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Policy Briefing

Making money at the early-stage:
the challenge for venture capital in the UK

Investing in early-stage companies is currently not an attractive option for private finance. Venture capitalists feel that they can make greater returns elsewhere and that many early-stage businesses are not 'investment ready'. This consequent lack of investment is hurting the development of the UK's next generation of world-beating businesses.

Unfortunately, publicly-backed schemes have not yet demonstrated commercial levels of financial return. The UK urgently needs to 'learn by doing' – building different models of investment and rigorously evaluating their effectiveness. If the returns are high enough, private money will follow.

Venture capital helps drive innovation

Financial capital is important in the development of innovative businesses

A healthy and innovative economy needs dynamic financial markets, where businesses are able to raise money efficiently.[1] The amount and type of capital they need varies across sectors and at different stages of their life cycle. At the seed stage, many entrepreneurs use informal sources of finance – money from savings, friends and family.[2] As they progress, the majority seek debt finance from banks.

Venture capital is necessary for innovative early-stage businesses and can increase levels of innovation

Innovative entrepreneurs seek to develop and exploit new ideas, markets and products. Their businesses are particularly important because they provide a disproportionate source of new employment and wealth.[3] However, innovative entrepreneurs tend to have intangible assets and ambitious growth plans that require large amounts of finance, show a significant delay before generating revenue and consequently entail high risk. As a result, savings are inadequate and debt finance is inappropriate.

Venture capital – where private investors invest in an early-stage company in exchange for an equity stake – is an alternative form of finance that is structured to address these challenges.[4] In addition to helping to commercialise an idea, venture capital can increase the level of innovation within businesses.[5]

Venture capital is rarely used by UK early-stage businesses

Despite the UK's large private equity industry, only 6 per cent is used for early-stage investment

The size of the private equity industry in the UK (of which venture capital is a subset) is second only to the United States.[6] However, during 2005, despite £27bn of funds being raised from investors,[7] only 208 start-ups and 285 other early-stage companies received venture capital[8] - a total investment of £382m representing just 6 per cent of private equity invested.

Early-stage businesses struggle to raise the venture capital they need

HM Treasury has stated that 'many small businesses with high-growth potential still find it difficult to access the risk capital, and particularly the equity, they need to realise their ambitions.'[9] The CBI agrees with this position and argues that 'firms with sound business propositions cannot get the finance they need to grow.'[10]

Early-stage investment is relatively unattractive to investors

Early-stage deals are high risk and cost relatively more

Investing in early-stage businesses frequently entails higher risk because they often have unproven business models, less experienced management and fewer tangible assets. This necessitates a rigorous pre-investment

1. Edquist, C. (2005), Systems of Innovation, in Fagerberg, J. et al (eds.) The Oxford Handbook of Innovation (Oxford University Press, Oxford).

2. European Commission (2006), Community Guidelines on State Aid to Promote Risk Capital Investments in Small and Medium-Sized Enterprises, Official Journal of European Union (EU, Brussels). This defines 'seed capital' as finance 'provided to study, assess and develop an initial concept'. It also defines 'start-up capital' as finance 'provided to companies which have not sold their product or service commercially and are not yet generating a profit'. 'Early-stage' is defined as the seed stage and start-up stage.

3. Storey, D. (1994), Understanding the Small Business Sector, (Routledge. London). This showed that only 4 per cent of the new firms born in any particular year accounted for half of all the jobs created by the surviving firms after 10 years had elapsed.

4. BVCA (2006), Report on Investment Activity 2005, (BVCA, London). This defines 'private equity' as 'the term generally used in Europe to cover the industry as a whole', both buy-outs and venture capital. They define 'venture capital' as 'a subcategory covering the start-up to expansion stages of investment'.

5. Kortum, S. and Lerner, J. (1998), Does venture capital spur innovation?, NBER Working Paper No. 6846, (National Bureau of Economic Research, Massachusetts, US).

6. PricewaterhouseCoopers (2006), PwC Global Private Equity Report 2005, (PricewaterhouseCoopers LLP, London).

7. BVCA (2006), Report on Investment Activity 2005, (BVCA, London).

8. BVCA (2006), Report on Investment Activity 2005, (BVCA, London). This is based on information from 360 BVCA Members, who represent most, but not all, UK-based private equity and venture capital providers and their advisers.

9. HM Treasury (2003), Bridging the finance gap: a consultation on improving access to growth capital for small businesses, (HM Treasury, London).

10.CBI (2005), The Small Business Service Five Years On, (CBI, London).

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examination that involves the employment of accountants, lawyers and industry specialists. Many of these costs are fixed and thus represent a larger proportion of smaller early-stage deals compared to larger, later-stage investments. Venture capitalists also have to be prepared to provide a high level of non-financial support, sometimes including mentoring or taking a seat on the board.

Exit opportunities for early-stage investments are limited[11]
For those few investments that are successful, it may be five to seven years between a venture capitalist's initial investment and realising the associated return. Companies in some sectors, such as life sciences, can take several more years to develop into going concerns and may require an even longer payback period.[12]

In the US, the substantial liquidity and growing track record of the NASDAQ as a market for initial public offerings (IPOs) has fuelled early-stage investment by providing investors with a realistic expectation that they will be able to sell their stake. Historically, the UK and Europe have lacked such a prominent market. However, the growing liquidity of the Alternative Investment Market (AIM) is improving its viability as an exit vehicle, with over 2,500 companies having joined the market since its launch in 1995.[13]

Average returns on early-stage deals have been unimpressive
Early-stage deals that make significant returns are rare. The available data indicate that the rates of return from the early-stage sector are currently lower than the rest of the private equity and venture capital market. In fact, for funds raised between 1996 and 2005, the three year average net returns of UK private equity funds were 21.2 per cent compared to -2.4 per cent for venture funds.[14] It is unsurprising that available finance has been attracted to expansion-stage and other areas of private equity to the detriment of early-stage businesses.

Many entrepreneurs are not 'investment ready'

Investors cite a shortage of companies deserving of venture capital
Venture capitalists invest in a small proportion of opportunities. This is partly because 'high potential firms begin with very little verifiable data about their characteristics, financial or otherwise. This makes it difficult for them to communicate the quality of their business to external suppliers of finance.'[15]

In addition, entrepreneurs are often unaware of investors' aspirations and expectations, and don't properly factor them in when seeking venture capital. Investors view this as businesses not being 'investment ready', often citing poor quality business plans, weak management teams and the absence of clear exit strategies.

Despite needing finance, many entrepreneurs are unwilling to cede control
Many entrepreneurs believe that the objectives of venture capitalists conflict with the objectives that they have set for their business. The EU has noted that 'entrepreneurs can be reluctant to dilute their ownership or cede a share of control to equity investors and instead try to borrow or accept limits to the firm's growth.'[16]

'Angel' investors are playing an increasing role

Nearly 4,000 angels belong to networks
'Business angels' - wealthy individuals who generally make investments of up to £100,000 in smaller businesses - are increasingly occupying the space left behind by venture capitalists.[17] They are making more and larger investments into early-stage businesses, and coalescing into networks based upon geography or sector.

In 2005, a total of 725 business angels were recruited to 17 business angel networks, bringing the total number within these networks to 3,885.[18] By networking and operating in syndication, business angels are better able to leverage their investment and are increasingly acting like venture capital funds.

More research is needed on the dynamics and challenges of angel investment
There is great potential for angel investors to serve as the patient, experienced, and expert source of money required by many early-stage businesses, although it is unlikely that they will be able to fulfil all of the companies' finance requirements. However, because the sector is fragmented, evidence of its impact is weak. The Department of Trade and Investment (DTI), working with the newly created British Business Angels Association, should continue to conduct research into the size and composition of the

11. To realise the capital gain on an investment, a venture capitalist must sell their share of the company, either to another investor, to an acquiring business (known as a trade sale), or through an initial public offerings (IPO) on a stock market.

12. Minshall, T. and Wicksteed, B. (2005), University spin-out companies: Starting to fill the evidence gap, a report on a pilot research project commissioned by the Gatsby Charitable Foundation.

13. London Stock Exchange (accessed on 7th March 2007), Welcome to AIM, available at www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/aim_new/

14. PricewaterhouseCoopers (2006), BVCA private equity and venture capital performance measurement survey 2005, (BVCA, PricewaterhouseCoopers LLP, London).

15. Cruickshank, D. (2000), Market Failure in the Provision of Equity to SMEs, in Competition in UK Banking: A Report to the Chancellor of the Exchequer, (HM Treasury, London).

16. EU Directorate-General for Enterprise and Industry (2005), Best practices of public support for early-stage equity finance. Final report of the expert group, (European Commission, Brussels).

17. Mason, C. (2002), Report on Business Angel investment activity 2000-2001, (Hunter Centre for Entrepreneurship at Strathclyde on behalf of National Business Angels Network and British Venture Capital Association, London).

18. BBAA (accessed on 7th March 2007), British Business Angels Association Statistics 2005, available at www.bbaa.org.uk/portal/images/stories/PDFDOCS/bbaa_statistics_2005_briefing.pdf

angel community, investment trends, and the motivations for and barriers to increased investment.

The Government has attempted to boost the supply of venture capital

The public sector is a significant force in the venture capital market

The UK Government has acknowledged that many small businesses find it difficult to access the risk capital they need.[19] The EU has additionally argued that the unattractive risk-return profiles of investments in early-stage businesses are a 'fairly permanent' market failure and 'that for the foreseeable future public incentives will be needed to correct it.'[20]

In response, the UK Government has introduced several schemes that sit alongside a number of regional and European initiatives. As a result, 26 per cent of all active funds that invest in small and medium-sized enterprises (SMEs) are publicly-backed either in whole or in part, and an additional 24 per cent are Venture Capital Trusts (VCTs) that benefit from targeted tax relief.[21]

Publicly-backed funds have adopted different models to increase the supply of capital

Most government funds 'provide capital to be managed by independent fund managers, either supplemented by private sector investment in the fund or conditional on investments being matched by private sector capital.'[22]

Funds have been targeted at different levels, such as Early Growth Funds which can provide finance up to £100,000, Regional Venture Capital Funds which can invest up to £500,000, and Enterprise Capital Funds which are currently being set up to provide funding of up to £2m. The University Challenge Seed Fund targeted the commercialisation of intellectual property generated by universities, whereas the UK High Technology Fund focused on early-stage high technology businesses.

The devolved administrations have also taken action. For example, the Welsh Assembly Government provides venture capital funds and investment support through Finance Wales. The Scottish Executive, through Scottish Enterprise, has invested in a £45m Co-Investment Fund to support a range of businesses requiring investment of up to £2m.

Tax incentives have drawn money into smaller businesses

In addition to publicly-backed investment funds, the Enterprise Investment Scheme and VCTs offer income tax and capital gains tax relief to investors who invest in certain types of small, higher-risk, unquoted trading companies whose value does not exceed £7m. There are currently around 45 VCTs,[23] which raised £520m in 2004/05.[24]

Public schemes have drawn in additional money, but not made attractive returns

Publicly-backed schemes complement private investment

The Government has argued that 'despite the significance of the publicly-backed funds, there appears to be little in the way of a disruptive overlap between their activities and those of the privately-backed funds,' and that they may well be complementary and mutually-reinforcing.[25] Additionally, the Government has suggested that publicly-backed funds have made smaller investments in smaller businesses and have a greater appetite for making seed investments.[26]

Publicly-backed schemes have not made attractive returns and new schemes are moving away from early-stage investment

Despite their significant scale, the limited early information available indicates that publicly-backed funds have yet to show attractive returns on their investments. This may relate in part to the time horizons involved with early-stage investment or the governance structure of public funds, which can present problems with multiple objectives.

Without strong returns, additional private money will not be independently attracted into the early-stage sector, which will remain dependent on government funds. This is particularly concerning, as many publicly-backed funds have already made the majority of their investments. Meanwhile, the most recent scheme, Enterprise Capital Funds, is not targeted at early-stage businesses.

The Government must ensure that it is using public money to demonstrate multiple models of investment, rigorously evaluating them and learning lessons for incorporation into follow-on programmes run by the public or private sector.

19. HM Treasury (2003), Bridging the finance gap: a consultation on improving access to growth capital for small businesses, (HM Treasury, London).
20. EU Directorate-General for Enterprise and Industry (2005), Best practices of public support for early-stage equity finance. Final report of the expert group, (European Commission, Brussels).
21. Small Business Service (2005), A Mapping Study of Venture Capital Provision to SMEs in England, (SBS, London).
22. Small Business Service (2005), A Mapping Study of Venture Capital Provision to SMEs in England, (SBS, London).
23. Small Business Service (2005), A Mapping Study of Venture Capital Provision to SMEs in England, (SBS, London).
24. HM Treasury (2006), Meeting the Productivity Challenge, (HM Treasury, London).
25. Small Business Service (2005), A Mapping Study of Venture Capital Provision to SMEs in England, (SBS, London).
26. Small Business Service (2005), A Mapping Study of Venture Capital Provision to SMEs in England, (SBS, London).

Entrepreneurs need to become 'investment ready'

Entrepreneurs need to prove that their businesses represent high quality opportunities
It is understandable that venture capitalists maintain a high quality threshold for investment. Entrepreneurs must ensure that they have a sound business proposition that has the potential to be profitable and deliver significant returns to investors. They must recognise the needs of investors, ensure that they have a high quality business plan, strong management team capable of delivering the business plan, and a clear strategy of how investors will be able to achieve an exit.

The Government must do more to ensure that businesses are 'investment ready'
The UK Government has worked with the Regional Development Agencies to deliver programmes to improve the 'investment readiness' of businesses in England. Through its Business Gateway, the Scottish Executive also has an Investment Readiness Support Programme.

As part of the DTI's business support simplification programme, NESTA would like to see these types of programmes inform an 'investment readiness' scheme. This should focus on ensuring that early-stage businesses are aware of the types of finance available, which ones are most suitable for their business objectives, and how to focus on the sound business practices that will attract investment.

Good early-stage investors provide 'more than just money'

Providing support can reduce risk for investors
As well as financial capital, investors in early-stage businesses often provide business advice, access to networks, commercial development and legal support. Specialists in key areas, such as in establishing licence agreements, may prove particularly valuable. Investors often also use their personal and professional networks to recruit critical additions to a business' management team or increase its customer base.

In addition to these high-value forms of support, early-stage investors may further help their portfolio businesses by improving so-called 'hygiene factors'. These include general services such as accounting, human resources and physical space which may not be economical for small businesses to retain themselves.

The benefits from these hands-on relationships are two-way, reducing risk for investors, and increasing the amount of time that a business can allocate to value-added activities.[27]

There is a need to make larger investments into early-stage businesses
Average investments into early-stage businesses in the UK are smaller compared to their counterparts in the US. This limits the growth of early-stage businesses, as entrepreneurs spend time seeking additional investment rather than aggressively developing their businesses. Early-stage investment needs to be of a sufficient scale to give entrepreneurs the financial foundation to prove their business model and position for expansion.

NESTA Investments seeks to demonstrate models of early-stage investment that generate competitive returns

Investing £50m over five years
NESTA is investing £50m in early-stage businesses over the next five years, split between NESTA Ventures and NESTA Capital. In each case, the emphasis will be on developing and deploying distinctive models of early-stage investment in order to demonstrate attractive financial returns.

NESTA Ventures invests directly in early-stage companies. The target level first round of investment is £250,000, which will be delivered in tranches to match the needs of a portfolio company's cash flow. The maximum total investment per company over the course of its development will be £750,000.

NESTA Capital invests in seed/early-stage funds, either as a limited partner or co-investor and will also consider acting as a cornerstone investor. NESTA Capital aims to make two or three investments a year ranging from £1m to £3m.

Emphasis on 'soft' support
NESTA has established the largest venture capital-based mentor network in the UK to provide the right type of business support when needed. Furthermore, as a start-up progresses in its development, NESTA is frequently able to source personnel for investees, either through its own networks or those of mentors.

27. Suchman, M. (2000), Dealmakers and Counselors: Law Firms as Intermediaries in the Development of Silicon Valley, in Martin Kenney (ed.), Understanding Silicon Valley, (Stanford University Press, Palo Alto); and Gompers, P. and Lerner, J. (2001), The Venture Capital Revolution in the Journal of Economic Perspectives (AEA Publications, Pittsburgh); and Hambrecht, W. (1984), Venture Capital & the Growth of Silicon Valley, (California Management Review, Berkeley).