20Survey/2013%20Performance%20Measurement%20Survey.pdf

[52] The table shows the average annual rate of return (IRR) for each asset class over a 1-year, 3-year and 10-year time horizon, as viewed from the end of 2013. Longer time horizons are a preferable benchmark for equity investments, as they are long-term investments whose returns are volatile year-on-year.

[53] Private Equity total is a weighted average of Venture Capital, Small MBO, Medium MBO and Large MBO.

Figure 2.3: Average since-inception VC returns (IRR) to December 2013, by vintage year, 2002-09



Source: BVCA

These average return figures nonetheless obscure significant variation between higher- and lower-performing funds. The BVCA publish a breakdown which highlights the range of fund performance. These figures demonstrate that high returns can be made from the best funds, even in an environment where returns overall are subdued[54]: for all venture funds established since 1996, since-inception returns (IRR) at the 10th percentile were 14% per year, and 6.1% at the 25th percentile, compared to an average of 2.4% and median of -3.8%. Funds at the 90th percentile recorded an IRR of -19.1% p.a.

In spite of this, it is arguable that the relatively poor aggregate returns of past funds have coloured the views of potential investors, contributing to a difficult fundraising environment even before the global financial crisis of 2008-09. Looking forward, however, the higher aggregate returns for more recent vintages suggest the prospects are improving for VC, making it more attractive to investors as an asset class.

It is important to make clear that the relatively poor past financial returns of VC are not themselves evidence of a market failure. Similarly, this chapter has already demonstrated the positive spill-overs to investment in innovative firms, such that social returns are healthier than the private returns presented above. From a purely societal perspective, it is only the social returns, which account for spill-over benefits and thus fully capture the economic value of equity investment, that should be of importance to an organisation such as the British Business Bank, and shape the Bank's analysis and market interventions.

However, private returns matter: if investors do not anticipate a satisfactory return their investments, they might reduce or withdraw their funding for VC, which would leave viable

[54] As the BVCA analysis pools together all funds established since 1996, this includes many of the funds which suffered from the aftermath of the Dotcom crash

businesses with growth potential starved of the funding they need to grow. In view of the "pecking order" theory of finance options, this can have a severe impact on those firms seeking equity.

Difficulties in achieving exits have been apparent in recent years – although 2014 appears to have been a stronger year

Developments in exit markets are likely to have been a significant factor behind the lengthening of holding times in recent years. A lack of exit opportunities has a direct effect of forcing early stage equity investors to hold onto portfolio companies longer, whilst the "buyer's market" this creates has a negative impact on the returns investors can expect from a trade sale or IPO.

Evidence of a reduction in exit activity can be found in a 2013 study for the BVCA[55]: the report shows the likelihood of exit via an IPO fell significantly in the previous decade in both Europe and the USA, whilst the time taken to those IPOs which did happen increased. In contrast, the paper did not find a similar reduction in trade sale activity across the two areas, which means the overall reduction in exit activity could be fully explained by a lack of IPOs.

The report also, however, shows that Europe lagged the USA in successful exits, due to a lower probability of trade sales in Europe[56]. Thus, from a European perspective, the exit market has been characterised by both an absolute weakness in falling IPO activity and a relative weakness in a lack of trade sales compared to the USA.

The BVCA study goes on to explain the main determinants of a successful exit as being the experience of entrepreneurs and venture capitalists. The fact that the USA has more experienced VC fund managers, and that serial entrepreneurs account for more than twice as many deals as in Europe, explains the stronger performance of the USA. But as European VCs (many of which are based in Britain) become more experienced, the performance gap might be expected to narrow in future.

A study for the City of London Corporation and TheCityUK[57] offers a deeper investigation of the reasons for the previously-falling IPO activity overall. Market conditions could be described as a running theme through most of the explanations, whether in the guise of: a change in sentiment towards small business offerings in a weak macroeconomic climate; a lack of companies achieving rapid growth in a recessionary environment; or a lack of venture capital available to grow businesses to IPO, due to difficulties in raising funds (see below).

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[55] BVCA (2013) "European Venture Capital: Myths and Facts", available at: http://www.bvca.co.uk/Portals/0/library/Files/News/2013/European_MandF_Report_21Jan13.pdf

[56] The likelihood of an IPO exit is roughly the same in the two areas

[57] City of London (2011) "Trends in IPO Listings by SMEs in the EU", available at: http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2011/Trends%20in%20IPO%20Listings%20by%20SME%27s%20in%20the%20EU.pdf

The latter point raises the possibility of a negative feedback loop being at play, whereby a lack of exit opportunities affects returns and the ability to raise new VC funds, which in turn affects the availability of finance to fund a company through to an exit.

However, more recent data from Dow Jones VentureSource[58] provides some cause for optimism. It shows liquidity has improved in the European VC market during 2014, driven mainly by an increase in IPOs: there were 55 IPOs in Europe in 2014, compared to just 18 in 2013, which suggests there is some making up for the lack of listings in recent years. Trade sales saw a relatively more modest, though still significant, increase (from 152 deals in 2013 to 181 in 2014). There is hope, therefore, that the weaknesses in exit markets which have likely affected returns and deal-making in recent years might become less of a problem in future.

Trends in VC fundraising show a "later stage" gap

Recent trends in venture capital fundraising can be found in statistics published by the European Venture Capital Association (EVCA). These show a rather nuanced picture, and demonstrate the importance of stage[59]. Early stage fundraising – for funds making seed and some venture investments – collapsed in 2008 and remained depressed to 2011, before bouncing back strongly in 2012 and 2013. This recovery was supported in large part by British Business Bank and other Government schemes; changes to the tax-advantaged venture capital schemes in 2012 – the introduction of SEIS, the expansion of the EIS and VCT investment limits from £2m to £5m, and the increase in EIS and VCT limits on gross assets and employees pre-investment to £15m and 250, respectively – are likely to have had a positive impact on the early stage fundraising climate[60].

In contrast, later stage VC fundraising did not see any kind of recovery in 2012 and 2013, having been largely unaffected by the "seed boom" at the early fundraising stage. Similarly, balanced funds (which invest at both early and later stages) have not seen the sort of increase observed at the early stage, meaning that the fundraising boom has been concentrated in specialist funds rather than more generalist VC funds.

Growth-stage fundraising is more volatile; a smaller number of larger funds makes for bigger variations between successful and unsuccessful or inactive years. But it is clear that over the full period the magnitude of funds raised for the growth stage comfortably outstrips that for other stages.

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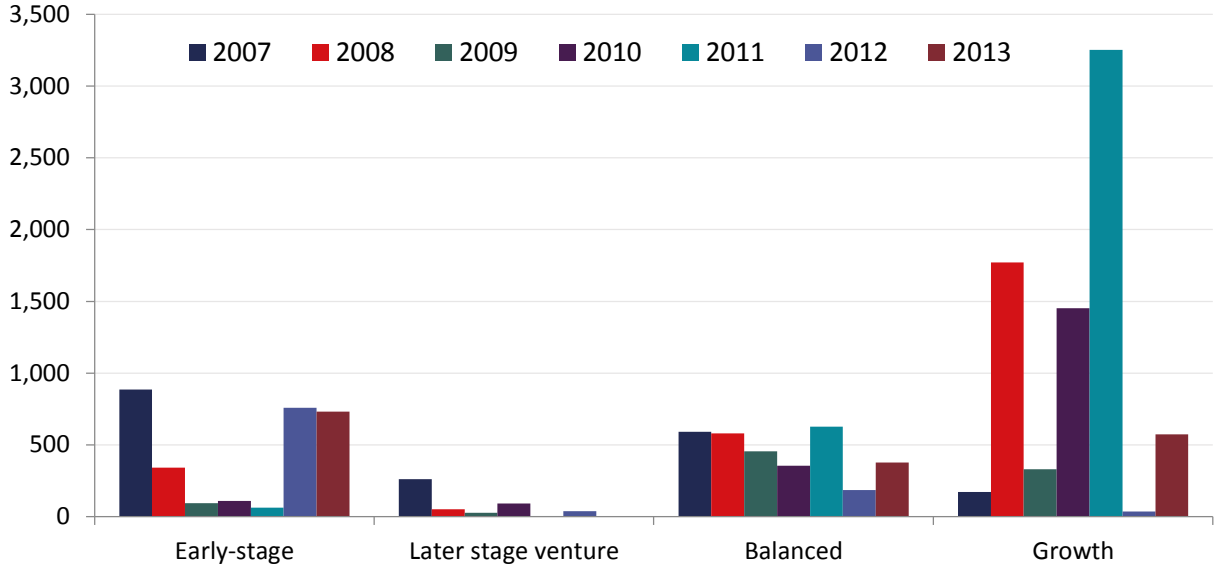
[58] Dow Jones (2014) "Venture Capital Report" available at http://images.dowjones.com/company/wp-content/uploads/sites/15/2015/01/VS_Report_Europe_4Q14.pdf

[59] It is important to note that fundraising stages are different to investment stages (which are described in detail in Box 1). EVCA defines "Early stage" in this case as "funds focused on investing in companies in the early stages of their lives" – in other words, covering seed as well as some early stage venture investment. "Later stage venture" fundraising covers more of the venture stage, whilst "balanced" funds do not focus specifically on either early or later stages. "Growth" fundraising is more self-explanatory and similar to the growth investment stage. In each case, the classification is based on self-reporting by fund managers.

[60] It has been difficult to fully ascertain the extent of the impact from these changes to the tax-advantaged venture capital schemes, due to the difficulties in creating a robust counterfactual. However, an evaluation was undertaken in late summer 2014, with the published report due in the coming months.

Figure 2.4: Fundraising by stage, EUR million



Source: EVCA

The increase in "early-stage" fundraising fits with growing business angel activity at the seed stage, fuelled by increasing syndication, the introduction of SEIS and the expansion of EIS and VCT, with market participants reporting VC funds and angels increasingly investing alongside each other and also getting involved in crowdfunding deals (see Box 2). The later stage remains short of capital, beyond the reach of the thriving angel networks and under-served by VC funds, which seem to have been diverted to either early stage (where the British Business Bank is an active investor) or growth and buyout/generalist private equity funds, where deal sizes are larger and businesses are less risky. This is consistent with the notion of an equity gap that now reaches into the later stage venture space. However, it should be borne in mind that the self-reporting of classification by fund managers adds a degree of subjectivity to the investment stage definitions.

The extent of the unaddressed gap at later stage VC is perhaps shaped by existing public interventions in the market: EIS and SEIS mainly support seed and early stage investments[61], whilst the previous ECF investment limit of £2m until recently restricted the programme below the later stage. UKIIF is able to invest in this space indirectly through its underlying funds, many of which can still make investments, and the VC Catalyst Fund is in the early stages of dispersing its funding, which will also be available for later stage investments.

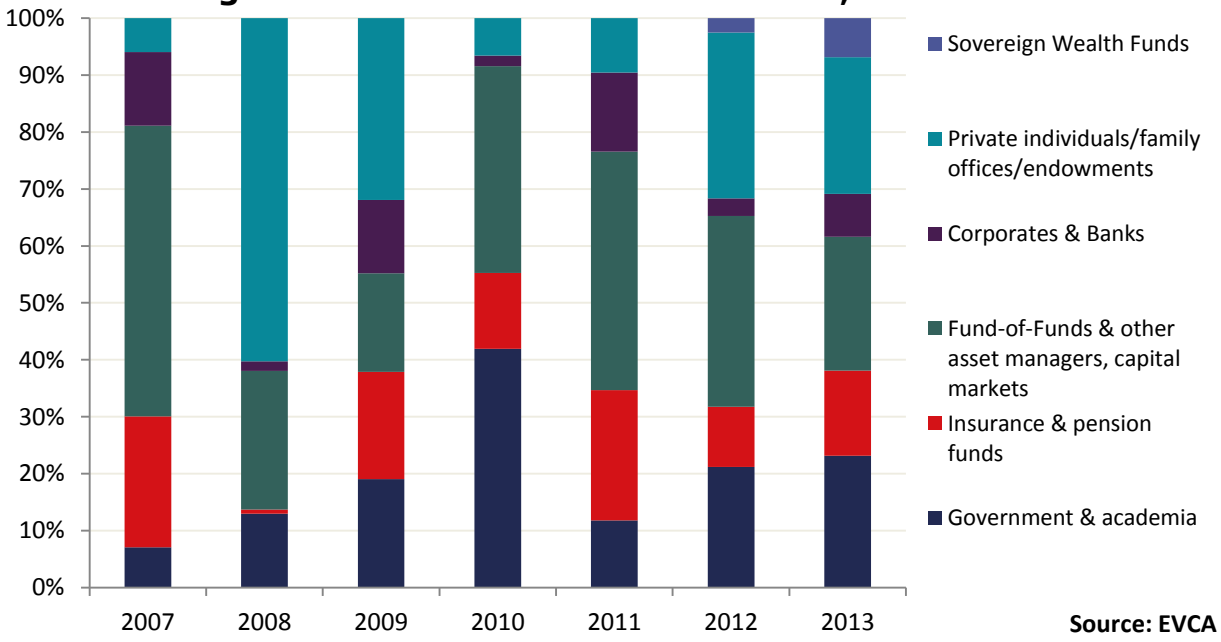
VCTs have been able to invest up to £5m since 2012, and have made a contribution to funding businesses at the later stages. The extent of VCTs' impact on the overall market is explored in a new evaluation of the tax-advantaged VC schemes, due to be published in the coming months.

[61] Although the EIS investment limit is now £5m, most angel deals will be smaller than that as they are limited by the financial capacity of the participating investors, who can invest up to £1m each. The EIS scheme does explicitly allow some fund structures, where investors can syndicate to increase round sizes and invest via nominees, but these 'approved funds' have not been widely used. Nevertheless, so-called 'unapproved' fund structures are used by investors, and constitute a sizeable proportion of EIS investments.

All this speaks to a need for a renewed focus on the British Business Bank and Government to address the later stage equity gap, which is why the ECF programme has been re-launched with State Aid approval for larger funds and the ability to participate in bigger funding rounds.

However, a look at fundraising in the VC industry suggests there should be careful consideration given to the role of Government as a source of capital. Figure 2.5 provides a breakdown of investors in VC funds, which shows that, since 2007, the contribution of what can be broadly defined as institutional investment (insurers, pension funds, fund-of funds, other private equity sources and capital markets) has declined significantly, whilst that of Government has increased. Sovereign Wealth Funds and private individuals/family offices have also taken up some of the slack from institutions.

Figure 2.5: Investors in UK VC funds, 2007-13



Source: EVCA

Two important questions arise from this analysis:

1. What is the appropriate level of Government involvement in VC?

In the short to medium term, our view is that there is an evolving role for Government, particularly in the later stage VC market, where the trends that have increased the public share mean there is still a need for further investment to fill market gaps[62]. The British Business Bank and Government must not crowd out private sector investment; based on recent trends, we do not believe this is currently an issue, but it is important to remain vigilant as and when private markets regain momentum.

In the long term, the aim of the British Business Bank, and of Government more generally, is to create a self-sustaining early-stage equity market, with less need for widespread

[62] It is worth noting that the VC market overall has been shrinking as the Government share has been rising, meaning the cause is a withdrawal of institutional funding more than public schemes.

Government support. This goal is reflected in the interventions of the Bank, which aim to build capacity amongst providers and encourage private investment:

- ECFs are often a manager's first fund, and so provide new managers with valuable experience and the opportunity to establish themselves in the market. Those managers who succeed with their ECF may continue to make investments in smaller firms by raising fully private funds after their ECF mandate expires. ECFs are also intended to demonstrate that positive returns can be made from early stage VC, particularly after the Dotcom and global financial crises, such that more private investors will be attracted to the asset class.

- A key objective of the Angel CoFund is to encourage the development and "professionalisation" of angel investment. The way in which the fund operates, setting a high standard for due diligence and subjecting all deals to close scrutiny from an independent Investment Committee, is intended to instil rigorous investment principles in business angels that they might apply to other, purely private, investments[63]. At the same time the CoFund team provide support and advice to applicants, to encourage especially newer angels looking to enter the market.

The British Business Bank's equity programmes are long-term initiatives to develop a market that can better function without as much support. It will take time to ascertain the effectiveness of these initiatives, but as and when results are available they should be used to review the scale and form of intervention required going forward. Of crucial importance is a programme of robust evaluation, to provide the best possible evidence on which to base such decisions.

2. What, if any, action should be taken to reverse the downward trend in institutional investment?

UK and overseas institutional investors, such as insurers and pension funds, collectively have trillions of pounds worth of assets under management[64]. Increasing their allocation to venture capital by just a small fraction could substantially increase the amount of funding available to smaller firms with growth potential.

For institutional investors, venture capital sits alongside other 'alternative assets' in pension funds' portfolios such as hedge funds, private equity and gold. While UK pension funds' asset allocation to alternative assets has historically been relatively low, this has changed dramatically recently. In 2000, pension funds invested 1% of their total portfolios in alternative assets; by 2011, this had risen to 9%[65]. There has also been an increase in asset allocation to unquoted equities (i.e. private equity, venture capital and unlisted equity

[63] In a similar vein to ECFs, there is an important "demonstrator" element to the CoFund: if the investments are successful it can show how applying more rigour to investment decisions can benefit the investor.

[64] http://www.investmentfunds.org.uk/

[65] UBS Pension Fund Indicators 2012, available via Financial Library: http://www.financiallibrary.co.uk/abstract/pension-fund-indicators-2012-13917

investment vehicles), from 0.9% of defined benefit schemes in 2009 to 3.1% in 2013[66]. Yet the increased focus on alternative assets has not been reflected in VC funding.

The recent lack of institutional investment in VC is perhaps unsurprising, given the relatively poor aggregate returns the asset class as a whole has generated over a 10-year period – particularly relative to other forms of private equity. The headline benchmarks necessarily measure returns over a long time period, and do not account for the dispersion of performance by different funds, so are not entirely reflective of recent activity or the potential returns from high-performing managers. Nevertheless they are important metrics for would-be investors; therefore, relatively weak past returns can have a lasting impact on current fundraising for VC funds, even if the future prospects are looking brighter[67].

Aside from the issue of returns, a 2011 BIS paper[68] identified the small size of UK funds and a lack of knowledge of how to identify strong funds to invest in as barriers to institutional investment in UK venture capital.

However, as returns improve, there is an opportunity for institutional investors to look again at venture capital. How and whether to encourage this process is a question that might be considered by Government and the British Business Bank, in conjunction with market participants. One enabling factor would be to demonstrate and publicise successes, as well as funds' performance more generally, to improve perceptions of VC and better inform potential investors.

2.3 Angel investment

Most of the preceding discussion has been focused on venture capital, as the equity gap is generally thought of as being at the venture stage: the gap is widely thought to have a lower bound above zero because of the presence of business angels to serve the market at the smaller end. But angels face their own set of issues.

To begin with, the standard logic of the equity gap doesn't so much apply to business angels, as they tend to operate with a lighter touch in terms of due diligence than VC funds[69], and are more constrained in investment sizes by their own financial resources[70]. As a result, angels are a mainstay of the seed and early stages, largely unaffected by the considerations and pressures that lead VC funds to make larger investments.

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[66] Pension Protection Fund (2014) "The Purple Book", available at http://www.pensionprotectionfund.org.uk/Pages/ThePurpleBook.aspx

[67] It is not just about actual returns. Institutions have long memories of bad investment experiences, which will affect perceptions of the returns available, whether or not they match current performance.

[68] BIS (2011) "BIS Equity Finance Schemes: Survey of Fund Investors", available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32226/11-984-bis-equity-finance-schemes-survey-fund-investors.pdf

[69] due to their sector specialisms and/or more detailed knowledge of particular markets/technologies

[70] Also, many angels have a different motivation to VC funds, in that they invest for their own enjoyment as well as to make a return. This lends itself to lighter-touch investing based more on enthusiasm for a business or project, and potentially also less following-on once a business has become established.

The issues are more in awareness of angel investment as a finance source, encouraging both wealthy individuals to invest and small businesses to seek the funding, and ensuring a good "standard" of investment – properly researched, sufficient time allocated to monitoring performance, providing management advice to the business[71]. It is difficult to gauge how this is developing for the market as a whole, as much activity goes unrecorded and both angels and recipient businesses are hard to track. A recent British Business Bank survey[72] found awareness of business angel finance increased between 2012 and 2014, although at 36% of respondents it still lagged behind venture capital, amongst other things. Only 15% of businesses knew how to go about finding angel funding, suggesting more can be done to improve firms' understanding of their options[73].

Recent contact with the market suggests there is a growing level of syndication, with angels working together more formally on more and bigger deals. As the angel market grows and matures, a greater degree of such "professionalisation" of investment, of the sort the Angel CoFund encourages, is desirable.

Of course, no discussion of angel investment is complete without mentioning tax reliefs. EIS and SEIS are a major part of the angel space, providing incentives to individual investors to mitigate the risk of investing in higher-risk small and growing businesses. Along with the Angel CoFund, the tax-advantaged venture capital schemes enable larger angel investment sizes – which stretches the reach of angels and allows them to make investments in traditional "equity gap" territory. This is, undoubtedly, a large degree of Government involvement, but one which is justified in encouraging investment into viable, risky, high-potential SMEs that might otherwise not receive the funding they need, and in building a market for, and culture of, angel investment that might mean less intervention is needed in future.

[71] This latter point is a core aim of the Angel CoFund, which aims to drive up standards of business angels by providing co-investment from the British Business Bank – but only if a deal clears an independent Investment Committee.

[72] British Business Bank (2014) "SME Journey Towards Raising Finance 2014 Survey" (BMG Research), available at http://british-business-bank.co.uk/wp-content/uploads/2014/12/Final-BMG-SME-Journey-Research-Report.pdf

[73] Although given the niche nature of early stage equity, it can be argued only a subset of the business population need know about angel investment. What matters is those firms most suited to angel funding are aware of it; this unfortunately cannot be determined from the SME Journey survey.

Chapter 3: Recent trends in equity finance

Historically, detailed, robust data on equity investment into small businesses has been limited. Most of the datasets available have only offered partial market coverage: generally only covering one type of equity finance, and not capturing all deals of that type[74]. Existing data also do not give a sense of how the different types of funding and investors interact; how and whether firms use different sources as they enter new stages of development for example, or the extent to which investors are active at different stages and through different vehicles.

To address these issues, and provide a "whole of market" view on small firm equity investment, BIS and the British Business Bank commissioned Beauhurst[75] to develop an "equity tracker" that provides detailed breakdowns of investment across the range of investors and funding vehicles, as well as for stage, sector, location, investment size etc. A report presenting the prototype equity tracker has been published alongside this paper; this chapter incorporates some of the high-level findings.

The rest of this section presents an analysis of investment trends, based principally on data from Beauhurst and supplemented by other industry sources. After a brief discussion of trends in total investment at all stages, the analysis will explore the different stages in turn, focusing on seed, venture and growth stage investments.

3.1 High level trends

Total early stage equity investment is increasing

High-level statistics from Beauhurst indicate an increasing amount of visible[76] investment over time. In 2014 Q3, £588m was invested in 232 deals, up from £417m in the same quarter of 2013. The number of recorded deals fell in 2014 Q3 compared with the previous quarter, but this is likely to be a temporary "blip" in an otherwise upward trend.

Although the Beauhurst data is available quarterly, as shown in figure 3.1, when breaking it down into lower-level categories such as stage, sector and region, it is more appropriate to present the data as annual totals to avoid the volatility associated with a smaller number of relatively "lumpy" investments. As such, subsequent charts based on Beauhurst data will cover annual totals for 2011-2013, and the first three quarters of 2014.

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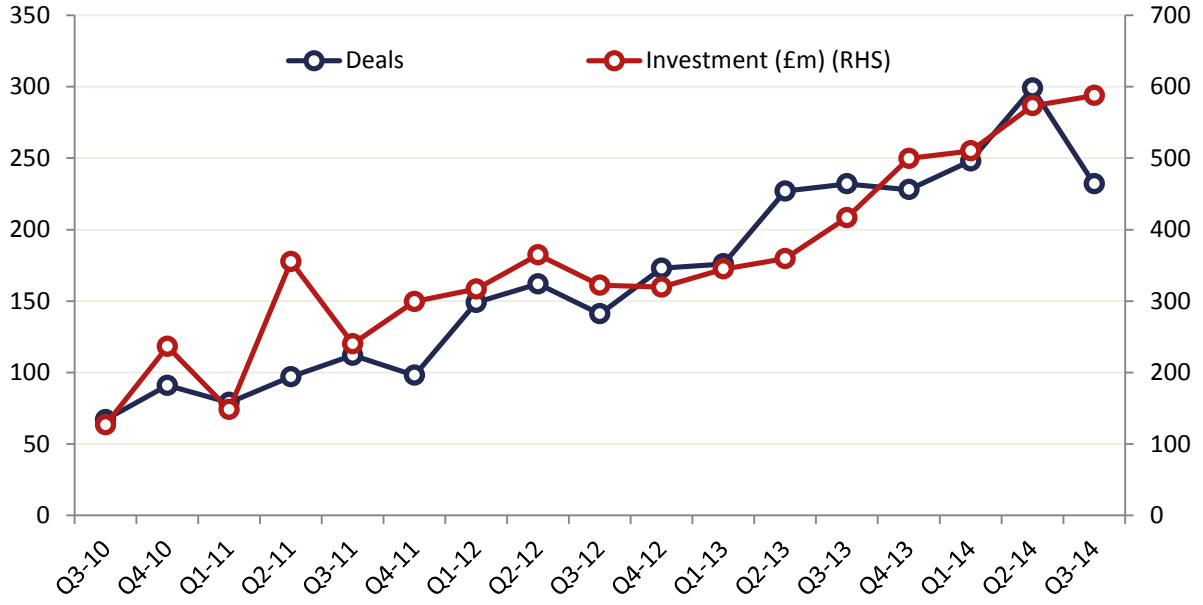
[74] For example, the British and European Venture Capital Associations only cover VC and PE investment by their members, and EIS statistics only those deals that qualify for the tax relief.

[75] Beauhurst is a provider of market data on equity investment. They were contracted to develop the equity tracker following an open tendering process. See http://about.beauhurst.com/ for more information. Further details on the methodology used by Beauhurst in compiling their data can also be found in the equity tracker report, published alongside this document.

[76] The data captures only those deals which have been publicly announced (for example through press releases or articles) and for which an investment date has been specified; so-called "hidden" deals are currently excluded. Beauhurst are working on a solution that might reveal much of the hidden activity, which they believe to be significantly greater than publicly announced deals. Nevertheless, it should be borne in mind the data in this chapter covers only "visible" deals.

Figure 3.1: Equity deals and investment, 2010 Q3 to 2014 Q3



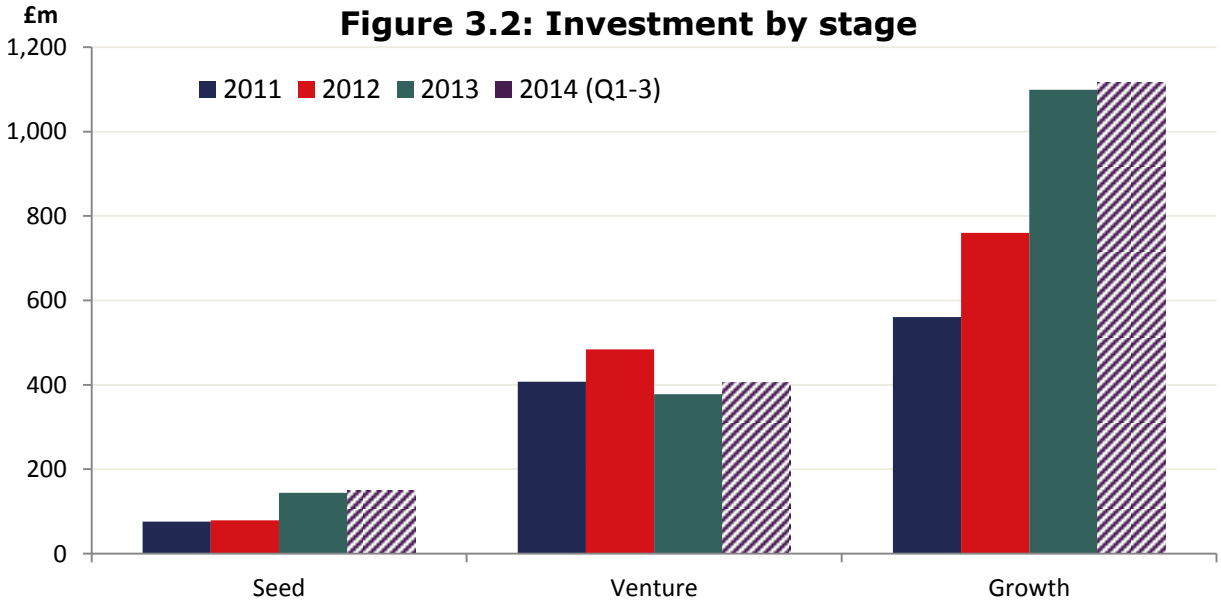
Source: Beauhurst

Venture investment lags seed and growth

Investment at the venture stage bucked the overall trend by falling between 2012 and 2013. Although 2014 is looking like a stronger year, the trend is broadly flat, whereas investment is clearly on an upward trajectory at the seed and growth stages. As the largest component, growth investment drives the overall series.

A brief explanation of how the investment stages are classified is provided in Box 1.

Figure 3.2: Investment by stage



Source: Beauhurst

Box 1: Investment stage classifications

Beauhurst divides the market into three stages: seed, venture and growth. Buyouts and public market deals are not included, as the focus is on early stage, growing companies. The classification of deals by stage is a matter of judgement rather than specific rules: each deal is looked at by a Beauhurst analyst, who reaches a decision with the help of a set of proprietary guidelines. These guidelines consist of a set of around 50 criteria which are believed to provide an indication of the company's stage, such as age, trading status, revenues, development and use of intellectual property.

The relatively simple breakdown by stage used by Beauhurst differs from organisations such as EVCA and BVCA, which tend to distinguish between seed and start-up, and between early and late stage venture[77]. The reasons for using the simpler taxonomy are:

1. In some cases there isn't enough information to decide on a principled basis which of the two seed or venture subgroups a company lies in

2. The simpler taxonomy can be used for all sectors, whereas a more complicated one would be more difficult to apply consistently across sectors.

3. A less detailed breakdown reduces "noise" in the data resulting from smaller numbers of deals being categorised into narrower stages – the small base sizes can lead to large swings in reported investment from one quarter to the next.

The following table summarises the differences between the Beauhurst taxonomy and the more detailed classifications of investment stage used by EVCA and BVCA, and offers some broad descriptors of the types of activity and company supported in each case.

[77] The EVCA and BVCA classifications are also based on self-reporting by fund managers, whereas Beauhurst apply their own judgements based on objective criteria.

Beauhurst classification	EVCA classification	Detailed breakdown (BVCA)	Broad descriptors; finance used for
Seed	Seed	Seed	R&D; initial concept
	Start-up	Start-up	Product development; initial marketing; pre-revenue
Venture	Later stage venture	Early stage	Post-product development; supporting commercial sales; pre-profit
		Late stage venture	Expansion of operating company which may or may not be profitable; already been backed by VCs
Growth	Growth	Growth/Expansion	More developed, profitable companies looking to expand/enter new markets

Source: Beauhurst; EVCA; BVCA

Technology is consistently the leading sector for deals

The technology sector[78] continues to lead the way in terms of deals and investment, followed by business and professional services[79]. Industrials, media, retail and leisure are other sectors with some notable activity.

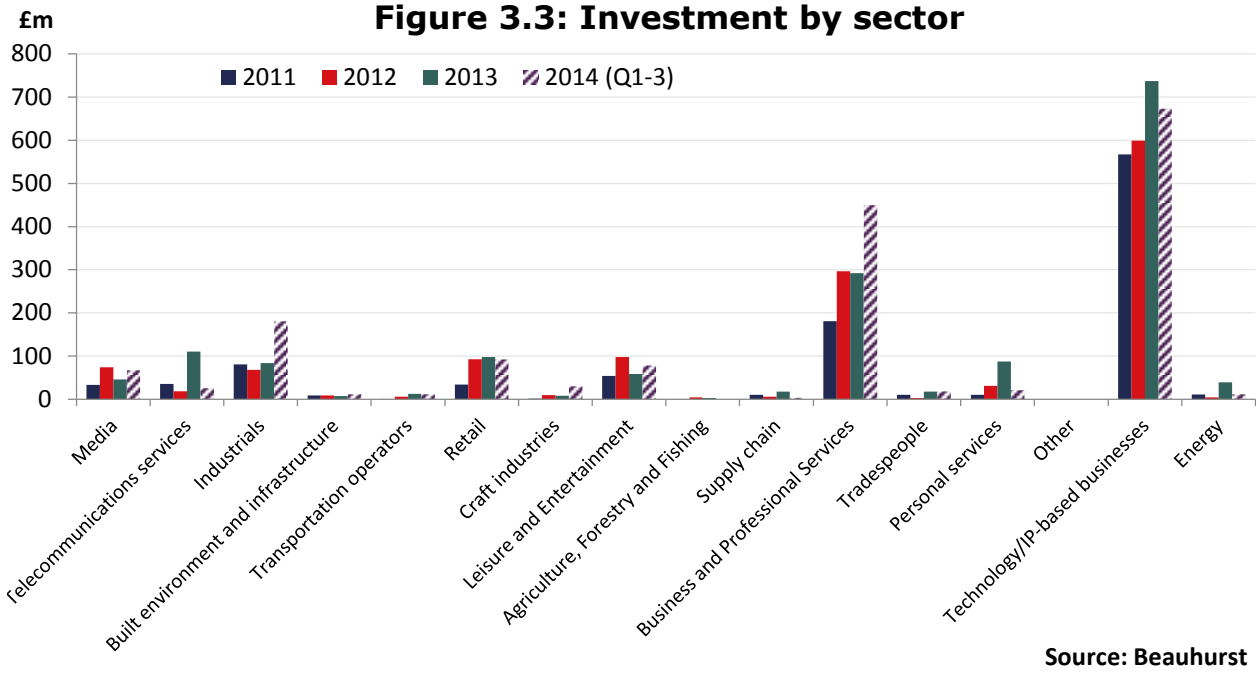
The extent to which investment is concentrated in the technology sector varies by stage of investment. At the seed and venture stages, investment is heavily skewed towards technology; at the venture stage in particular, software-related businesses have seen a significant increase in investment over the past 4 years, whilst investment in firms in other sectors has remained relatively flat. At the growth stage, the business and professional services sector comes close to technology in deal volumes and amounts invested.

[78] Including software, clean tech, life sciences, hardware, materials and medical technology

[79] Including financial, insurance and legal services, IT and estate agency, amongst other activities

The implication might be that the funding escalator is different for business services firms than for tech firms; those in business services could be able to grow further without the need to resort to equity finance (either using internal funds or external debt). The same logic might explain the general predominance of tech firms in deals: in view of the "pecking order" theory of business finance, tech firms may in general find it harder to finance themselves from cash flows or through external debt if they are small, young, pre- or early trading, or lacking collateral, and find themselves relying on equity to a much greater extent than firms in other sectors.

Figure 3.3: Investment by sector



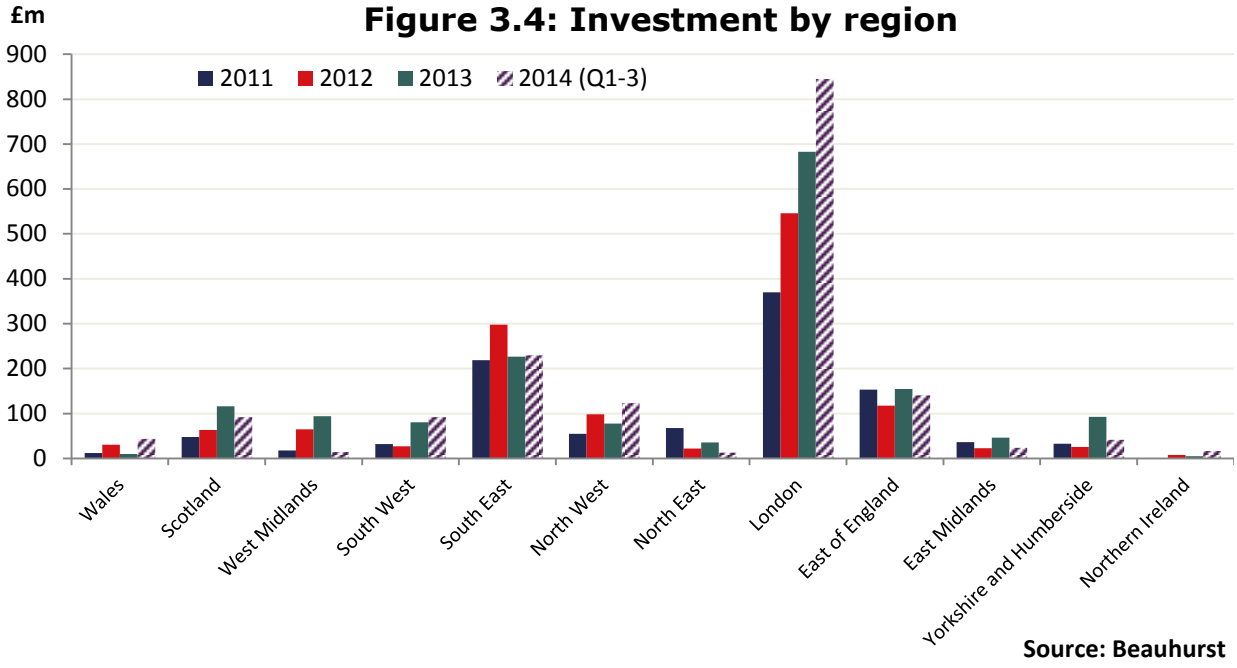
Source: Beauhurst

London continues to receive most investment

By region, the largest share of deals and investment can be found in London, where strong increases are observable year-on-year. The predominance of London is persistent at the seed, venture and growth stages; the capital benefits from being the home of most major equity investors, and many dynamic businesses with growth potential and ambitious entrepreneurs – in other words, both supply and demand are relatively strong. Though the other UK regions and countries lag significantly, most saw a pick-up in activity between 2011 and 2013, suggesting recent increases in equity investment are not just limited to London or Southern England.

The British Business Bank and Government nonetheless recognise the significant disparity that exists in equity investment across the regions and countries of the UK. The Bank is currently working closely with Local Enterprise Partnerships to bring forward new funds, backed by ERDF funding, to succeed the previous cohort which received investment between 2007 and 2014.

Figure 3.4: Investment by region



Source: Beauhurst

3.2 Seed-stage

The seed stage encompasses investment by some early-stage VC funds as well as business angels, plus most investment made through crowdfunding platforms. The equity tracker dataset captures investment from these different funders and presents it as a unified estimate of activity at the seed stage.

The Beauhurst dataset includes the whole of the visible angel market – both deals by angel networks and by individual angels. There is, however, a perennial problem of "hidden" deals when trying to measure angel activity; deals that are not publicly announced are extremely difficult to track. This issue is not a new one: the concept of "invisible" as well as "visible" angel investment was first noted in a report for BIS back in 2010[80]. Beauhurst is currently working on a solution to capture hidden business angel activity.

For this report, we use the data on visible investments by angel networks, and draw upon statistics for investment through EIS to give an additional proxy of business angel activity.

The seed stage can stretch to large deal sizes

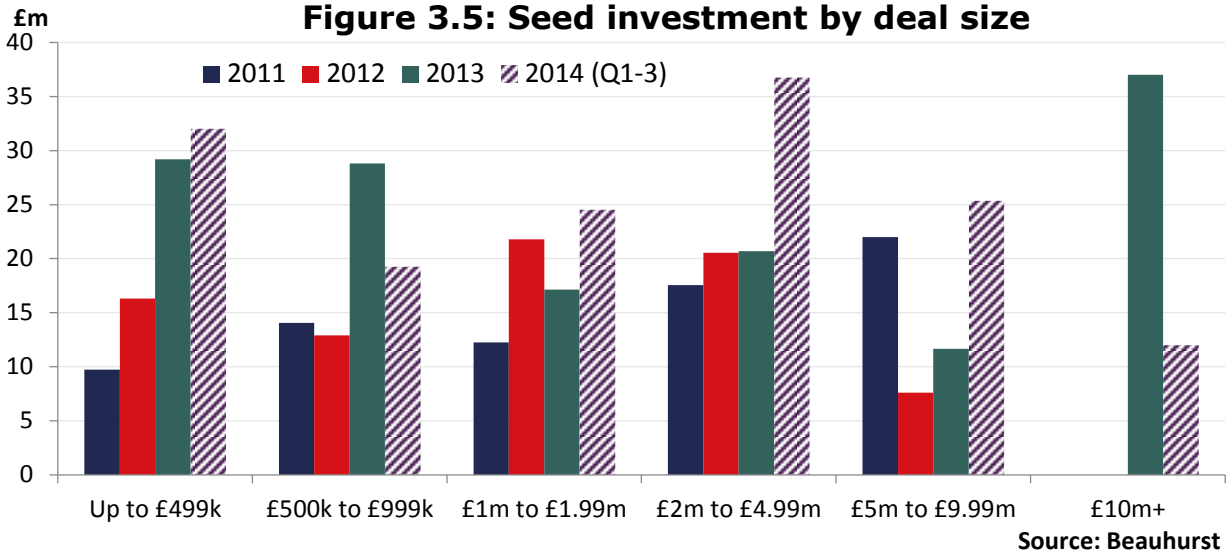
Most visible seed deals are unsurprisingly below £500k. But even at the seed stage there are a few deals for larger amounts (even for £10m+)[81]. These are significant in value terms,

[80] Mason C & Harrison R (2009) "Annual Report on the Business Angel Market in the United Kingdom: 2008/09"; available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32214/10-994-annual-report-business-angel-market-2008-2009.pdf

[81] This is most likely due to the differing capital intensity between sectors: a large investment might be needed to develop an early-stage product/company in an industry such as pharmaceuticals, whereas early-stage capital requirements are likely to be much lower for a software firm

although over time the biggest increases in investment are at the smaller deal sizes. This is possibly related to recent changes to EIS and SEIS, which might encourage smaller-scale seed investments. The increase in the £2m-£5m bracket may similarly be related to the extension of EIS to cover investments of up to £5m (from a previous limit of £2m) in 2012.

Figure 3.5: Seed investment by deal size



Source: Beauhurst

Private equity funds are the largest investors at the seed stage

Breaking down the investor types, it is apparent there is a range of different investors at the seed stage, most of which have been involved in an increasing number of deals year-on-year. Private equity[82] funds were involved in the largest number of deals for the greatest value[83] in 2013, while the importance of direct Government investment[84] to many seed deals is clear.

This analysis nonetheless understates the importance of Government to the market: the data captures only the entity which invests in the company (the General Partner in the case of a fund structure), without reference to the investors providing the capital (the Limited Partners). As much of the support is delivered through funds (in the case of British Business Bank programmes and VCTs) or through individual investors (EIS and SEIS), these groups will be over-represented compared to Government[85]. Despite the Government category including only direct investment programmes, it still appears as a significant market player.

[82] Beauhurst classifies as "private equity" any independent investment fund. In other words, VC funds are classed as private equity by this definition; at the seed stage (as well as venture) most of the recorded investment is likely to come from VC funds rather than pure private equity, as the deal sizes are generally too small for the latter.

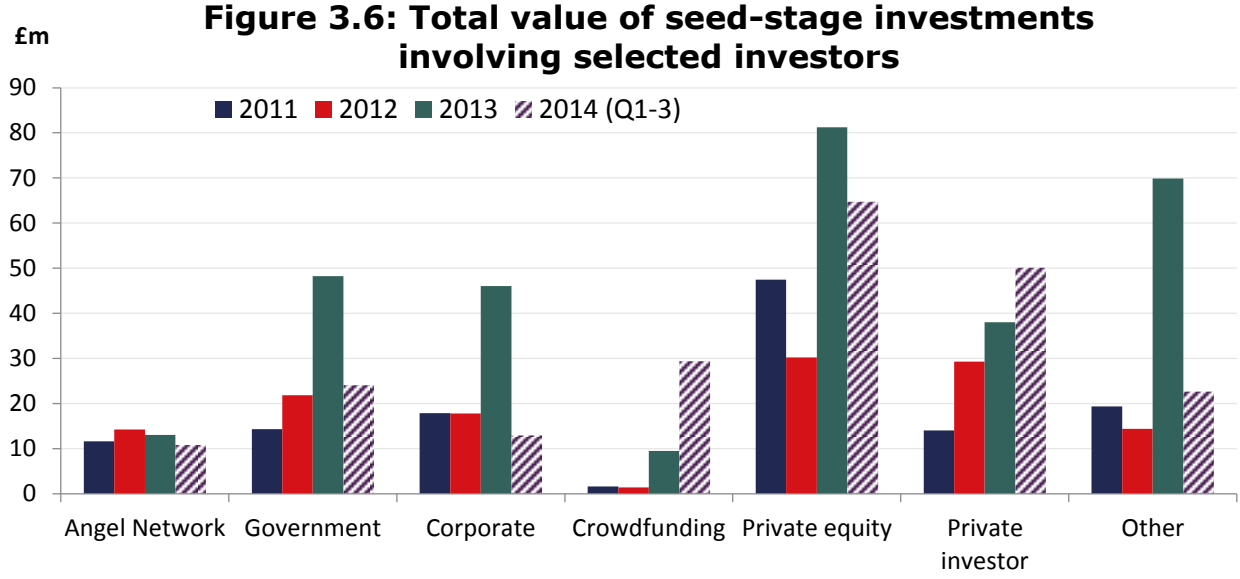
[83] Note that this is the total round size in which an investor participated, not their individual contribution

[84] This includes direct funding from central and local Government and devolved administrations

[85] In practice, this means that most of the "Government" category is made up of funds operated by local and devolved Government, which are more direct in their approach to investing in the market. In contrast, activities of the British Business Bank would be counted in the investor category of the partner delivering the scheme, not central Government. For example, the ECF programme is classed as private equity, as it is private funds which make the investments.

The rapid growth of equity crowd funding is also apparent; there is some way to go in terms of investment amounts, but crowd funded investment values are getting close to those of angel networks[86]. By the third quarter of 2014, deal numbers had exceeded those of private equity to make crowdfunding the biggest investor by volume of deals.

Figure 3.6: Total value of seed-stage investments involving selected investors



Source: Beauhurst

Box 2: Equity crowdfunding

As well as developing the equity tracker, the British Business Bank commissioned Beauhurst to produce a case study that focused on equity crowdfunding, to get a more detailed picture of activity and investment in this particular asset class, which has lately been generating much discussion and excitement. The report will be published shortly.

The key messages of the equity crowdfunding report are:

- Although it remains a small proportion of overall investment, equity crowdfunding has grown rapidly in recent years – from less than £2m in 2011 to £24m in the first half of 2014 alone.
- Unsurprisingly, crowdfunding is particularly significant at the seed stage: almost one-third of seed deals were crowdfunded in the first half of 2014. That these deals are generally small is likely due to retail investors' lesser financial resources and preference for smaller commitments. This is further supported by SEIS, which provides more generous tax incentives for investment into companies raising less than £150,000.
- The rise of crowdfunding poses a challenge to angel networks. Business angels are

[86] Noting that this is only a subset of overall angel investment

making use of crowdfunding platforms to tap a wider pool of potential partners, both sophisticated and retail investors. The increased use of crowdfunding platforms relative to angel networks appears to vary by location: in Scotland, where angel networks are well-established, the platforms have made little inroads; in the South West, the home of CrowdCube, crowdfunding has had a much greater impact.

- The sectors receiving most investment show a strong B2C focus: mobile apps, consumer electronics, food and drink, leisure and entertainment, social media, online gaming and e-commerce were some of the leaders in terms of deals. This is to be expected, as retail investors tend to back projects they understand and are enthusiastic about. Crowdfunding allows a company to tap into the enthusiasm of their existing customer base, and reach new customers through their listing on a platform.

The report represents a useful addition to the growing literature on equity crowdfunding[87].

Focus on angels

As previously discussed, the missing part of the equity tracker data is invisible business angel investment. In this section we present some trends in angel investment using an alternative approach, based principally on EIS statistics[88].

Angels are a diffuse group who are generally hard to observe. Many make only one or two investments in a year and do not wish to make themselves apparent to market observers. There are a few angel networks in operation that do publicise their investments, but overall the invisible activity is thought to comfortably exceed visible investment[89]. A reasonable amount of survey data has been collected in recent years on the demographics, experience and attitudes for subsets of the angel population[90], but EIS statistics are the main source of regular information on investment.

[87] See for example Nesta (2014) "Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014", available at: http://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf

[88] Because of lags in the data (2012-13 is the most recent year available), only one year of SEIS claims data has been published. SEIS statistics for 2012-13 are used to complement the analysis, but the main focus is EIS as the larger source of investment, and because a time series of EIS investment is available.

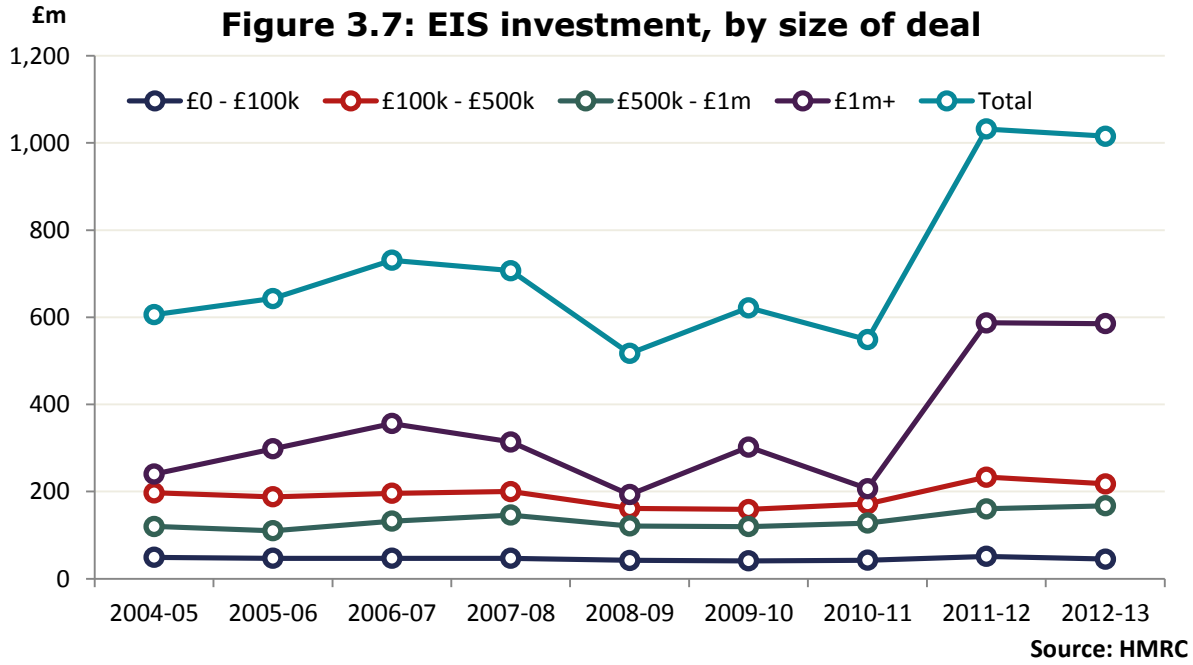
[89] One of the earliest indications of this can be found in Mason C & Harrison R, "Annual Report on the Business Angel Market in the United Kingdom: 2008/09"; available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/32214/10-994-annual-report-business-angel-market-2008-2009.pdf

[90] See for example Nesta (2009) "Siding with the Angels"; available at: http://www.nesta.org.uk/publications/siding-angels

The EIS (as well as SEIS) data only offer a limited insight into angel activity: not all angel investments involve claiming tax relief[91], and not all EIS investment is made by angel investors[92]. The statistics are only available annually, and are significantly lagged (the most recent data available is for the 2012-13 tax year). Nonetheless, they provide some indication of trends in angel activity.

Figure 3.7 shows EIS investment between 2004-05 and 2012-13. Total investment increased up until 2006-07, after which point there were 4 generally weaker years (particularly at the height of the crisis in 2008-09). Investment increased sharply in 2011-12 to more than £1bn, and remained at a similar level in 2012-13; if the £84m of SEIS investment is included the total funding can be seen to have increased further.

Figure 3.7: EIS investment, by size of deal



Source: HMRC

What is notable from figure 3.7 is the extent to which total investment is driven by the very largest deals. Throughout the series it is the £1m+ investment sizes that determine the growth of the overall series; these account for around 10% of deals but more than 50% of investment[93]. Below this there is a relatively long tail of smaller deals: more than 40% are below £100k, but between them they account for less than 10% by value.

The SEIS data for 2012-13 show a further 1,120 companies receiving investment totalling £84m. Although investment is skewed towards the largest eligible deals – more than half of

[91] For example, investments that are not made using ordinary shares. An estimate from Nesta in "Siding with the Angels" put the proportion of angel investments involving EIS (before the introduction of SEIS) at 57%.

[92] Whilst angel investors make up a large proportion of EIS investors, EIS is not solely limited to angels and instead incentivises any private individual to invest in small and growing companies

[93] Although the share of £1m+ deals is only above 50% in 2011-12 and 2012-13. This suggests that the increase in income tax relief from 20% to 30%, the increase in investment limits in 2012 and renewable energy investments (see below) might account for the larger investment sizes observed.

funds were provided in deals of between £100,000 and £150,000 – adding in SEIS serves to reduce the extent of the bias towards bigger deals observable in the EIS data, albeit only slightly (deals of more than £1m still account for more than 50% of combined EIS and SEIS investment).

The surge in EIS claims between 2010-11 and 2011-12 is probably due to an increase in the income tax relief from 20% to 30% in 2011, but it also reflects investment in renewable energy schemes that benefitted from DECC support[94]. However, investment in "Energy and Water Supply", which includes renewable energy schemes, only constituted 20% of all EIS investment in 2012-13, and accounted for a minority of the overall increase since 2010-11. Changes to the qualifying company rules for SEIS, EIS and VCT have been made over recent years to ensure that EIS, SEIS and VCT are well-targeted at encouraging investment into higher-risk small businesses with growth potential[95].

EIS statistics point to significant regional variations in angel investment. Approximately two-thirds of investment in 2012-13[96] went to companies registered in London or the South East[97]. The regional shares of SEIS investment are similar, with London and the South East taking 44% and 18% of funding respectively.

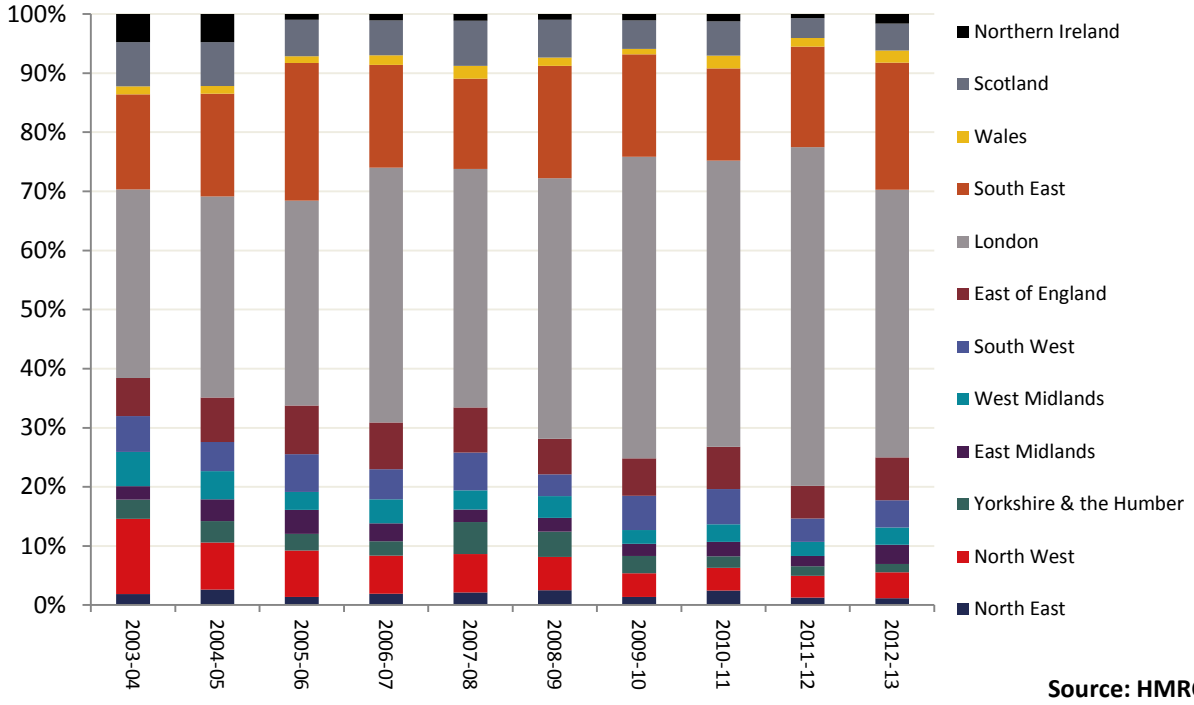
[94] Principally Feed-in Tariffs (FiTs), Renewable Obligation Certificates (ROCs) and the Renewable Heat Incentive (RHI)

[95] The Government excluded most companies benefiting from FiTs in 2012 from the venture capital schemes, with exceptions for anaerobic digestion, hydroelectric generation and community energy generation. This was followed at Budget 2014, when the FiTs exclusions were mirrored for companies benefiting from ROCs and the RHI. At Autumn Statement 2014, the Government announced that all commercial renewable energy generation benefiting from DECC support would be excluded from the venture capital schemes.

[96] Regional EIS statistics should be interpreted with some caution, as the recorded location is the head office of the business, which may or may not be where the investment is directed or used. This "reporting unit" issue will skew the data towards London and the South East somewhat, although the extent of bias is limited by the small size of firms receiving investment – most will not have multiple office locations.

[97] This is partly due to London having more firms than elsewhere; adjusting for regional business stock narrows the gap somewhat, but still shows London and the South East taking a disproportionate share of investment

Figure 3.8: Regional shares of EIS Investment



Source: HMRC

A key question is whether these variations are a supply or demand side issue; whether these investment patterns reflect the location of wealthy investors (who invest relatively near to where they live), or whether they are where the type of risky, ambitious, potential high-growth businesses suited to angel investment tend to cluster.

We do not have a definitive answer to this question. Nevertheless, figure 3.9 takes one approach. It plots the proportion of high net worth individuals[98] by region alongside EIS investment and the incidence of high growth firms (used as a proxy for the incidence of investment-ready firms[99]). Data is for 2009 in the case of EIS and high net worth individuals, and 2010 for high growth firms[100]. Simply put, we might expect the proportion of EIS investment by region to look similar to the location of high-net worth individuals if supply reasons are more important, and to look more like the incidence of high growth companies if demand side reasons are more significant.

As it turns out, EIS investment appears to track the incidence of high net worth individuals more closely than high growth firms. This might point to supply-side constraints on angel investment, although it is not conclusive. The analysis is mainly driven by London, where there

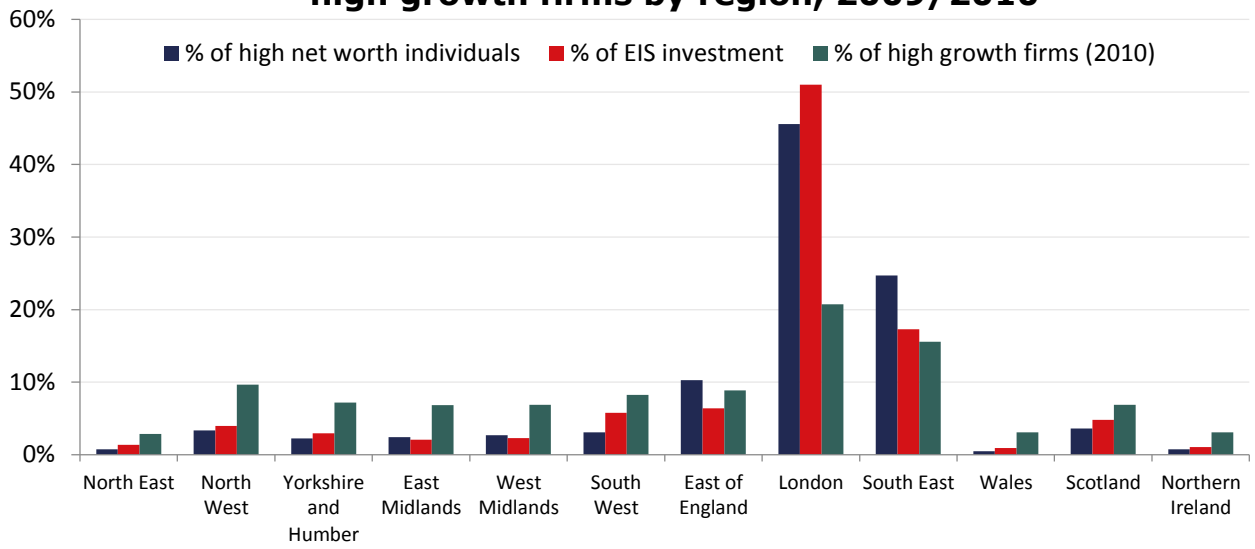
[98] High net worth data comes originally from Datamonitor but is sourced via Beaverstock J, Hall S and Wainwright T (2010), "Scoping the Private Wealth Management of the High Net Worth and Mass Affluent Markets in the United Kingdom's Financial Services Industry"; available at: http://www.nottingham.ac.uk/business/businesscentres/crbfs/documents/researchreports/paper71.pdf

[99] This is clearly an imperfect proxy, as firms that have achieved high growth – defined as 3+ years of 20%+ growth in turnover/employees – are likely to be beyond the stage where angel investment is required. Nonetheless it can provide some general indication of the dynamism of small firms in a region, and the extent of investment readiness.

[100] Due to the study that produced the high net worth figures being from 2009, and the high growth firms series beginning in 2010.

is a very high concentration of wealth and investment, which impacts upon funding available to other regions (particularly further-away ones) if the bulk of high-net worth individuals who live there do not travel far to make investments. EIS rules[101] allow for angel investors in certain circumstances to become directors of the company they invest in and make their business expertise available to it, which may account for some of the trend. Nevertheless, the issue of regional dispersion of equity investment is one which merits further study.

Figure 3.9: Distribution of wealth, EIS investment and high growth firms by region, 2009/2010



Source: ONS; HMRC; Datamonitor

Aside from the investment data, two new reports, based on surveys of angels, shed some new light on investor characteristics and investment patterns. The first[102] highlights the importance of syndication; 90% of angels surveyed are members of a syndicate, and for many of these membership of a group or network is crucial to their decision to be an angel investor. Investments are mostly for less than £100,000 (88%), and are generally made at "seed", "start-up" or "early stage", which together broadly correspond to the definition of seed investment used by Beauhurst. However, around 10% of recorded investments are made at the "late stage", which is consistent with the Beauhurst data in that angel networks are noticeably active at the venture stage.

The second report[103], produced by the Enterprise Research Centre (ERC) for the Centre for Entrepreneurs and UK Business Angels Association, goes into more detail on investment patterns by sector and region. The regional data addresses the question of whether angels travel to make investments: 58% have made at least one investment outside their home region, and 22% have invested outside the UK. This appears to run contrary to figure 3.9 above, which showed a correlation between wealth and EIS investment, but there are

[101] http://www.hmrc.gov.uk/manuals/vcmmanual/vcm11070.htm

[102] Mason C, and Botelho T (2014) "The 2014 Survey of Business Angel Investing in the UK: A Changing Market Place", available at: http://www.gla.ac.uk/media/media_362647_en.pdf

[103] Enterprise Research Centre (2015) "A Nation of Angels - assessing the impact of angel investing across the UK", available at: http://www.centreforentrepreneurs.org/campaigns/13-nation-of-angels

numerous potential explanations for the difference. For example, the ERC research does not cover what proportion of deals or value are invested inside or outside angels' home region, whilst figure 3.9 is based on the distribution of wealth rather than angels themselves – it may be that wealthy regions draw investment as much as investors, if there is a strong local demand environment[104].

The ERC research also highlights the importance of EIS and SEIS to angel investment: just under 90% of respondents had invested through one of the schemes, whilst almost 80% of investment was channelled through them (55% EIS; 24% SEIS). This is a considerably higher percentage than was estimated by Nesta in 2009[105] – most likely the result of the extension of the investment limit for EIS (as well as VCTs) from £2m to £5m in 2012.

Both reports show angels having significant involvement in equity crowdfunding (see Box 2): the Glasgow study finds 22% of respondents have invested through a crowdfunding platform, whilst the ERC reports 45% of angels investing alongside a platform. The difference between these figures most likely arises from differences in the age and experience profile of respondents: the ERC study interviewed a younger and less experienced cohort (more than half began investing in the past 5 years, whereas the average duration as an investor in the Glasgow study is 10 years), and found that younger angels are more likely to invest alongside crowdfunding platforms.

A less experienced cohort may also explain why, in the ERC study, more than 40% of angels have yet to experience a positive exit. The lack of experience of a significant proportion of angels could be seen as both a positive and a risk – positive in that supply is expanding as new angels join the market, but a risk about what happens if the market weakens, or these new investors do not achieve hoped-for returns.

3.3 Venture-stage

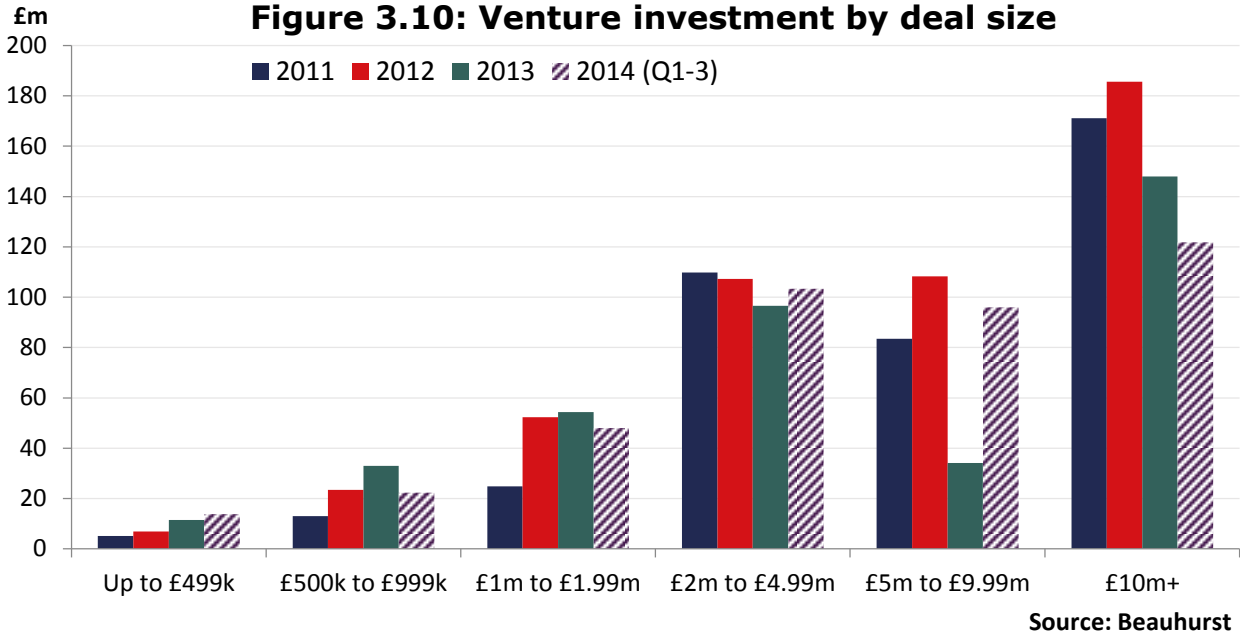
Venture investment is relatively stronger at smaller deal sizes, possibly driven by Government activity

Although venture-stage investment spans a range of deal sizes, value is concentrated at the larger end. Investment has increased year on year for deals below £2m; for deals above £5m, where the small number of deals involved makes the series volatile, it increased in 2012 but fell in 2013. Investment has, however, appeared to be weaker in the £2m-£5m bracket: there were year-on-year declines between 2011 and 2013, and although there has been a pick-up in the first three quarters of 2014, the overall trend in investment compares unfavourably to that observable at smaller deal sizes.

[104] Other potential reasons include sampling issues (the ERC analysis is based on a relatively small survey sample compared to the administrative data sources used in figure 3.9); survey response error; or it could simply be that angel investment has moved on in the years between the EIS comparison (2009) and the ERC survey (2014)

[105] Nesta (2009) "Siding with the Angels"; available at: http://www.nesta.org.uk/publications/siding-angels

Figure 3.10: Venture investment by deal size



Source: Beauhurst

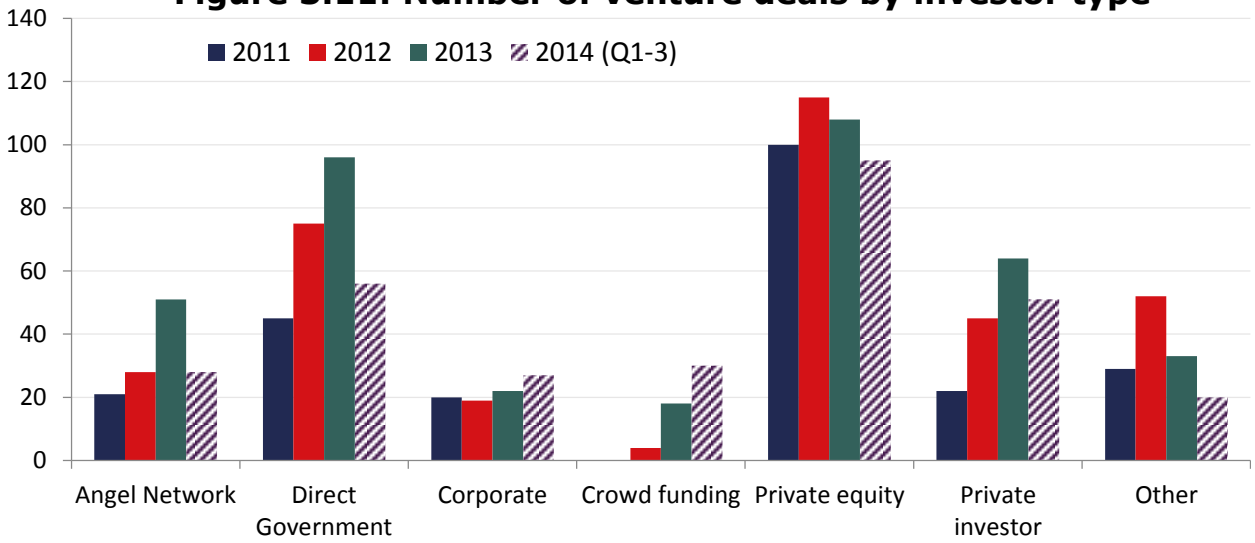
A likely reason for the relative outperformance at deal sizes below £2m is the consistent support provided by the British Business Bank and Government in this space. A look at the number of venture-stage deals by investor type shows the increasing role of Government (even when only considering direct investments[106]), to the point where Government led almost as many deals as traditional private equity in 2013 (although the gap widened again in the first three quarters of 2014).

In terms of investment, private equity decreased in 2013, and there were also declines for corporates and private investors[107]. Direct Government investment held up, though, whilst angel networks and crowdfunding platforms – likely eligible for EIS and SEIS reliefs – increased their investment.

[106] As previously mentioned, this analysis only captures the end-investor, not limited partners, and hence Government will be under-represented to the extent that it provides capital for others to invest (such as through the ECF programme)

[107] Investment has picked up again in 2014 Q1-3, but it is unlikely to fully make up for the decline seen between 2012 and 2013

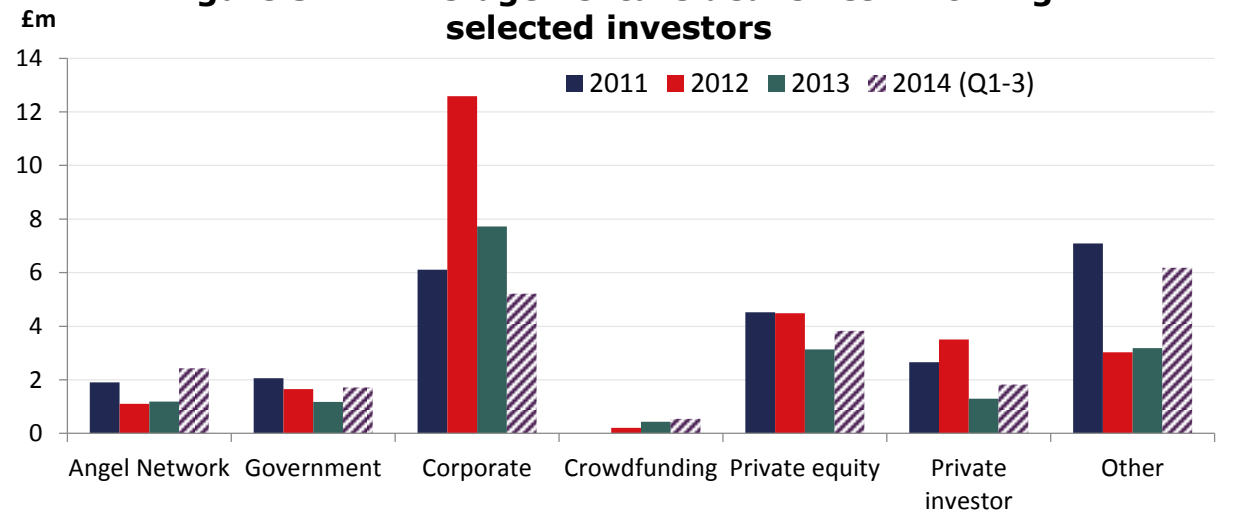
Figure 3.11: Number of venture deals by investor type



Source: Beauhurst

It is notable that those investors who have made a growing number of deals – angel networks, private investors and the crowd, as well as Government – are those that invest at the "lower" end of venture, in terms of investment amounts, whilst investment by private equity and corporates, at the "larger" end of venture, has been relatively stagnant. The average venture deal sizes involving each investor group can be seen in figure 3.12, which shows that private equity (generally VC) funds participate in relatively large deals, whilst corporate investors are involved in even bigger deals (although the average has fallen dramatically since 2012).

Figure 3.12: Average venture deal sizes involving selected investors



Source: Beauhurst

These trends suggest that, consistent with the VC fundraising data presented at figure 2.4, the weakness in venture investment is concentrated particularly at the later stage. Early stage venture may be relatively better-served, thanks to significant British Business Bank and Government support, but with less support available for larger deals, later stage venture is suffering from a lack of private investment. This fits with the view of a widening equity gap, stretching to larger deal sizes as private investors are in retreat.

The widened equity gap has been recognised by the British Business Bank and Government, with the key policies adjusting to reflect the scarcity of funding in the £2m-£5m space. Firstly, in 2012 the investment limits for EIS and VCTs were increased to £5m[108]; then in 2014 the ECF programme extended its own investment limit to £5m, with the first new fund with these rules closing in November 2014. On top of these changes to existing schemes, there was also the introduction of the VC Catalyst Fund in 2013, which supports capital-raising in funds towards the later stage of venture, with no limit on investment sizes[109].

A focus on VC funds

The preceding analysis covered venture as a stage, as opposed to venture capital as an investor. This is a more comprehensive approach to assessing the funding environment for small firms; however, as VC is the largest investor at the venture stage (as well as the seed stage), it merits separate consideration[110].

This section draws upon data from EVCA[111] on VC investment into UK businesses. This is based on data reported by members to relevant national associations[112], so is not comprehensive in its coverage of the market and is not consistent with the equity tracker data[113], plus the data only covers the period up to 2013. Nonetheless, it can provide some insight into investment specifically by VC funds.

VC fund investment declined between 2008 and 2013, due largely to a lack of later-stage activity

The total value of VC investment in UK companies recorded by EVCA fell sharply in 2009, as the financial crisis took its toll, and continued declining up to 2013. By 2013, investment was around £475m, down from a peak of over £1,200m in 2008[114].

EVCA divides VC investments into those at seed, start-up and later stage venture; as explained in Box 1, the first two categories broadly correlate to the seed stage in the Beauhurst taxonomy used above, whilst EVCA's "later-stage venture" is most similar to the venture category used by Beauhurst. It is apparent from figure 3.13 that the sharp decline in 2009 was due mainly to later stage (venture) investment; this category kept falling, and in 2013 was around one-quarter of the 2008 high.

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[108] Although average investment rounds remain significantly below the limit

[109] Investment is pari passu (on equal terms with private investors), so there are no state aid implications

[110] It helps that there is also a reasonable amount of data available on VC investments.

[111] http://www.evca.eu/research/activity-data/annual-activity-statistics/

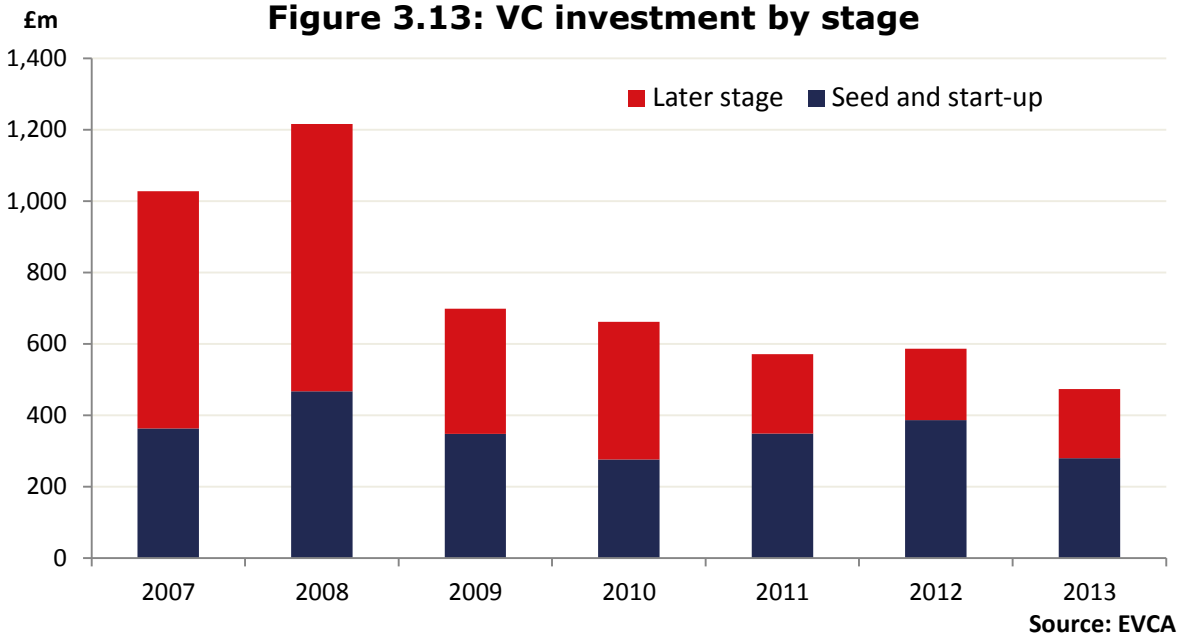
[112] Figures from EVCA are used in preference to those from the BVCA; the former capture all investment into UK companies from EVCA members, regardless of where the funds are based, whereas the BVCA statistics only cover investment by UK-based funds.

[113] Beauhurst capture more deals so their investment figures are higher.

[114] Note that EVCA publishes its data in euros: these have been converted to sterling for this report using exchange rates published by the ECB: http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=120.EXR.A.GBP.EUR.SP00.A

The EVCA statistics tell a broadly similar story to Beauhurst; in the latter, activity at the venture stage is relatively weak, and there is an argument to be made that the main problem is later stage venture. There is, though, a significant difference in their timeliness: Beauhurst are capturing activity from 2014, which looks to be a considerably stronger year than 2013 for venture investment. This might suggest the EVCA statistics for 2014 will also show a pick-up in investment. However, due to the different time periods covered, and the lack of an industry-wide consensus on how to define stage of evolution, comparisons between the datasets should be made with caution.

Figure 3.13: VC investment by stage



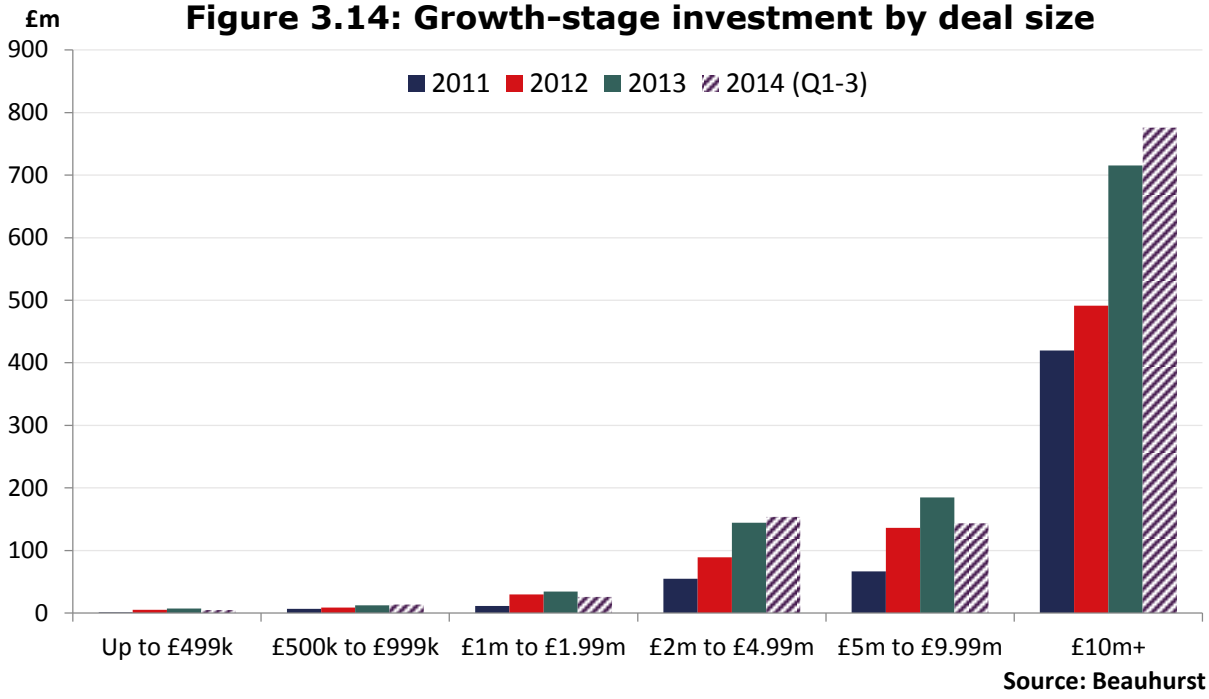
A similar picture is also found in a recent BVCA paper[115], which finds increasing seed activity – with rounds of less than $1m accounting for a growing proportion of deals – whilst later-stage activity is relatively flat. The BVCA suggests that, in the tech industry especially, there is a "crunch", where firms funded at the seed or early stage are faced with a shortage of available capital at the later stage. The concern is that successful businesses with strong growth prospects are unable to obtain the funding they need, or must move abroad to fulfil their potential. The paper also offers some support for the notion of "bifurcation" of the VC market, as funds either move up into larger funds or focus on smaller funds.

3.4 Growth-stage

Unsurprisingly, the majority of growth-stage investment is made in multi-million pound deals; two thirds of investment is in deals of £10m and above. There are though deals recorded at the full range of size brackets: the fact that some growth deals can be less than £500k, but some seed deals can reach £10m, emphasises the point that investment stages can mean very different things for different businesses.

[115] BVCA (2014) "VC Evolved", available at: http://www.bvca.co.uk/Portals/0/library/documents/VC%20Evolved/VC%20Evolve%20Brochure%202014.pdf

Figure 3.14: Growth-stage investment by deal size



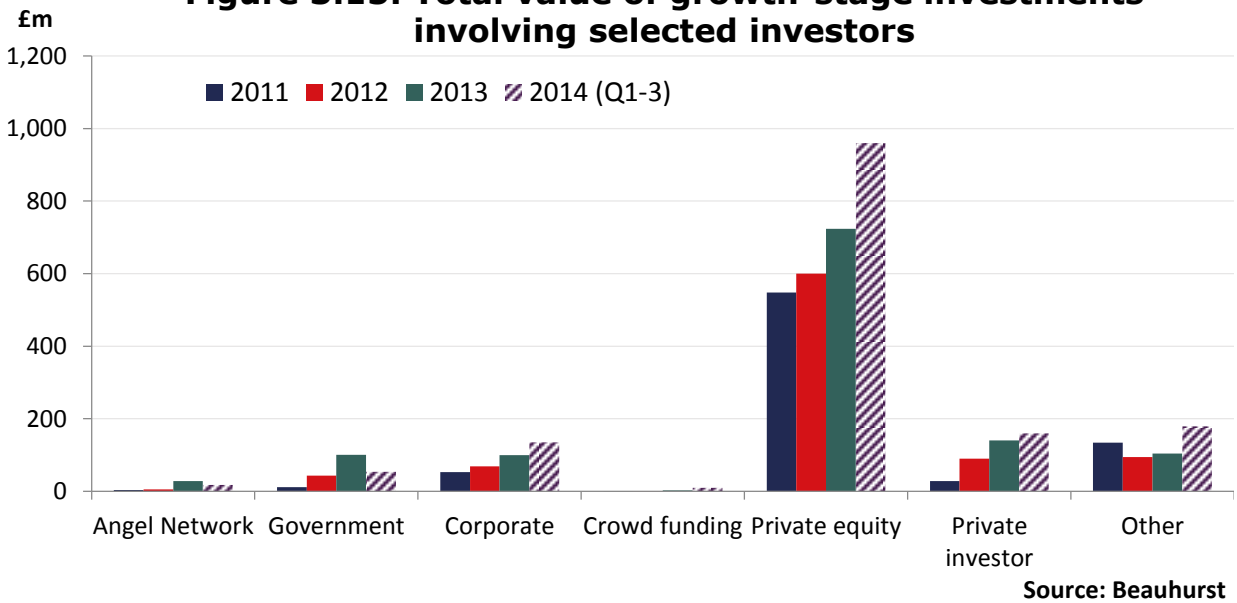
Source: Beauhurst

Private equity is the dominant investor group at the growth stage, and is stepping up investment

Private equity is by far the largest investor at the growth stage, and is showing year on year increases. Other classes of investor also show a general increasing trend in investment, but private equity continues to account for the majority of investment.

This picture is somewhat similar to the seed stage, where private equity has been increasing (aside from a dip in 2012), but contrasts with the venture stage, where investment from private equity declined in 2013. This points to a venture capital industry which is splitting into seed and growth specialisms, leaving venture relatively under-served.

Figure 3.15: Total value of growth-stage investments involving selected investors



Source: Beauhurst

A focus on VC/private equity investors at the growth stage

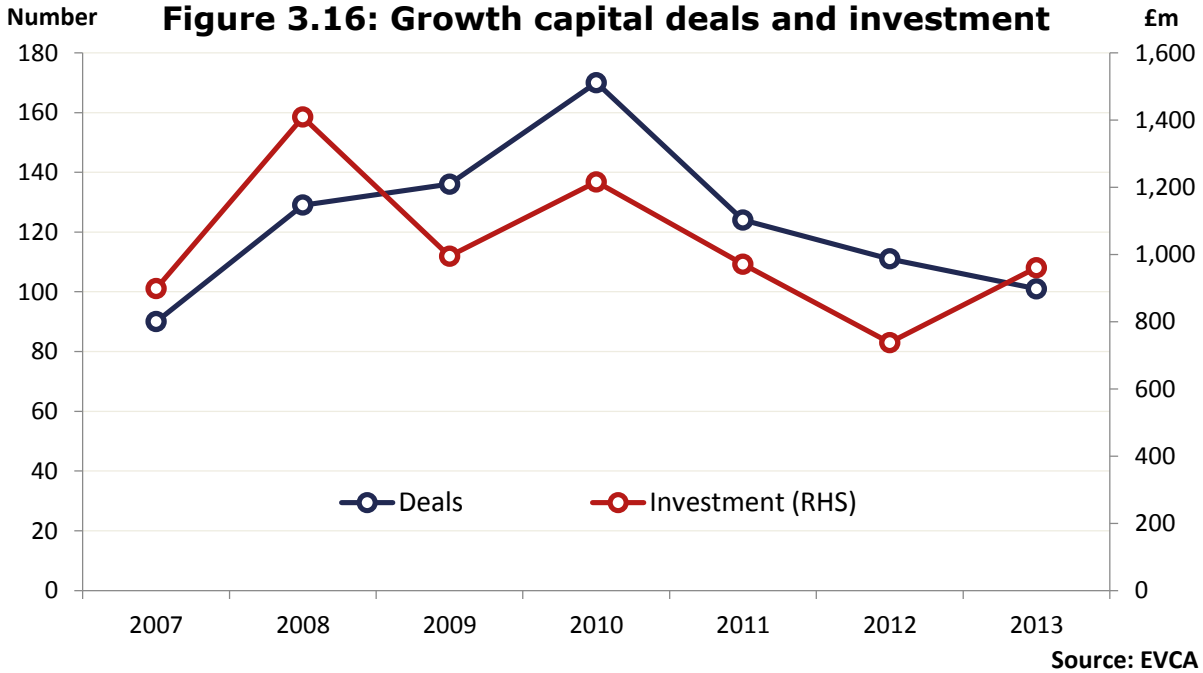
As with the venture stage, the EVCA statistics cover investment by venture capital and private equity funds more generally at the growth stage[116]. Given that VC/PE funds are similarly important to growth investment[117], a brief overview of their activity at the growth stage is provided below, noting similar caveats about the comprehensiveness of the EVCA statistics and lack of comparability with equity tracker data.

Growth investment has outperformed venture in recent years

Although down on its 2008 peak, growth investment showed signs of improvement in 2013, increasing by 30% year-on-year. Compared to venture, the growth stage experienced a smaller proportional fall from peak to trough, and in 2013 was 30% below its peak (compared to 75% for "later stage" venture). As with venture capital, the signs for 2014, from the Beauhurst data and from market commentators, might suggest an increase in investment in 2014.

The number of deals peaked two years later than investment; this suggests there was still demand during the financial crisis, and either deals were done for smaller amounts than was desirable, or different types of businesses were able to receive growth investment at the time (those which were less capital-intensive). The average investment size picked up again in 2013, as total investment increased with fewer deals.

Figure 3.16: Growth capital deals and investment



Source: EVCA

[116] As classified by EVCA, based on self-reporting by fund managers

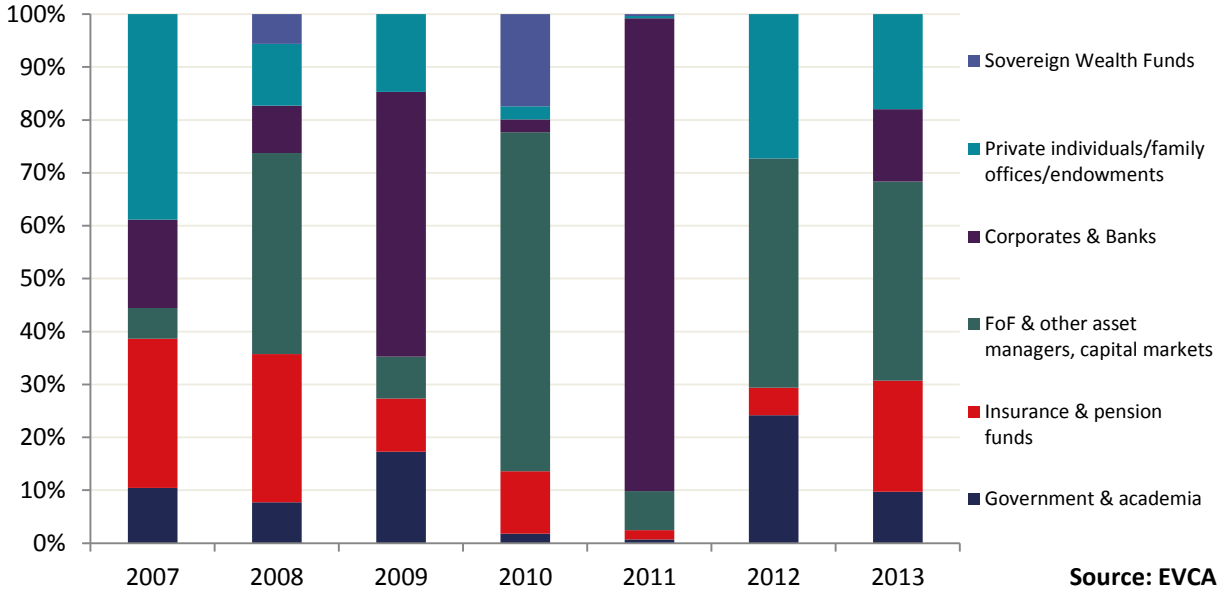
[117] They in fact account for a greater share of funding at the growth stage

The trend in the EVCA data might appear to contradict the Beauhurst figures, which show year-on-year increases in growth-stage investment. As the majority of this investment is carried out by private equity funds (as demonstrated above), in theory the two estimates should look similar. In practice, however, they may differ for any number of reasons, chief among them the coverage of funds and deals (EVCA appears to capture more formal fund investments, including those made by non-UK managers) and differences in the definition of "growth investment". Given the higher investment (compared with the "private equity" series in particular from Beauhurst) but also lower number of deals in the EVCA data, it is reasonable to conclude that the EVCA definition of "growth investment" is indeed different to that of Beauhurst, which most likely explains the different results observed.

A look at the sources of funding for growth-stage funds shows a volatile picture from year to year. Most noticeable are the spikes in the share of corporates and banks in 2009 and 2011; the former came from corporate investors, whilst the latter reflects the establishment of the Business Growth Fund, which involved a commitment by the major banks of £2.5bn – a huge amount compared to their usual allocations to growth-stage funds.

One thing that is not apparent from a look at growth investors as opposed to venture investors is an increasing contribution from Government; the share increased in 2012 but does not appear to be part of a trend. This is likely because the limits on investment in schemes such as ECFs have prevented the funds making many growth-stage investments. We might therefore see a change in the contribution of Government as a growth investor in future, as ECFs begin to invest in larger deals (up to £5m).

Figure 3.17: Investors in UK growth funds, 2007-13



3.5 An international perspective

The preceding analysis has presented a wide range of data on equity investment in the UK. This data paints a compelling picture of what is happening domestically, but in order to provide greater context it is important to compare the UK position with that of our main international competitors. The extent of any such comparison is limited by the availability of comparable data[118], so for this section we focus on the activity of VC funds, for which the data is most available[119].

Israel leads the way in VC investment; the UK is on a par with France and Germany but trails the USA and Canada

The main means of international comparison is to look at total VC investment as a proportion of GDP, which is presented for selected countries in figure 3.18. The chart highlights a difference between the three European countries (UK, France and Germany), where VC investment relative to GDP peaked in 2008 and has been generally falling since to a ratio of around 0.03%, and the other countries:

- The USA and Canada both have a significantly higher VC to GDP ratio than the European countries, with the USA's share noticeably higher than Canada's (0.18% of GDP in 2013 compared to 0.1%). Both followed a similar trend of weakening VC in 2008 and 2009 and recovery since (with a setback in 2012). This latter part of the time series is where their paths diverge relative to the UK, France and Germany, none of which have seen a noticeable pick-up in VC investment since 2009.

- Israel has by far the highest VC to GDP ratio, with very good availability of innovation and early stage funding supporting a strong technology cluster, and with significant Government support dating back to the early 1990s[120]. After a decline in 2009-10 related to the global financial crisis, the VC to GDP ratio increased again to 0.79% in 2013, cementing Israel's significant lead in venture capital usage.

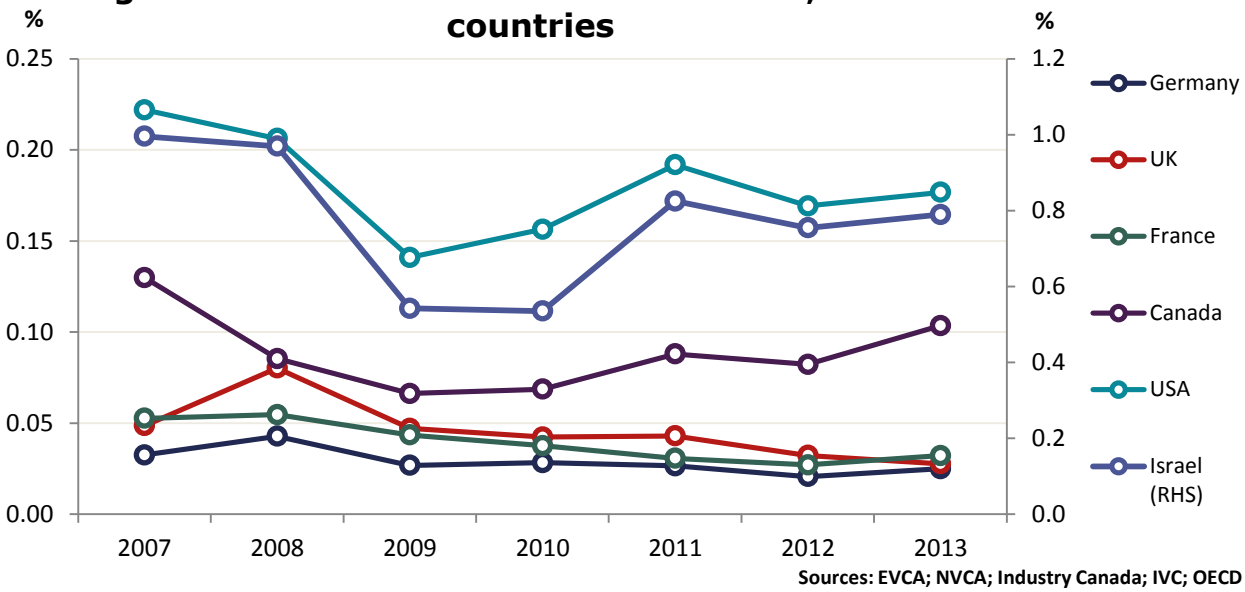
The overall picture is one where the UK has historically been slightly above the major European nations, but significantly behind North America and Israel. It is clear that much more can be done to increase VC investment, in the UK and elsewhere in Europe, to close the gap to the leaders.

[118] The equity tracker is amongst the most detailed data available on equity investment, but covers the UK only. There is considerably less in-depth information available for other countries.

[119] EVCA for European countries; NVCA for USA; Industry Canada; IVC for Israel

[120] 1993 saw the introduction of Yozma, a Government initiative that offered tax incentives and match-funding to foreign VC investments in Israel. Yozma is credited with effectively launching the Israeli VC industry (see, for example, the OECD's Venture Capital Policy Review of Israel: http://www.oecd.org/israel/2491258.pdf). The scheme was phased out in the late 1990s as private investors became established in a thriving market.

Figure 3.18: VC investment as % of GDP, selected countries



Sources: EVCA; NVCA; Industry Canada; IVC; OECD

The policy toolkit is remarkably similar across countries

The OECD studied the policy environment in member countries in a 2013 paper[121], based on a questionnaire of policy officials. The results of the survey showed widespread use of equity funds backed by Government, be they direct Government investments, fund of funds or co-investment funds, and most were either new or expanded in the preceding 5 years. Public financial institutions that develop and administer such funds, such as the British Business Bank, are also common to most major OECD countries.

There is likely to be a common countercyclical element to the increased Government support across OECD countries, but the findings also suggest a shared understanding of the usefulness of equity to the funding mix and the role of Government in supporting investment.

Also notable from the OECD survey was an increasing usage of tax reliefs (front-end and back-end) to incentivise investment. The UK was an early adopter of tax incentives, having introduced EIS and VCTs approximately 20 years ago; other countries appear to be following the lead in recent years.

In summary, UK policies supporting early stage equity investment appear to be in line with other members of the OECD. The policy toolkit varies little across countries, quite possibly because years of learning, trial and error have led to a convergence of policy "best practice" in this space.

[121] Wilson, K. E. and F. Silva (2013), "Policies for Seed and Early Stage Finance: Findings from the 2012 OECD Financing Questionnaire", available at http://dx.doi.org/10.1787/5k3xqsf00j33-en

Table 3.1: Government-backed equity fund activity in selected OECD countries, 5 years from 2007-12

	Public Equity Funds	Fund of Funds	Co-investment Funds
Australia			▲
Canada	▲	▲	
Denmark	▲	▲	
Finland	○	○	▲
France	▲	▲	▲
Germany		▲	○
Ireland	△	△	▲
Israel			△
Italy	△	△	△
Japan			
Korea		▲	
Mexico	▲	△	○
Netherlands			▲
New Zealand		○	○
Norway	▲	▲	▲
Poland		○	
Portugal		▲	▲
Spain			
Sweden	▲	○	▲
Switzerland			
United Kingdom		▲	▲
United States*			

*Note: The United States only has seed and early stage equity programmes at the state level which are not included. Source: OECD

✔ :Country has corresponding programme	○ :Remained unchanged
▲ :Increased	▼ :Decreased
△ :Started in the last 5 years	▽ :Ceased during the last 5 years

Conclusions

The preceding chapters have presented a detailed analysis of trends in equity investment and market developments. Although there are positive signs in the recent data, notably at the seed stage, familiar market failures remain, in particular the persistent, if evolving, equity gap. This chapter outlines some of the key conclusions and highlights areas in which the British Business Bank can work with the market to improve the quantity and quality of early stage equity investment.

Deliver the extended ECF programme, with larger funds and investments

Chapter 2 outlined the principle of the equity gap, and explained how the gap not only persists, but also stretches to higher investment sizes. We also saw how fundraising for seed investment has recovered much quicker than for later stage venture, which looks relatively poorly served.

Two important observations arise from this. Firstly, with the shifting contours of the equity gap, the British Business Bank needs to be able to address the market failure at this larger level of investment. Secondly, with the seed and early stage looking better-served, it is necessary to note the significant public support for this funding, representing the successful deployment of existing British Business Bank funds and the strong uptake of EIS, VCT and SEIS tax incentives for private investors.

Both of these point to a continued, and expanded, role for Enterprise Capital Funds in the market. The ECF programme is the flagship British Business Bank scheme supporting early stage equity. ECFs have been an important investor in early stage VC since their inception in 2006, addressing an area where private investment was, and remains, limited. They are a significant reason for market participants suggesting the equity gap has become less of a problem at the early stage – which suggests they are at the same time successful and still needed for early stage investment.

Until late 2014, ECFs were unable to address the full extent of the equity gap, as their state aid approval limited investment sizes to a maximum of £2m[122]. This arguably hardened what was previously a loosely-defined boundary between segments of the market that could be considered more or less well-served. But this can now change, with the new state aid approval allowing investment sizes of up to £5m (and funds with a British Business Bank contribution of up to £50m, twice as much as currently) – an important development that allows ECFs to address the equity gap in a much more comprehensive fashion.

The additional funding of £400m announced at Autumn Statement 2014 will allow the successful ECF programme to support investment across the range of stages, continuing to back early-stage investments, but also for the first time directly addressing the equity gap in later-stage VC. The launch of IQ Capital II – the first of the new type of ECF – in November 2014 represents an important step forward in this regard.

[122] With some allowance for follow-on investment beyond this limit to avoid dilution

Consider the options for encouraging "patient capital" investment which supports companies with longer-term capital-intensive propositions

Chapter 2 outlined the perception that there is limited availability of longer term funding for capital-intensive projects with long lead times, sometimes referred to as "patient capital", which may limit certain small businesses' ability to grow to their full potential. The reasons cited for this apparent lack of finance – a VC industry structured to make investments over a 5-7 year time horizon, larger funds being incentivised into larger deals, and a possible unwillingness of investors to commit their money for longer periods – are standard features of the industry. This might mean many VC investors are not willing to provide the investment that some businesses seek; the more "patient" investment may need to be provided instead by a different type of investor, or otherwise something similar may be achieved through greater secondary trading between funds.

A lack of evidence currently makes it difficult to ascertain whether or not the recent trends observed and intelligence received demonstrate a market failure, or whether the market is adapting to fund such businesses. The British Business Bank plans to carry out more research into "patient capital", to develop the evidence base and consider any gaps in the market. Drawing on this analysis, the Bank will continue to explore the funding options for long-term, capital-intensive projects, working alongside new and existing investors and funds.

Investigate options for additional private sector capital to expand the successful Angel CoFund

Since its launch in November 2011, the Angel CoFund has played an important role in providing co-investment for relatively large angel deals, providing financial backing to help extend the reach of angel syndicates into deal sizes that are traditionally considered beyond their limits and part of the equity gap. The early assessment of the CoFund (forthcoming) found widespread support for the rationale and aims of the scheme, and a clear sense that it was meeting a gap in the market. The early assessment also found a clear consensus that, at a total size of £100m, the CoFund could not account for a large share of angel investment overall. However, the CoFund is not intended to be the biggest market player, but it does mean to demonstrate a high standard for the level of planning and due diligence that goes into deals. It is too early to tell what the prospects are for exits and obtaining further investment.

In order to extend its financial reach, the CoFund is exploring additional partnerships with private sector organisations. Private sector engagement has always been part of the CoFund's DNA; it was established in partnership with four investment funds[123], and the CoFund is itself a private company. Until now though, the capital has come solely from Government[124]. Opportunities to bring in additional funding from the private sector to complement the existing board-level input and add to the resources of the CoFund should be carefully considered, and supported where they represent a good deal for the British Business Bank, the angel community and smaller businesses.

[123] Octopus Investments, OION, Braveheart Investments and Hotspur Capital Partners

[124] Which is of course co-invested alongside private angel capital

Increase awareness of equity financing options amongst smaller businesses

A frequent theme of the British Business Bank's engagement with small businesses, whether directly or through surveys, is that the majority have limited awareness of the range of financing options available to them. Sources such as business angels, equity crowdfunding and growth loan finance in particular are less well-known. At the same time, the analysis in chapter 2 found a general lack of "investment readiness" amongst firms seeking equity investment. A healthy finance market, like any other market, requires an understanding of the range of options available, so businesses can make informed choices, find the right product for them, and make an effective application for funding.

The role of the British Business Bank, and of Government more generally, is to raise awareness and provide the necessary education so that small firms might make more informed choices, and understand how to approach investors in such a way as to maximise their chances of success. The Bank is already well underway in this regard; we have produced the Business Finance Guide in conjunction with the ICAEW Corporate Finance Faculty, which sets out the main things to consider and outlines sources of finance available to businesses – ranging from start-ups to SMEs and growing mid-sized companies.

To date (January 2015), the British Business Bank has distributed over 70,000 hard copies of the guide, marketed the electronic version to more than 600,000 businesses, and had around 7,000 views of the guide's webpage: http://british-business-bank.co.uk/bfg/

This paper, alongside the recently-published report on finance markets more generally[125], outputs from the "equity tracker" and forthcoming evaluations of British Business Bank programmes, represents another element of our awareness-raising, with more activities to come.

Deliver the pilot for the "Help to Grow" scheme

The Prime Minister announced in February 2015 that the British Business Bank will deliver the pilot for the Help to Grow scheme, aiming to unlock £100m through growth loans supporting fast-growing companies in reaching their potential. The scheme will provide growth loans to viable small businesses which might otherwise struggle to obtain funding, either because they are considered outside the risk appetite of banks, or because they are unlikely to generate the high returns sought by venture investors[126].

A key aim of the new pilot will be to develop the market, encouraging entry by private providers especially at deal sizes of between £0.5m and £2m, to address an identified funding gap of up to £1bn per year. On the demand side, the objective should be to raise awareness of

[125] British Business Bank (2014) "Small Business Finance Markets 2014", available at: http://british-business-bank.co.uk/performance/small-business-finance-markets-2014/

[126] A business suitable for a growth loan product might be described as more mature than a "typical" candidate for venture finance, possibly at a later stage, with established profitability but looking to affect a significant growth or change in the business.

growth loans as an option for small businesses[127]. Should be pilot be successful, the scheme may be rolled out on a larger scale.

The British Business Bank will issue a request for proposals addressed to potential private sector delivery partners in March at Budget. Whilst the final structure and timing of activity will be subject to the proposals submitted by potential commercial partners, it is likely that a range of different approaches will be trialled, including guarantees for loan products and co-investment alongside debt funds.

Work to attract institutional investment to early-stage equity

Institutional investors in the UK and overseas have multi-trillion pound balance sheets, but only allocate a very small proportion of their funds to venture capital. In large part, this is because of perceptions of low returns (which have been largely justified by past VC performance), but sub-scale funds and a difficulty in identifying high-performing managers are also identified as barriers.

Although past returns may have a lasting effect on the prospects for VC fundraising, and institutions which had their fingers burned in the Dotcom crash have long memories, there are some reasons for optimism about the attractiveness of VC to these investors in future, as returns improve in a recovering economy.

There is also a significant opportunity here: just a small increase in institutions' allocation to VC would make a significant difference to the UK fundraising landscape. Government institutions (including, but not limited to, the British Business Bank) should consider whether and how to help facilitate this, for example by encouraging more disclosure of performance data and greater publicising of successes. Government might also consider helping connect potential investors with VC funds, as part of its wider role of addressing information and regulatory barriers to investment.

A useful first step would be to conduct some further research into the attitudes and motivations of institutional investors, to gain a deeper understanding of the current context, and what might encourage them to return to the asset class.

Improve the available data by establishing an "equity tracker" for early stage investment

A perennial problem over the years hampering the analysis of trends in equity markets has been the lack of reliable data. Typically, there has been some aggregated data available on venture capital investment[128], information on investments made using EIS, SEIS and VCTs, and little else.

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[127] Only 15% are aware of "mezzanine finance" (which is a type of growth finance), and even fewer (5%) are aware of a specific supplier. Source: http://british-business-bank.co.uk/wp-content/uploads/2014/12/Final-BMG-SME-Journey-Research-Report.pdf

[128] For members of the BVCA/EVCA only

To address the lack of data, the British Business Bank and BIS commissioned Beauhurst to produce a prototype "equity tracker" that brings together investment from different sources (funds, angels, crowdfunding platforms) into a "whole of market" view of early-stage equity investment. The Beauhurst dataset is built from the bottom up, so offers a richness of data and a series of detailed breakdowns by stage, sector, region, investor and size of investment. There is the ability to further interrogate the data for a range of bespoke analyses too.

Some high-level results from the prototype equity tracker are included in this report; the full tracker report has been published alongside this paper, whilst a special case study on equity crowdfunding will be published soon. The British Business Bank and BIS will consider how to take the project forward and make the best use of the newly available data on equity investment.

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